

# IIROC NOTICE

## **Rule Notice Guidance Note**

Dealer Member Rules  
UMIR

*Please distribute internally to:*

Corporate Finance  
Institutional  
Internal Audit  
Legal and Compliance  
Operations  
Registration  
Regulatory Accounting  
Research  
Retail  
Senior Management  
Trading Desk  
Training

*Contact:*

Joe Yassi, V.P. Business Conduct Compliance  
416 943-6903 [jyassi@iiroc.ca](mailto:jyassi@iiroc.ca)

Louis Piergeti, V.P. Financial & Operations Compliance  
416 865-3026 [lpiergeti@iiroc.ca](mailto:lpiergeti@iiroc.ca)

Mike Prior, V.P. Market Surveillance  
416 646-7217 [mprior@iiroc.ca](mailto:mprior@iiroc.ca)

Victoria Pinnington, V.P. Trading Review & Analysis  
416 646-7231 [vpinnington@iiroc.ca](mailto:vpinnington@iiroc.ca)

Sandra Blake, V.P. Registration  
416 943-6911 [sblake@iiroc.ca](mailto:sblake@iiroc.ca)

**15-0021  
January 27, 2015**

## **Annual Consolidated Compliance Report**

IIROC is pleased to present the Annual Consolidated Compliance Report for 2014/2015. This Report is intended to assist IIROC Dealer Members in focusing their supervision and risk management efforts to ensure compliance with regulatory requirements. The Report deals with current issues and challenges to be addressed by Dealer Members to improve investor protection and foster market integrity in an environment which is rapidly evolving and becoming increasingly complex.



## Table of Contents

|        |  |    |
|--------|--|----|
| 1.     | Introduction: Effective and Efficient Compliance Examinations.....                 | 4  |
| 2.     | Key IIROC Priorities for 2015.....   | 5  |
| 2.1.   | Financial and Operational Compliance .....   | 5  |
| 2.1.1. | <i>Cyber Security</i> .....  | 5  |
| 2.1.2. | <i>Outsourcing</i> .....   | 6  |
| 2.1.3. | <i>Balance Sheet Leverage</i> .....  | 7  |
| 2.1.4. | <i>Liquidity</i> .....   | 8  |
| 2.1.5. | <i>Use of Free Credit Balances</i> .....   | 8  |
| 2.2.   | Trading Compliance.....  | 9  |
| 2.2.1. | <i>Implementation of Risk Assessment Process for Post-Trade Surveillance</i> ..... | 9  |
| 2.2.2. | <i>Manipulative and Deceptive Trading Practices</i> .....                          | 9  |
| 2.2.3. | <i>Gatekeeper Reporting</i> .....  | 9  |
| 2.2.4. | <i>Odd Lot Orders</i> .....  | 10 |
| 2.2.5. | <i>Electronic Trading Rule (ETR)</i> .....   | 10 |
| 2.2.6. | <i>Third-Party Access</i> .....  | 11 |
| 2.2.7. | <i>Wash Trades</i> .....   | 11 |
| 2.3.   | Business Conduct Compliance .....  | 13 |
| 2.3.1. | <i>Client Relationship Model (CRM) Implementation</i> .....                        | 13 |
| 2.3.2. | <i>Business Titles and Financial Designations</i> .....                            | 15 |
| 2.3.3. | <i>Social Media</i> .....  | 15 |
| 2.3.4. | <i>Joint OSC Mystery Shopping Project</i> .....                                    | 16 |
| 2.3.5. | <i>Conflict of Interest Study</i> .....  | 16 |
| 2.3.6. | <i>Order-Execution Only Platforms</i> .....  | 17 |
| 2.3.7. | <i>Seniors' Issues</i> .....   | 17 |
| 2.3.8. | <i>Principal-Agent Business Models</i> .....                                       | 18 |
| 2.3.9. | <i>Enhanced (“Close” and “Strict”) Supervision</i> .....                           | 18 |
| 3.     | Results of Recent Targeted Reviews and Surveys.....                                | 19 |
| 3.1.   | Know Your Client Obligations and Enhanced Suitability.....                         | 19 |
| 4.     | Recurring/Significant Deficiencies Noted in 2014.....                              | 19 |
| 4.1.   | Written Internal Control Policies .....  | 20 |
| 4.2.   | Internal Controls in Practice.....   | 21 |
| 4.3.   | Accounting, Reporting, and Margin Calculation Errors.....                          | 22 |
| 4.4.   | Books and Records.....   | 23 |



|  |    |
|--|----|
| 4.5. Operational Issues .....  | 24 |
| 4.6. Outsourcing .....   | 25 |
| 4.7. Best Execution .....  | 26 |
| 4.8. Inadequate Supervision of Employee/Agent Accounts.....  | 26 |
| 4.9. Outside Business Activities (OBA).....  | 27 |
| 4.10. Conflicts of Interest – Policies & Procedures.....   | 27 |
| 4.11. Recurring/Significant Registration Deficiencies.....   | 27 |
| 4.11.1. <i>Registration Applications and Changes of Registration Information –<br/>            Form 33-109F4 and Form 33-109F5</i> ..... | 27 |
| 4.11.2. <i>Notices of Termination of Registered Individuals and Permitted Individuals<br/>            – Form 33-109F1</i> .....          | 32 |
| 4.11.3. <i>Ownership Changes and Other Dealer Member Filing Requirements</i> .....   | 32 |
| 5. Conclusion.....   | 35 |



## **1. Introduction: Effective and Efficient Compliance Examinations**

The securities industry continues to experience significant change in terms of market structure, sales practices, investment products and technological innovation. IIROC recognizes that the dynamic nature of the environment presents many challenges to Dealer Members, leading many to review their business models and look for ways to effectively contain or reduce costs. It is against this backdrop that IIROC reinforces the importance of its Dealer Members maintaining robust, effective supervisory, compliance and risk management frameworks.

IIROC's risk-based approach to regulation recognizes that there may be different ways to implement an effective risk management framework. Our compliance examination program contemplates an appropriate measure of flexibility in the ways in which Dealer Members comply with their regulatory responsibilities, within the context of their respective business models.

One of IIROC's strategic priorities is to enhance the efficiency and effectiveness of its regulatory compliance examinations. Toward that end, we are devoting more time to understanding Dealer Member business models and assessing the effectiveness of our Dealer Members' policies, procedures, internal controls, risk management programs and overall supervisory frameworks, before beginning our field examinations. These off-site, pre-examination risk assessments help IIROC compliance examiners determine the appropriate scope of each review and the extent of the substantive examination testing procedures that should be performed. This top-down approach, which each of IIROC's compliance departments uses, enables examiners to focus on the areas of greatest potential risk and regulatory concern, and be more efficient in performing their on-site assessments of Dealer Members' controls and supervisory infrastructure.

To further improve the efficiency and effectiveness of our compliance reviews, and to minimize undue strain on Dealer Members' administrative resources, IIROC increased the number of integrated examinations conducted in 2014. Integrated examinations are performed when at least two of the three Compliance units (i.e. Business Conduct Compliance, Financial & Operations Compliance, and Trading Conduct Compliance) review a Dealer Member at the same time. This approach provides IIROC with a holistic risk assessment of the Dealer Member's business activities and eliminates the duplication of information requests that the firm would otherwise receive. The Dealer Member is provided with a consolidated examination report at the completion of its integrated exam. We are continuing to streamline our integrated exams, and to assess the costs and benefits. To that end, Dealer Member feedback is welcome.

For the past year IIROC has conducted post-exam surveys. Feedback provided by Dealer Members is used to better identify and address areas for improvement in our compliance



exam processes. Most feedback to date has shown that Dealer Members find the risk-based approach taken by the IIROC Compliance teams to be beneficial in increasing the overall efficiency and effectiveness of the examination process.

This Report outlines the key areas of focus for IIROC's Compliance teams in the upcoming year. The Report also outlines common deficiencies in Registration and issues noted in the previous Compliance examination cycle. Dealer Members must address such findings promptly and thoroughly, and ensure they have adequate systems for supervision, compliance and risk management.

## **2. Key IIROC Priorities for 2015**

Outlined below are the key areas of regulatory concern for IIROC, including new risks that have recently emerged in the challenging and continuously evolving Canadian capital market. These new risks have been integrated into the scope of IIROC's current and future regulatory programs.

### **2.1. Financial and Operational Compliance**

#### ***2.1.1. Cyber Security***

Cyber security continues to be a key issue for Dealer Members and for IIROC.

One aspect of advancing technology is that cyber-attacks are becoming more sophisticated, with potential for greater damage. For regulators and financial market participants, the increased efficiencies and improved capabilities of today's information technology infrastructure come with incremental cyber-security risks.

Given the increasing automation of, and interconnections among business functions, information and operational systems, an appropriate response to the challenge of cyber security must take an enterprise-wide perspective and be part of each firm's overall risk-management program.

We recognize that proactive management of cyber risk is critical to the stability of IIROC-regulated firms, the integrity of capital markets, and the protection of investor interests. Last year we highlighted certain Gatekeeper Reports that documented cases involving client accounts, and published best practices that could help prevent such events.

IIROC is committed to developing a framework for industry best practices and will draw input from industry and other financial services regulators, both domestic and global. This undertaking seeks to reframe the cyber-security discussion as a risk-management and strategic



issue to be addressed at the Board of Directors and/or the senior management level of IIROC-regulated firms.

IIROC will also develop partnerships with other supervisory and governmental agencies to ensure the sharing of critical intelligence and expertise in a timely manner. In addition, through ongoing dialogue with industry participants, authorities and financial services leaders, we will maintain awareness of new and emerging threats, stay informed of best practices, and be well positioned to coordinate cyber defense efforts.

To further support cyber-security efforts by IIROC-regulated firms, we will conduct a “table-top” exercise with a cross-section of Dealer Members. This will test firms’ preparedness to deal with cyber-attacks, including coordination among Dealer Members and with regulators for sharing information to mitigate the impact of an attack, and protocols for updating clients and other stakeholders during such an emergency. The test will take place on March 3, 2015, and assist in developing best-practice recommendations that can be applied by all Members, irrespective of size and business model, and which will be part of IIROC’s forthcoming risk management framework.

### **2.1.2. Outsourcing**

On January 13, 2014, IIROC published Guidance Note 14-0012- *Outsourcing Arrangements* - and in the 2014 examination cycle, we commenced detailed reviews of Dealer Members’ risk management infrastructure around outsourcing arrangements. Of the Dealer Members examined during our current exam cycle, outsourcing arrangements were in place at more than half of the firms, with 65% of these arrangements found to have been with affiliates of the firm. IIROC will, in the upcoming examination cycle, continue to focus on the outsourcing of risk management.

Based on our reviews of Dealer Members to date, we have noted the following Industry best practices:

- a. Outsourced functions are set out in written, legally binding contracts that include, among other things:
  - a detailed description of the services being outsourced;
  - specification of the required performance and quality levels;
  - the rights of the Dealer Member, Panel Auditor and IIROC to have access to and to inspect the service provider’s controls, as well as its books and records;
  - termination (exit) clauses and minimum periods to execute a termination provision;
  - pre-conditions or consent of the Dealer Member prior to subcontracting; and
  - requirements pertaining to the protection of confidential information.



- b. A written policy governing the selection and review of outsourced arrangements, including methods to assess the standard of performance of the service provider.
- c. The appointment of an internal outsourcing champion who reports to an Executive Committee or Board of Directors, and is responsible for the supervision of, and compliance with, all aspects of the written outsourcing policy.
- d. Due diligence and routine reviews of service providers are conducted, including a review of the service provider's control environments through the receipt of a core functions audit report (CSAE 3416 or SSAE 16 or equivalent).
- e. Periodic reviews of the quality and accuracy of outsourced services are performed by the Dealer Member.
- f. The Dealer Member's business continuity plan includes a comprehensive exit strategy to address disruptions at outsourced service providers. Tests are performed to ensure minimal disruption to the Dealer Member if service providers are unable to deliver their outsourced services.
- g. In addition to requirements for the protection of confidential information generally, where the service provider is an affiliate (i.e. a non-arms-length service provider), there are preventative controls in place designed to limit the control and access of employees of the affiliated service provider, including those dually-employed by the Dealer Member and the affiliate, over Dealer Member data, records and assets.

The examination of Dealer Members' risk management framework over third-party vendors, suppliers and service providers will continue to be an examination priority in the upcoming year.

### **2.1.3. Balance Sheet Leverage**

Aggregate industry financial results show that the weighted average leverage ratios between 2003 and 2014 have ranged between a low of 8 (in 2008) to a high of 15 (in 2003) and is currently 13.5<sup>1</sup>. This is well within the maximum 20:1 ratio benchmark used by other domestic and international regulatory authorities.

The primary cause of the industry's return to a pre-credit crisis industry weighted balance sheet ratio is due to the increase in repo book financing activities by Dealer Members, using permitted un-invested customer free credit balances and the firm's own invested capital to generate net interest income.

---

<sup>1</sup> Balance Sheet Leverage Ratio = (Total Assets less customer monies held in trust / Total Regulatory Capital)



IIROC has carried out specified examinations of Dealer Members to look at the risk management practices of individual firms with balance sheet leverage ratios greater than 20:1. The review consisted of: a) reviewing the firm's policy on leverage, b) reviewing the risk management processes in place to monitor leverage, and c) analyzing the quality and liquidity of collateral received in its leverage activities.

Excessive balance sheet leverage can present substantial risk to the orderly wind down of any self-clearing Dealer Member in financial distress. IIROC will continue to monitor Dealer Members with balance sheet leverage ratio greater than 20:1 and assess the reasons behind the excessive balance sheet leverage of the firm. For example, a common business strategy to finance leveraged debt trading is to engage in repo financing transactions. In such cases, IIROC carries out a review to verify the quality and liquidity of the collateral underlying repo financing transactions in the event of an immediate need to deleverage their balance sheet.

#### **2.1.4. Liquidity**

In addition to monitoring balance sheet leverage ratios, the capital formula is designed to ensure that Dealer Members have sufficient liquid assets to meet their obligations, but remain flexible enough that transactions within the bounds of good business practice are not prohibited or severely restricted.

The management of the sources and uses of liquidity, also referred to as "cash management", is critical to any self-clearing firm to ensure that it has sufficient funds to return customer un-invested monies on demand and withstand any unexpected business disruptions in its normal daily operations.

The focus of examinations includes specified examination procedures to assess the adequacy of self-clearing and Type 4 Introducer's cash management policies and procedures, as these types of firms are responsible for financing, clearing and settlement of trades.

IIROC will continue to focus its examinations on the cash management risk framework of Dealer Members. Industry best practices observed to date include establishing and monitoring set limits based on liquidity ratios, instituting a contingency funding plan, and stress testing of cash resources to ensure cash accessibility is adequate in the event of an unexpected cash outflow.

#### **2.1.5. Use of Free Credit Balances**

IIROC will continue to monitor the industry's voluntary compliance with the proposed limitation of the use of client free credit balances to 12 times their current early warning reserve (EWR) level.





Findings from examinations, as well as a review of regulatory filings of Dealer Members show full industry compliance with this proposed limitation, expected to be published for public comment in early 2015, as a rule amendment to Statement D of Form 1.

## **2.2. Trading Compliance**

### ***2.2.1. Implementation of Risk Assessment Process for Post-Trade Surveillance***

The Trading Review & Analysis (TR&A) preliminary review team has implemented a new risk assessment process designed to assist IIROC in focusing resources on those issues that pose the most significant risk to market integrity. The model assesses matters both qualitatively and quantitatively, within the context of the most significant risks to market integrity as identified by IIROC.

### ***2.2.2. Manipulative and Deceptive Trading Practices***

IIROC continues to detect instances of potential spoofing, in particular where orders are entered during the pre-opening and are subsequently amended to obtain advantageous fills ahead of other Participants at the opening. All instances are reviewed by IIROC and escalated for possible further regulatory action where appropriate. Participants are reminded of their obligation to monitor for this type of behavior. As gatekeepers to the securities market, Participants must develop and implement appropriate policies and procedures to effectively prevent, detect, address and report manipulative and deceptive activity, in accordance with the requirements of UMIR Policy 7.1.

### ***2.2.3. Gatekeeper Reporting***

During the past year 343 Gatekeeper Reports were received by IIROC. While UMIR 10.16 requires the filing of a Gatekeeper Report when a Participant has ascertained that a violation of an applicable provision of UMIR has occurred, IIROC notes that Participants are reporting matters where a *potential* violation has occurred. The top three issues reported in the last year were: potential artificial pricing at or near the close; manipulative orders entered in the pre-opening; and securities act violations such as insider trading. IIROC appreciates the reporting of these potential violations and encourages all Participants to continue to bring similar matters to our attention in a timely manner. All Gatekeeper Reports are reviewed by TR&A and if deemed necessary, further information may be requested from the Participant. Upon completion of TR&A's review, matters are escalated for possible regulatory action where appropriate.



#### **2.2.4. Odd Lot Orders**

IIFROC published Notice 13-0297 - *Variation and Cancellation of Odd Lot Trades* - on December 10, 2013, confirming that IIFROC will not cancel or vary certain, unreasonable odd lot trades. Odd lot orders that are entered with extremely deep limits can result in trades at unreasonable prices, a potential violation of UMIR 5.1 - Best Execution. IIFROC reminds Participants that, in entering odd lot orders, they must take reasonable steps to ensure their clients are not disadvantaged, including but not limited to ensuring that any technology or person handling odd lot orders attaches appropriate limit prices to these orders. Notwithstanding the fact that erroneous odd lot trades are not varied or cancelled by IIFROC, such trades will be reviewed to ensure Participants are complying with their Best Execution obligations.

#### **2.2.5. Electronic Trading Rule (ETR)**

When properly applied, controls can effectively preclude the entry of orders that might trade at unreasonable prices and interfere with fair and orderly markets. Participants are required to employ controls that address a range of trading risks, including erroneous order entry, capital and credit limits, and fair and orderly trading. Introduced in March 2013, the ETR has raised expectations of Dealer Members in terms of their risk controls, including the automated controls that precede order entry.

IIFROC has found that some Participants do not meet the risk controls requirements set out under UMIR 7.1(6), with some Participants relying solely on controls that may be overridden by a trader. IIFROC has intervened in some cases when controls were overridden by trading staff, resulting in erroneous trades.

We remind Dealer Members that care should be taken to ensure threshold limits are appropriate for the types of orders usually managed by each trader. Improperly set controls, such as an order volume threshold that is significantly lower than the typical order size handled by a trader may result in frequent alerts that, when triggered, require the use of override commands. This approach may work to lower the value of the warning, resulting in erroneous trades and undermining the purpose of risk controls.

At the same time, we recognize that layered controls that provide a warning at a lower threshold and require further authorization before an outer limit can be exceeded may be a necessary part of a Participant's risk control system to ensure effective management of the risks associated with electronic access to marketplaces.

Participants and Direct Electronic Access (DEA) clients that employ automated order systems (AOS) must ensure that these systems are operating effectively, including testing prior to implementation, after an upgrade or at least annually. Through Trading Conduct examinations, IIFROC has found that not all Participants had properly documented their



internal testing or were able to provide attestations confirming that testing has been conducted by an outside party.

As Dealer Members are required to have tested or obtained attestation of testing of any AOS used internally and/or by clients by March 1, 2014, IIROC will be reviewing for evidence of this testing.

### **2.2.6. Third-Party Access**

The Third-Party Electronic Access rule<sup>2</sup> became effective in March 2014. The rule requires Participants to revise agreements with those clients who have direct electronic access. In cases where a Participant is providing direct access to another Dealer Member, a new Routing Arrangement (RA) agreement is required.

Participants that provide access to existing DEA and RA clients were required to have updated agreements in place by September 1, 2014. In August 2014<sup>3</sup>, IIROC provided a 60-day extension (to October 30, 2014) to Participants that were unable to meet the September 1 deadline. IIROC reviews DEA and RA agreements as part of its examination process and has found a number of Participants that continued to execute outdated agreements after the March deadline.

In addition, Dealer Members offering order execution services are not permitted to allow order execution services clients to use their own automated order systems to generate orders to be sent to the Dealer Member. Any client that chooses to use its own automated order system to generate orders must be treated as a DEA client. IIROC has identified Dealer Members that were not aware of or did not act on the requirements as set out in Dealer Member Rule 3200 A(1)(b)(i), and will continue to review for any clients that should now be separately identified and treated as DEA clients.

### **2.2.7. Wash Trades**

In the previous Annual Compliance Report, IIROC noted some instances where Participants may have had an incorrect understanding of what is considered to be a wash trade, interpreting certain trades as a change of beneficial or economic ownership on the basis that each order is entered by a different employee of the client using a different trading strategy.

We clarified that, regardless of the trading strategy behind each order, any trade that does not result in a change of beneficial or economic ownership is considered a wash trade and may be

---

<sup>2</sup> See IIROC Notice 13-0184 - *Provisions Respecting Third-Party Electronic Access to Marketplaces* – July 4, 2013

<sup>3</sup> See IIROC Notice 14-0198 - *Extension Requests for the Updating of Client Agreements for Third-Party Electronic Access to Marketplaces* – August 13, 2014



considered manipulative and deceptive trading activity. IIROC also reminded Participants of the need to put in place steps that prevent wash trades, including the use of marketplace-offered self-trade prevention features.

IIROC received feedback from the industry and the Investment Industry Association of Canada (IIAC)<sup>4</sup> on this issue. Generally, concerns were raised with regard to shortcomings and inconsistencies among marketplace self-trade prevention mechanisms, conflicts between self-trade prevention and the Order Protection Rule, incompatibilities with certain business models and the requirement to file Gatekeeper Reports related to wash trades.

In April 2014, IIROC clarified its position on wash trades in a response to the IIAC letter.<sup>5</sup> We confirmed that, if a Participant or Access Person uses an automated program trading system to generate orders, the matching of orders for the same beneficial or economic owner will not be treated as a manipulative or deceptive activity *provided the Participant or Access Person has taken reasonable steps* to ensure that the automated program trading system does not enter orders that may execute as a “wash trade” on a regular basis. We set out our expectations regarding whether a Participant has taken such reasonable steps, including the requirement to perform regular monitoring and to assess marketplace self-trade prevention and management tools as they become available, as summarized below.

#### *Regular Monitoring*

IIROC’s expectation is that a Participant will *regularly monitor* its level of wash trades. This expectation is consistent with UMIR Policy 7.1 which requires a Participant to develop and implement supervision and compliance procedures appropriate for its size and lines of business.

#### *Assessment of Tools*

IIROC’s expectation is that a Participant will *consider* using methods that would be practical for its business to prevent wash trading. Technological enhancements to self-trade prevention/management features continue to be introduced by marketplaces which may address many of the issues previously noted by the industry. While *IIROC does not require a Participant to use marketplace tools* to prove that reasonable steps have been taken to prevent wash trades, our expectation is that a Participant’s consideration of methods to prevent wash trades *would include a review and assessment* of available marketplace tools in light of their clients or business model.

---

<sup>4</sup> See IIAC letter: <http://iiac.ca/wp-content/uploads/IIAC-Submission-to-IIROC-re-Wash-Trades-March-14-posted-April-21-2014.pdf>

<sup>5</sup> See IIROC Response: <http://iiac.ca/wp-content/uploads/IIROC-Response-to-IIAC-Letter-on-Wash-Trades-April-21-2014.pdf>



## **2.3. Business Conduct Compliance**

### **2.3.1. Client Relationship Model (CRM) Implementation**

The purpose of IIROC's CRM initiative is to enhance investor protection by increasing the transparency of dealings between Dealer Members and their clients. Beginning in March 2012 IIROC introduced a series of rule amendments designed to achieve the CRM objectives. Rules are now in effect regarding: i) account relationship disclosure, ii) management of conflicts of interest, iii) enhanced suitability assessment and suitability assessment triggers, iv) pre-trade compensation disclosure and enhanced trade confirmation reporting.

IIROC's Business Conduct Compliance (BCC) department has performed targeted reviews of Dealer Members' implementation of various aspects of CRM. In particular, reviews of a cross section of Dealer Members' Relationship Disclosure documents, as well as Know Your Client (KYC) information collection methods have been completed. Reviews focusing on the management of conflicts of interest and enhanced suitability assessment methodologies will take place in the coming year. These reviews will assess how effectively Dealer Members are complying with CRM provisions, identify best practices and inform future policy guidance.

#### *Enhanced Suitability Assessment Obligation*

CRM requires Dealer Members to perform enhanced suitability assessments to ensure investment recommendations are appropriate for the client, taking into account a variety of factors including the client's current financial situation, investment knowledge, investment objectives, time horizon, risk tolerance and the composition and risk level<sup>6</sup> of the client's current investment portfolio. To assess Dealer Members' compliance with these requirements, a review of a cross section of Dealer Members' approaches to portfolio suitability assessment will be conducted in the coming year. IIROC recognizes that there are different ways to implement a suitability assessment framework, depending on the Dealer Member's size, business model and product/service offerings. Regardless of the specific methodology used for suitability assessment, the firm's approach must consider all of the client specific factors, as outlined in Rule 1300.1(r), and must be consistent with the process described in the Dealer Member's Relationship Disclosure document.

#### *Relationship Disclosure*

Under CRM, the Relationship Disclosure (RD) document, which should be written in plain language, must provide the client with meaningful information relating to<sup>7</sup>:

---

<sup>6</sup> See IIROC Dealer Member Rule 1300.1 (p),(q).

<sup>7</sup> See IIROC Dealer Member Rule 3500.



- the products and services offered by the Dealer Member;
- the nature of the account and the manner in which the account will operate;
- the suitability assessment process;
- fees and commission charges;
- account reporting;
- conflicts of interest; and
- complaint handling.

IIROC's BCC department performed a targeted review of 56 RDs. The review found that many firms are using the same RD for different types of client accounts, including advisory accounts, order-execution service accounts and managed accounts.

IIROC will work to reinforce the requirement that Dealer Members provide clients with a meaningful relationship disclosure document. We continue to provide timely rule interpretation and application guidance on CRM – through ongoing discussions of CRM implementation, including committees, conferences and forums, and regular updates to a publicly available list of questions and answers on CRM2.

In order to achieve the goal of better informing clients, the RD should, at the very least, be tailored to the client account type. RDs which are not account-specific may mislead or confuse clients by providing them with information that is not relevant or applicable to their account type(s).

Based on our review, there is a wide variation amongst Dealer Members' RDs in terms of the quality and depth of the discussion of the suitability assessment methodology, as well as the discussion and disclosure of conflicts of interest.

The discussion of the suitability assessment should, at a minimum, include a description of the different KYC factors and an explanation of how they are taken into consideration, individually and combined, in assessing overall suitability. Also, the portfolio suitability assessment methodology being used by the Dealer Member should be explained in plain language.

The discussion relating to conflicts of interest must provide a high level description of the different types of conflicts that may arise at the firm and should include enough detail to enable clients to understand the significance of each type of conflict and how the Dealer Member will manage each conflict, in accordance with the requirements of IIROC Dealer Member Rule 42.



## *Fee Disclosure*

In July 2014 the first set of rule amendments under the CRM2 initiative<sup>8</sup> came into effect.<sup>9</sup> These amendments included the requirement to disclose, on a pre-trade basis, fees and charges associated with pending securities investment purchases and sales transactions, as well as enhanced debt security trade confirmation disclosure of compensation received by the Dealer Member on the trade. IIROC BCC examiners will be reviewing Dealer Member policies and procedures regarding this requirement, as well as reviewing audit trail materials to confirm that the required fee disclosures are being provided to clients.

### **2.3.2. Business Titles and Financial Designations**

In March 2014, IIROC issued guidance on the “Use of Business Titles and Financial Designations”.<sup>10</sup> The guidance identified supervisory best practices aimed at improving transparency regarding the use of business titles and financial designations by IIROC Approved Persons dealing with retail investors. As explained in the guidance note, “No IIROC Approved Person should hold his or herself out to the public in any manner, including without limitation, by the use of a business title or designation of qualifications or professional experience that deceives or misleads, or could reasonably be expected to deceive or mislead, a client or any other person as to the IIROC approval they hold, their proficiency or qualifications.”

The BCC department will, in the coming year, conduct a review of the use of business titles and financial designations by registrants. Specifically, BCC examiners will review Dealer Member policies and procedures to determine whether issues relating to the use of business titles and financial designations are adequately addressed in the context of the firm’s business model and account offerings. In particular, BCC examiners will review any business titles that convey an expertise in senior-related issues or retirement planning, to ensure that any individual claiming such expertise is appropriately qualified and competent.

### **2.3.3. Social Media**

The rapid growth of social media is significantly impacting the ways in which Dealer Members interact with existing and potential customers. IIROC Dealer Member Rule 29.7 requires the review, supervision and retention of advertisements, sales literature and correspondence used to promote the business of Dealer Members, regardless of the media used for the business communication. Social media does, however introduce a number of unique challenges in

---

<sup>8</sup> On December 12, 2013 IIROC published for comment proposed amendments to IIROC Rules 29, 200 and 3500 (collectively the IIROC CRM2 Amendments). The Notice of Approval and Implementation is in Rules Notice 14-0133 May 29, 2014.

<sup>9</sup> See IIROC Dealer Member Rule 29.9.

<sup>10</sup> See Guidance Note 14-0073.



terms of the monitoring, approval and retention of business communications made using various forms of social media.

It is IIROC's expectation that all Dealer Members will have robust policies and procedures dealing with any form of communication with clients and the public, including all forms of business communications through social media. IIROC's BCC department will be focusing on social media policies and procedures as part of the next examination cycle. The focus will include an analysis of the ways in which social media is being used by the Dealer Members and their Approved Persons, as well as the processes that Dealer Members have implemented to monitor and control the use of social media by their staff. The examination findings will inform policy development in this area.

#### **2.3.4. Joint OSC Mystery Shopping Project**

IIROC is participating in a mystery shopping project, in conjunction with the Ontario Securities Commission and the Mutual Fund Dealers Association of Canada. The objective of this initiative is to gain insight into the quality of investment advice currently being provided to retail investors in Ontario, and to get a better understanding of investors' experiences. The results of this initiative will serve not only as a valuable source of information, but will also supplement the findings of the CRM-targeted reviews described above. The mystery shopping results will provide information from the perspective of investors and may guide future policy development and investor education initiatives. The findings, conclusions and recommendations from this project will be presented in a report to be published in 2015.

#### **2.3.5. Conflict of Interest Study**

IIROC Dealer Member Rule 42 outlines the obligations of Dealer Members and Approved Persons to manage all existing and potential material conflicts of interest that may affect their business, including the requirement to have written policies and procedures for identifying and addressing material conflicts of interest. Rule 42 requires Dealer Members to identify all material conflicts that could potentially apply to their particular business activities and, once identified, address these conflict(s) in a fair, equitable and transparent manner, considering the best interests of the client. If the conflict cannot be addressed as above it must be avoided<sup>11</sup>.

To assess how effectively Dealer Members are identifying and addressing conflicts of interest, IIROC's BCC department will conduct a study of conflict of interest management practices at a cross-section of Dealer Members. The review will focus on three aspects of conflict of interest management:

---

<sup>11</sup> See all the sections of IIROC Rule 42 for the obligations of Dealer Members and Approved Persons respectively.





- the governance and oversight of conflicts management by senior management and the Board;
- compensation-related conflicts; and
- conflicts relating to the marketing and distribution of new products.

The study will involve the completion of a questionnaire by each selected firm and a review of the firm's policies and procedures and other documentation pertaining to conflict of interest management. The results will assist IIROC in determining whether there are aspects of conflict of interest management that may require additional guidance.

### **2.3.6. Order-Execution Only Platforms**

In 2013 IIROC conducted a targeted survey of all Order-Execution Only (OEO) Dealer Members to identify the types of services tools and products OEO firms made available to their clients. Under IIROC Rules 1300.1(t) and 3200, in order to be eligible for an exemption from a suitability determination for their clients, OEO firms must ensure that they do not provide recommendations in any form. Whenever a recommendation is made, or advice is given, a suitability determination is required. IIROC Member Regulation Notice 0098 provides guidance regarding what might constitute a recommendation.

Since MR 0098 was published in September 2001, the range of products being offered and the number and types of tools available to support investment decisions (model portfolios, asset allocation, rebalancing, etc.) have expanded considerably. This trend is likely to continue in the foreseeable future as a result of technological advances, changing investor preferences, and competitive pressures. While some of the tools being offered provide valuable assistance and useful investment information to OEO clients, other tools could be seen as a means for providing implicit, if not explicit, recommendations.

To help ensure that IIROC rules strike an appropriate balance between ensuring investor protection and providing OEO clients with important tools to assist in their self-directed investment decisions, IIROC has initiated a consultation process. Discussions will seek input from both the industry and investors on what constitutes advice or recommendations.

### **2.3.7. Seniors' Issues**

As a result of demographic trends, the number of seniors receiving financial advice and other investment-related services from IIROC Dealer Members has increased significantly in recent years. Further, IIROC's Complaints and Inquiries data show that, each year, seniors consistently represent a significant portion of all regulatory and service complaints. Seniors' issues are a regulatory priority for IIROC and we have created an internal, multi-departmental working group dedicated to working on issues relevant to seniors. This group, which addresses seniors' issues from a multi-disciplinary perspective, has spurred certain



enhancements to BCC examination modules, enabling BCC examiners to better identify, track and test for seniors-related business practices and to review supervisory controls implemented by firms in this regard. In the coming year, BCC examiners will focus on seniors-related issues, including the proper use of business titles and financial designations, Dealer Member supervision processes pertaining to the suitability of seniors' accounts (i.e. KYC approval and ongoing monitoring), as well as the provision, where appropriate, of seniors-specific training to registered staff.

### **2.3.8. *Principal-Agent Business Models***

Many IIROC Dealer Members, as provided for in IIROC Rule 39, operate using a Principal-Agent business model. Discussions with the industry, regarding Principal-Agent models currently in use by some IIROC members, has highlighted that payments are being made by Dealer Members (Principals) to their registrants (Agents) in a variety of ways. In light of these differences, as well as the requirements of certain IIROC Rules, including Rule 18.15 which stipulates that registered persons may only accept payment for securities-related activity that they conduct on behalf of a Dealer Member, from the Dealer Member or its affiliated companies, IIROC's BCC team is conducting a review of existing Principal-Agent relationships. Importantly, the results of this review will enable IIROC to assess Dealer Members' compliance with Rules 18.15 and 39, as well as IIROC rules relating to Dealer Members' supervisory responsibilities.

### **2.3.9. *Enhanced ("Close" and "Strict") Supervision***

When a registrant has been placed under close or strict supervision the Dealer Member that employs the registrant is required to file a monthly report with IIROC. This report attests to the fact that Dealer Members have satisfied their enhanced supervisory obligations for registrants subject to enhanced supervision, as outlined in the respective reporting forms. In field examinations IIROC's BCC examiners found instances of Dealer Members submitting the requisite monthly forms, but are unable to provide any evidence that the enhanced supervision has, in fact, taken place. In the coming year BCC, as part of its field examination process, will review Dealer Members' source documents provided as evidence of the Dealer Members' enhanced supervision.



### **3. Results of Recent Targeted Reviews and Surveys**

#### **3.1. Know Your Client Obligations and Enhanced Suitability**

Under CRM's enhanced suitability requirements, which came into effect in March 2013, Dealer Members are required to assess suitability from the standpoint of the client's entire portfolio.<sup>12</sup> In particular, the composition and risk level of the client's current investment portfolio must be considered when suitability assessments are performed. To meet these enhanced suitability obligations, it is critical that Dealer Members obtain comprehensive and reliable "Know-Your-Client" (KYC) information, without which suitability assessments cannot be made. To determine the depth and quality of KYC information being collected by Dealer Members, IIROC conducted a review of Dealer Member KYC information collection processes over the past year, focusing on the form used to collect the following KYC information: current financial situation, investment knowledge, investment objectives, investment time horizon, and investment risk tolerance.

The results of the review show that some Dealer Members were not collecting precise KYC information but rather, were assigning clients to one of a small number of investor profiles, based on general client information collected. The review also confirmed that, while the information collected relating to the client's current financial situation and investment knowledge was sufficiently thorough in most cases, the depth and quality of information collected regarding the client's investment objectives, investment time horizon and risk tolerance was much more varied. These results will help inform IIROC's future studies of Dealer Members' alternative approaches to suitability assessment.

### **4. Recurring/Significant Deficiencies Noted in 2014**

Over the course of the past year our Financial and Operations, Business Conduct Compliance and Trading Conduct Compliance teams noted certain recurring and/or significant compliance deficiencies. In light of these findings, IIROC's compliance teams, in addition to emphasizing the key objectives and priorities we have noted above, will focus on these issues in the coming year. It should be stressed that these deficiencies were not found at all firms, and that no single firm received a report containing all or even most of these deficiencies.

IIROC's approach to compliance allows for flexibility in the ways Dealer Members meet their regulatory responsibilities; however, significant compliance examination deficiency findings must be addressed by Dealer Members. A failure to adequately address repeat significant findings may result in a referral to IIROC's Enforcement unit.

---

<sup>12</sup> See IIROC Rule 1300 (p), (q), (r).



#### 4.1. Written Internal Control Policies

*IIROC Rule 2600, Internal Control Policy Statement 1, General Matters*, requires Dealer Members to maintain a set of internal control policies and procedures that are designed to assist management in achieving its objective of ensuring, as far as practical, the orderly and efficient conduct of the Dealer Member’s business. These policies must be in writing and approved at least annually by applicable members of senior management.

IIROC Financial and Operations examiners continue to observe written internal control policies that are inadequate, in that they inaccurately or insufficiently describe the policies and procedures in effect at the Dealer Member. Often Dealer Members’ written procedures are copied, nearly verbatim from the minimum requirements set out in *Rule 2600, Internal Control Policy Statements 2 through 8*, with little substantive description of processes specific to the individual Dealer Member, no description of who is responsible for performing the procedures, or how the firm evidences performance and supervision.

Dealer Members should note the General Matters statement directs that when drafting their written procedures, Dealer Members consider not just the minimum requirements of Internal Control Policy Statements 2 through 8, but also other sources that may suggest a higher standard, including authoritative literature, comments made by internal or external auditors or by industry regulators, as well as industry practices.

| Finding  | IIROC Rule, Guidance or Comment   |
|--|---|
| The absence of written policies and procedures for new business activities, or the failure to change written policies and procedures after the activities to which they relate have changed. | Consider new business lines, or new clearing and settlement processes.  |
| Written procedures that contradict IIROC Rules.  | For example, a procedure that permits the Dealer Member to use clients’ unsegregated securities to settle short inventory sales in violation of Rule 2600, IC Policy 6.3(f).                  |
| Deviations from minimum requirements with insufficient detail of alternative procedures that mitigate the related risk.  | For example, where a Dealer Member’s small staff does not permit effective segregation of duties in securities handling or cash management, but where alternative supervisory controls exist. |
| No written policies and procedures for handling clients’ unclaimed property to comply with current provincial legislations where DM carries on business.                                     | Legislation regarding the handling of unclaimed property differs by province. Dealer Members should develop policies that comply with the applicable requirements.                            |



| Finding   | IIROC Rule, Guidance or Comment  |
|---|--|
| No written procedures specific to the institutional trading accounts. | <i>MR Notice 09-171</i> - Very few dealer members describe in any detail the processes by which they monitor the creditworthiness of institutional clients and counterparties, or their settlement agents, or impose and monitor transaction limits. |

## 4.2. Internal Controls in Practice

These findings relate to practices at Dealer Members that fall short of either the minimum regulatory requirements or with industry standards. We emphasize that the control infrastructure starts with the establishment of a strong governance process, with suitably composed boards of directors and/or executive committees that meet regularly to discuss, among other things, strategy, financial performance, compliance matters and operational issues.

| Finding   | IIROC Rule, Guidance or Comment  |
|---|--|
| Non-performance of minimum required procedures, such as: <ul style="list-style-type: none"> <li>• Verify prices</li> <li>• Compare reported Risk Adjusted Capital (RAC) to the month-end estimate</li> <li>• Establish dual approval procedures for payments, including outgoing wire transfers</li> <li>• Separate incompatible cash management or back-office functions</li> <li>• Review deposit limits assigned to 3rd party custodians.</li> </ul> | Rule 2600 – Members are encouraged to review their written procedures to ensure they both satisfy the minimum requirement <i>and</i> describe specific procedures they know to be in effect.   |
| Estimates of RAC prepared using incomplete or out-of-date information.  | IIROC examiners noted inaccurate estimated month-to-date income, previous month equity not updated after filing the Monthly Financial Report (MFR), and the omission of capital requirements for securities positions and underwriting commitments. Dealer Member financial reporting departments should establish an effective channel of communication between the corporate finance and regulatory reporting departments to ensure that all underwriting commitments are captured in their RAC estimates. |
| Brokerage trading accounts are not reconciled to statements received from the counterparty. Other miscellaneous accounts such as related party, control, or suspense accounts, are not reconciled to supporting documentation or otherwise analyzed to  | <i>Notes and Instructions to Form 1, Statement B Line 20</i> describe the margin requirements for unresolved differences that potentially adversely affect Dealer Members’ capital. Introducing Brokers, including Type 2, should be aware that unless their carrying  |



| <b>Finding</b>  | <b>IIROC Rule, Guidance or Comment</b>   |
|---|--|
| identify unresolved differences.  | broker has agreed in writing that it will reconcile the account recording trades executed by the introducer, then the Introducer is responsible for reconciling that account to the counterparties' month-end statements. All reconciliations should be reviewed by senior management on a timely basis. |
| Written limits, for example, for proprietary trading or client or single account security concentration, are inappropriate in comparison to the Dealer Member's level of RAC. | <i>Rule 2600, Internal Control Policy Statement 2.3</i> requires that activity limits for major functional areas be designed to ensure the firm maintains at least the minimum required RAC. Member Regulation Notice MR-0159 provides guidance regarding single security concentration.                 |

### 4.3. Accounting, Reporting, and Margin Calculation Errors

These findings relate to errors in the compilation of Monthly Financial Reports or weekly estimates of Risk Adjusted Capital. The more significant instances are usually complicated and specific to circumstances of the Dealer Member; therefore, Dealer Member staff should always consider the risk of unique activities and consider whether it is appropriately captured in IIROC's capital formula.

| <b>Finding</b>   | <b>IIROC Rule, Guidance or Comment</b>   |
|--|--|
| Inappropriate netting or off-setting of items within financial statement or RAC estimate line items.                           | <i>General Instructions to Form 1</i> - The MFR and weekly RAC estimates must be prepared according to International Financial Reporting Standards, with limited exceptions as set out in the notes and instructions to Form 1. These standards set out conditions under which accounting balances may be offset or reported on a net basis. |
| Failure to account for material items, such as a mark-to-market loss on an underwriting position, within the RAC estimate.     | <i>MR Notice 0316</i> – write-downs for underwriting commitment should be reflected in RAC estimates in addition to potential changes in the margin rate or eligibility of margin relief taken for expressions of interest.  |
| Inaccurate calculation of client net equity.   | <i>Notes and Instructions to Form 1, Schedule 10</i> - Dealer Members using multiple platforms to account for different business lines should ensure all client accounts are accounted for.  |
| Continued margin relief for an account whose guarantor did not return a confirmation requested by the Dealer Member's auditor. | <i>Rule 100.15(e)</i>  |



| <b>Finding</b>   | <b>IIROC Rule, Guidance or Comment</b>   |
|--|--|
| Failure to provide capital for an underwriting commitment at the commitment date, or to correctly determine the date of the commitment, or to provide capital for the commitment at the correct margin rate. | <i>Rule 100.5</i> – Subject to reconfirmation or syndication terms documented in the commitment letter, Dealer Members’ commitments are effective when offered to the client or syndicate. Dealer Members must ensure they have the capital capacity to cover their commitment even if they anticipate a substantial portion will be sold to or affirmed by institutions the same day. |
| Incorrect calculation of required margin or applicable offset for options positions.   | <i>Rule 100.9, 100.10</i>  |

#### 4.4. Books and Records

The minimum requirements relating to Dealer Members’ books and records are set out in Rule 200. These records are necessary for many reasons, including evidencing balances reported on financial filings or performance of operational or control procedures. In attempts to achieve an operational efficiency through computer systems, often provided by an affiliate, some Dealer Members are not meeting these minimum requirements.

| <b>Finding</b>  | <b>IIROC Rule, Guidance or Comment</b>  |
|---|---|
| Processes to download brokerage accounting system balances into the general ledger application have been automated, with insufficient checks or audit trails to ensure the accuracy of the download. Similarly, reports used for account management or regulatory reporting are produced from proprietary systems with data from the brokerage accounting application, without controls or procedures to verify the integrity of those reports. | Dealer Members should consider reconciling output between systems where possible, or where not, periodic testing of report data.  |
| Individual accounts were not opened for brokerage trading or financing counterparties, and accordingly, statements were not being delivered. Processes have been established such that the statement for certain trades or accounts appear to have been issued by an affiliate rather than the Dealer Member.   | <i>Rule 200</i> - All trades not executed through a continuous net settlement system must be posted to an account opened for the counterparty broker in order to facilitate the production of confirmations and month-end statements. Dealer Members using subsidiary systems for specific business lines must ensure that these systems satisfy Rule 200 requirements, or if not, use the primary platform for all recordkeeping purposes. |
| Dealer Members have implemented systems that record trades but do not issue trade confirmations for particular transactions or clients.   | Permission to suppress production of trade confirmation or month-end statements not within the context of trades matched electronically under Rule 200.2(l)(ix) requires an exemption from IIROC’s board  |



| Finding   | IIROC Rule, Guidance or Comment   |
|---|---|
|   | of directors and from applicable securities commissions.  |
| Using reports based on unadjusted numbers to compile MFR balances or margin requirements, with inadequate processes to ensure material back-dated entries are reflected in reported balances. | Dealer Members should be aware of their systems' deadlines for incorporating back-dated entries into standard reports, and ensure processes exist to capture the effect of later entries in their financial filings.  |
| Transactions, such as non-brokered private placements, and client-name mutual fund sales, not recorded in the Dealer Member's books and records.  | <i>MR Notice 0481.</i> Dealer Members must consider the nature of their involvement in arranging any sale of a non-brokered private placement, as well as the relationship it (or its advisors) has with the issuer, and are encouraged to contact their FinOps manager if they are in any doubt about whether the trade may go unrecorded. Consider in particular whether the Dealer Member has earned any fees, or whether the advisor has solicited or advised the client. For client name mutual funds, consider guidance issued in <i>Compliance Interpretation Bulletin C-106</i> . |

#### 4.5. Operational Issues

Operational deficiencies are often unique to individual Dealer Members, and often result from a lack of awareness of a particular rule, or because the Dealer Member's staff does not appreciate the regulatory impact of a change in business activities. To address this issue, Dealer Members should establish a process that ensures operational issues are discussed on a timely basis, amongst operational, managerial, compliance and financial reporting staff.

| Finding  | IIROC Rule, Guidance or Comment  |
|--|--|
| Non-employees, such as officers of a parent company or other affiliate, have signing authority over bank accounts.   | Failure for a Dealer Member to retain complete control over its cash balances poses the risk that those assets may be inappropriately swept in the course of managing financial matters arising at the affiliate and unrelated to the Dealer Member.   |
| Omnibus trading or clearing accounts – We continue to identify trading arrangements where the Dealer Member and the counterparty have not made appropriate, separate and distinct, custody arrangements for excess collateral held by the counterparty. In one instance, a Dealer Member used clients' fully paid and excess margin securities to satisfy the margin requirement on positions held in the omnibus account. In other instances, Dealers | <i>Rule 17.3, Notes and Instructions to Schedule 5 of Form 1.</i> Dealer Members lodging securities to cover the counterparty's required margin must provide capital for the value of collateral that exceeds the margin required and should review this excess on a daily basis. To avoid a capital charge a firm may transfer excess collateral to a separate custody account governed by a Rule 2000 compliant custody agreement. Dealer Members providing such custody services must |





| Finding   | IIROC Rule, Guidance or Comment  |
|---|--|
| providing a separate custody account failed to reflect the securities held in custody as being held in segregation.   | correctly identify excess collateral securities held in custody as segregated on their statements, and Dealer Member customers should review their statements to verify compliance.  |
| Failure to provide notice and, if applicable, request approval, for shareholder transactions, new affiliates, or changes to lines of business or operations.  | <i>Rule 5, Rule 6, IIROC Notice 10-0060.</i> Dealer Members are encouraged to err on the side of caution and contact their FinOps manager for additional support.  |
| Establishing custodial arrangements governed by an agreement that does not satisfy the minimum terms of segregation set out in Rule 2000.1.   | <i>Rule 2000.1</i>   |
| Segregation related software didn't account for reduced margin due to hedged positions in calculating the segregation requirement. In another instance, a segregation location was not recognized as such, and so positions were marked current on the month-end statement, and the deficiencies were not flagged by daily reports. | <i>Rule 2600, Internal Control Policy Statement 4</i> Dealer Member must review annually their segregation policies and procedures. Dealer Members should incorporate procedures to test the system coding and integrity of segregation reports. |

#### 4.6. Outsourcing

IIROC issued guidance on outsourcing in Member Regulation Notice 14-0012. Members with significant outsourcing arrangements are encouraged to establish an outsourcing policy, which documents the nature of activities outsourced, the due diligence to be performed when selecting a service provider, the contract entered into and the detailed policies and procedures the Dealer Member will regularly undertake to supervise compliance with the agreed terms of the arrangement and verify the integrity of information provided by the service provider.

| Finding   | IIROC Rule, Guidance, or Comment  |
|---|---|
| The outsourced activity is not governed by an appropriate legal agreement between the parties.  | The agreement should include a comprehensive list of services provided, and document such other terms contemplated in the notice, including regarding confidentiality of information, Dealer Member and regulator access, and termination provisions. |
| The outsourced activity is not effectively supervised by a person accountable to an officer of the Dealer Member.   | No outsourcing arrangement may delegate a Dealer Member's responsibility under regulation.  |
| Use of an affiliate's systems that either do not segregate the Dealer Member's books and records from those of another entity, or fail to ensure the Dealer Member retains an acceptable level of control | Members should make every practical effort to enter into agreements directly with software vendors and data processors. Where not feasible, Dealer Members must ensure as a minimum, their ledgers are distinct                                       |



| Finding   | IIROC Rule, Guidance, or Comment   |
|---|--|
| <p>over its books and records or customer assets. Examiners have found Dealer Members’ records to be inaccurate, and systems insufficiently tested.</p> | <p>from those of affiliates, that data is backed-up to servers located in Canada under the Dealer Member’s control, and can be recovered in usable form on a timely basis. Where the arrangement involves the custody or control of property of the Dealer Member or its clients, business continuity procedures that allow the Dealer Member to transfer this property to another entity should be arranged and tested.</p> |
| <p>The price for outsourced activities is not calculated in a manner that relates directly to the services provided.</p>                                | <p><i>Rule 18.15.</i> Dealer Members must remunerate Registered Representatives and their associates directly. Under <i>Rule 200.1(b)</i> all costs of a Dealer Member’s operations must be reflected in its ledger and cannot be absorbed by an affiliate in an attempt to improve or smooth the Dealer Member’s reported income.</p>   |

#### 4.7. Best Execution

Each Participant is required to diligently pursue the execution of each client order on the most advantageous terms reasonably available under the circumstances. IIROC continues to identify Participants that have not adequately considered their methodology for achieving best execution and are relying on the default or dated settings of their smart order router. In addition, Dealer Members and Participants that access marketplaces through another Participant are not always familiar with the methodology in place or whether it achieves best execution for their own clients.

Participants must have a documented approach to best execution, as prescribed under Part 4 of UMIR Policy 7.1. For those that rely on another Participant for execution, there must be a reasonable level of knowledge regarding, for instance, the Participant’s order routing practices and the marketplaces that are accessed, in order to assess whether they are achieving best execution for their own clients. Furthermore, clients should be given access to information about the firm’s order handling process.

#### 4.8. Inadequate Supervision of Employee/Agent Accounts

IIROC continues to have concerns regarding the supervision of employee/agent accounts held at other IIROC Dealer Members. In particular, various instances were identified in which Dealer Members did not have an adequate tracking system to ensure that all account statements were received and reviewed, as required by IIROC Dealer Member rules.<sup>13</sup> Dealer

<sup>13</sup> See Rules 38.1 and 2500 III B.7



Members must have robust processes to ensure that they are aware of all external accounts held by employees and that all confirmations and/or month end statements are received and reviewed against the grey and restricted lists on a timely basis.

#### **4.9. Outside Business Activities (OBA)**

IIROC continues to see instances where Dealer Members do not have adequate policies and procedures for the reporting, reviewing, approving and supervising of the OBA activities of their registrants. In particular, the documentation of the conflict of interest analysis, associated with OBA approval, was found to be lacking or absent in several cases. IIROC is reaffirming its expectation that OBA activities will be disclosed by firm registrants, and reviewed and approved by Dealer Members in accordance with IIROC requirements Dealer Members must ensure that documentation includes the analysis that was conducted and the reasons supporting the conclusion that an OBA either presented no risk of material conflicts of interest, or that any potential, material conflict could be adequately addressed through disclosure or other means.

#### **4.10. Conflicts of Interest – Policies & Procedures**

IIROC Dealer Member Rule 42 requires Dealer Members to develop and maintain written policies and procedures relating to the identification, and addressing of all existing or potential material conflicts of interest. Over the past year, BCC examiners noted various instances in which Dealer Members' policies and procedures lacked the requisite detail necessary to ensure that all existing or potential, material conflicts of interest associated with a Dealer Member's business were identified and appropriately addressed. In particular, Dealer Member policies and procedures should outline the required level of analysis and review for various types of conflicts and should also require that any analysis be documented appropriately. In some instances, the Dealer Member's analysis simply contained a blanket statement that there were no applicable conflicts relevant to the Dealer Member's business. IIROC considers that most business models will have existing or potential material conflicts. The Dealer Member must ensure that all analysis and conclusions are adequately documented, including conflicts arising from a Dealer Member's business model and reasons as to why they would not apply to the Dealer Member in question.

#### **4.11. Recurring/Significant Registration Deficiencies**

##### ***4.11.1. Registration Applications and Changes of Registration Information – Form 33-109F4 and Form 33-109F5***

A request for registration approval may be delayed if a registration application is incomplete or lacks sufficient detail. IIROC's Registration department undertook a review of the most common deficiencies encountered through our review of individual related filings over the



last year. The most common deficiencies are highlighted below, together with reminders about filing requirements and/or suggested practice tips or sources that can be used to assist firms and individuals, in addressing these deficiencies.

Many of the common deficiencies identified last year are repeated below. Firms must ensure that sufficient resources are allocated to the registration function, that an adequate number of staff, who possess the experience necessary to properly discharge their registration tasks, are assigned and that the firm create and follow appropriate policies and procedures.

| <b>Disclosure Regarding Current Employment, Other Business Activities, Officer Positions Held and Directorships (Form 33-109F4 - Item 10, Schedule G)</b> |  |
|---|--|
| <p>Late Filings</p>   | <p>Disclosure of outside business activities (OBAs) or changes to an already disclosed outside business activity are not being provided to IIROC within the filing deadlines prescribed in section 4.1(1) (b) of NI 33-109. There may still be potential conflicts of interest, even if the OBA is not securities related.</p> <p><u>Filing Requirements</u></p> <p><i>Provide details of new outside business activities or changes to an existing outside business activity by submitting a Current/Previous Employment Change Notice in accordance with Section 4.1(1)(b) of NI 33-109. An Approved Person must notify IIROC of changes to information previously submitted in a Form 33-109F4, within 10 days of the change. To meet the filing requirements, in addition to periodic attestations regarding outside business activities, firms should require Approved Persons to notify them in the event of a material change to their outside business activities and frequently remind them of this requirement.</i></p>  |
| <p>Reportable Outside Business Activities</p>   | <p>There is still confusion among Dealer Members as to what outside business activities should be reported (i.e. volunteer positions, positions of power or influence) resulting in these types of OBAs not always being disclosed.</p> <p><u>Filing Requirements</u></p> <p><i>To determine if the activity is reportable, Dealer Members should review the guidance set forth in the Companion Policy to National Instrument 31-103, IIROC Notice 13-0163 and CSA Staff Notice 31-326. Firms and Approved Persons are reminded that the following must be reported as “outside business activities” under NI 33-109:</i></p> <ul style="list-style-type: none"> <li>• <i>any business or employment activity with an entity other than the individual’s sponsoring firm – this would include any business or employment activity with an affiliated firm;</i></li> <li>• <i>acting as an officer, director or in an equivalent position for a company, other than the individual’s sponsoring firm – note: officer and director positions with affiliated firms must also be reported as an outside business activity;</i></li> <li>• <i>being an officer, director or a significant owner of a holding company or personal corporation; and</i></li> <li>• <i>having a paid or unpaid position of influence within a charitable, social or religious organization.</i></li> </ul> |
| <p>Description of</p>   | <p>In some cases, insufficient detail is being provided when describing the nature of the outside</p>  |



**Disclosure Regarding Current Employment, Other Business Activities, Officer Positions Held and Directorships (Form 33-109F4 - Item 10, Schedule G)**

|                                       |  |
|---------------------------------------|--|
| <p>Duties / Conflicts of Interest</p> | <p>business activity, the duties of the individual and the relationship to the business. Boilerplate disclosures are often provided when responding to question 5 of Schedule G of the Form (i.e., disclosure of conflicts of interest and potential for client confusion arising from outside activity). However, answers to the different parts of the question should be tailored to the specific activity at issue.</p> <p><u>Filing Requirements</u></p> <p><i>Disclosures should provide sufficient detail to demonstrate that the Dealer Member has thoughtfully considered the potential for client confusion and conflicts of interest that may arise as a result of the outside business activity and how this will be managed by the Dealer Member. In this context, firms should be considering whether the activity will (i) interfere with or otherwise compromise the Approved Person’s responsibilities to the Dealer Member and/or its clients; or (ii) be viewed by clients or the public as a part of the Dealer Member’s business based upon, among other factors, the nature of the activity and the manner in which it will be conducted or offered. If a Dealer Member does not believe that an outside business activity will result in any potential for client confusion or potential conflicts of interest the basis for this conclusion should be provided.</i></p> <p><i>From time to time conflicting information is provided by Dealer Members when responding to question 5 of Schedule G of the Form. Dealer Members are reminded to review their responses to ensure that consistent information is provided (i.e. stating that there is no potential for conflicts of interest or confusion in one area but providing the steps taken to control the potential conflict/confusion in another area does not demonstrate that the Dealer Member has carefully considered their responses to the questions in Schedule G.)</i></p> |
| <p>Supervisors</p>                    | <p>Relevant and meaningful information regarding a Designated Supervisor’s responsibilities and authority in managing the day-to-day activities of employees and Approved Persons of the Dealer Member is not being provided in some cases. As a result, IIROC is unable to determine if appropriate IIROC approval is being sought and whether applicable proficiencies have been met.</p> <p><u>Filing Requirements</u></p> <p><i>Dealers Members should clearly describe the supervisory responsibilities, authority and functions assigned to the Designated Supervisor. Including the rule reference under which the individual has been designated specific supervisory functions (i.e. designated to be responsible for the opening of new accounts under Rule 1300.2) is encouraged.</i></p>   |

**Use of Other Names (Form 33-109F4 – Item 1.3)**

|  |   |
|--|---|
| <p>Failure to complete disclosure of other names</p> | <p>There continues to be confusion as to when an update is required under item 1.3. Disclosures or changes to this information are not being filed as required or on a timely basis.</p> <p><u>Filing Requirements</u></p> <p><i>Dealer Members should familiarize themselves with the required disclosures in this area and also refer to item 10 of Form 33-109F4 to determine if an update to item 1.3 is triggered and/or if information has changed that warrants an update in this area. For example, if an Approved Person has their own incorporated business, disclosure should be made in item 1.3 in addition to</i></p> |
|--|---|



| <b>Use of Other Names (Form 33-109F4 – Item 1.3)</b>   |   |
|--|---|
|  | item 10.  |
| <b>Individual Categories (Form 33-109F4 - Item 6, Schedule C)</b>  |   |
| Unclear and/or inconsistent individual categories for registration, IIROC approval or review as a “permitted individual” | <p>There continues to be applications filed for registration and/or IIROC approval where categories are unclear or inconsistent, particularly in the selection of the “permitted individual”, “Executive” and “Supervisor” categories.</p> <p>Some firms continue to select a product type under Item 6 for individuals who are registering as Supervisor only. Supervisors do not have trading category or customer type, therefore only the category of “Supervisor” should be selected under the IIROC category type.</p> <p><u>Filing Requirements</u></p> <p><i>Dealer Members should refer to National Instrument 31-103, National Instrument 33-109, IIROC Notice 09-0307 and Parts 1-3 of the Guide to IIROC Categories before filing an application to ensure that appropriate registration and IIROC approval category selections are made.</i></p> |

| <b>Current Employment – (Form 33-109F4 – Item 10, Schedule G)</b> |   |
|---|---|
| Description of duties and responsibilities                        | <p>Duties and/or responsibilities are frequently omitted. Simply indicating the registration category is not sufficiently descriptive.</p> <p><u>Filing Requirements</u></p> <p>A description of the duties of the individual is beneficial rather than simply disclosing the registration category as various activities may be conducted under a registration category.</p> |

| <b>Civil Disclosure (Form 33-109F4 – Item 15)</b> |  |
|---|--|
| Late or incomplete civil disclosures              | <p>Disclosure and/or updates to civil matters are not being provided to IIROC within the filing deadlines prescribed in section 4.1(1)(b) of NI 33-1009. There also continues to be confusion as to when an update is required, resulting in disclosures not being filed and/or not being filed on a timely basis.</p> <p><u>Filing Requirements</u></p> <p><i>Item 15 requires disclosure of any current or successful civil claim alleging fraud, theft, deceit, misrepresentation or similar misconduct against you, as an individual, or a firm where you are or were a partner, director, officer or major shareholder in any province, territory, state or country. Dealer Members must notify IIROC, on behalf of their Approved Persons, of any new civil matters or changes to information already filed, relating to this item, within the prescribed timelines. In this context, Dealer Members should also be considering whether any client complaints that evolve into a civil action, wherein fraud, theft, deceit, misrepresentation or similar misconduct against was alleged, requires disclosure. Where there is an overlap between ComSet reportable items and reportable items to the Registration Department, to satisfy this obligation, the reportable items must be reported through both ComSet and NRD, as the filing</i></p> |



|  |  |
|--|--|
| <b>Civil Disclosure (Form 33-109F4 – Item 15)</b>                            |  |
|  | <i>of the civil matter through ComSet does not exempt the Dealer Member from providing this disclosure through NRD where applicable.</i>   |
| <b>Changes to Registered Individual and Permitted Individual Information</b> |  |
| Material Changes   | <p>Disclosure of material changes and the supporting documentation with respect to the change is not being provided to IIROC within the filing deadlines prescribed in section 4 of NI 33-109.</p> <p><u>Filing Requirements</u></p> <p><i>Provide details of all changes to the information previously submitted in an individual's Form 33-109F4 by submitting a Form 33-109F5 in accordance with Section 4.1 of NI 33-109. An Approved Person must notify IIROC of changes to information previously submitted in a Form 33-109F4 (Registration of Individuals and Review of Permitted Individuals), within 30 days for a change in items 4 (Citizenship) and 11 (Previous employment), and within 10 days of any other changes. To meet the filing requirements, in addition to periodic attestations regarding material changes, firms should require registered or permitted individuals to notify them in the event of a material change to his or her Form 33-109F4 and frequently remind them of this requirement.</i></p>  |
| <b>Exemption Requests from Proficiency Requirements</b>                      |  |
| Proficiency Exemptions   | <p>In some cases, firms are failing to provide sufficient information regarding the exemption sought, or in the alternative, the analysis that the firm conducted regarding the exemption request. As a result, IIROC is unable to evaluate the exemption request and determine if granting the relief is appropriate. Often the information provided simply lists the courses the individual has completed, as well as his/her employment experience (i.e. their resume). This information does not explain how it supports the exemption request or demonstrates equivalency. IIROC Registration's role is to evaluate the submission and make a recommendation to the applicable District Council. IIROC Registration staff cannot advocate on behalf of the firm/applicant. The onus is, therefore, on the firm/applicant to clearly state the basis for the exemption, by demonstrating equivalency through experience and/or alternative education.</p> <p><u>Suggested Practice</u></p> <p><i>If the exemption request is based on other courses the individual has taken, the request should provide a comparative analysis of the topics and information covered in those courses with the topics and information covered in the course for which exemptive relief is sought (e.g. CSC vs. CFA). If the exemption request is based on the individual's relevant experience, the request should provide details of what that experience is/was equivalent to the educational content of the course for which exemptive relief is sought. The exemption should demonstrate that the individual has the required competencies through his/her practical experience. It is expected that the Dealer Member review the individual's work experience to meet the requirements under section 5.1(1) of NI 33-109 to make reasonable efforts to ensure the truthfulness and completeness of registration information.</i></p> |



#### **4.11.2. Notices of Termination of Registered Individuals and Permitted Individuals – Form 33-109F1**

We have noted the following common deficiencies with respect to the filing of Notices of Termination:

| <b>Termination of Employment, Partnership or Agency Relationship</b> |  |
|--|--|
| Notice of Termination  | <p>The reasons for the cessation/termination are not always clearly provided. To the extent that any of the 9 sub-items requiring a “yes” or “no” response listed in Item 5 on Form 33-109F1 form the basis for the termination, this should be made clear in the disclosures (i.e. in addition to checking the “yes” or “no” boxes).</p> <p><u>Filing Requirements</u></p> <p><i>Dealer Members should provide enough information to clearly describe the reason an individual is no longer with the firm, as well as ensure that all ‘yes’ responses to the questions contain sufficient detail for IIROC to understand exactly what occurred (i.e. if a ComSet event has been referenced, details must be provided). Dealer Members can refer to ‘How to complete a Notice of Termination’ in the NRD User Guide found at <a href="http://www.nrd-info.ca">www.nrd-info.ca</a>.</i></p> |

#### **4.11.3. Ownership Changes and Other Dealer Member Filing Requirements**

IIROC Registration is involved in the review of filings made in connection with approvals sought from District Councils under IIROC Dealer Member Rules 5.4 (proposed ownership changes) and 6.3 (affiliated and related companies). We have outlined below some common deficiencies associated with the filings we receive, together with some suggested practices that will help to facilitate our reviews and minimize delays.

| <b>Changes in Dealer Member Ownership</b> |   |
|---|---|
| Rule 5.4                                  | <p>Under IIROC Rule 5.4, Dealer Members must seek District Council approval of any transaction that permits an investor, alone or together with its associates and affiliates, to own a significant equity interest in the Dealer Member or to own special warrants or any other securities that are convertible, at any time in the future, to a significant equity interest in the Dealer Member. “Significant equity interest” is defined in IIROC Rule 5.4(2) as 10% or more of the voting or outstanding participating securities or 10% or more of the total equity of the Dealer Member or the Dealer Member’s holding company.</p> <p>Dealer Members requesting the approval of District Council under IIROC rule 5.4 are required to be filed no less than 20 days in advance of the transaction so that we have sufficient time to review the transaction and any Investor Application Forms, as applicable (see also Member Regulation Notice MR0308 dated September 14, 2004 – <i>Investor Notification and Approval Process</i>). IIROC’s recommendation to District Council is dependent upon an assessment of whether the transaction is:</p> <ul style="list-style-type: none"> <li>a) likely to give rise to conflicts of interest,</li> <li>b) likely to hinder the Dealer Member in complying with IIROC rules and securities</li> </ul> |





## Changes in Dealer Member Ownership

legislation,

- c) inconsistent with an adequate level of investor protection, or
- d) otherwise prejudicial to the public interest.

IIROC often finds that these requests for approval do not provide enough information to allow us to make a proper assessment of the proposed transaction, which may result in delays before a recommendation is finalized. Dealer Members must also consider in any such transaction whether a “permitted individual” filing is required under NI 33-109 and/or whether a written notice must be filed with the applicable securities regulatory authority under sections 11.9 and/or 11.10 of National Instrument 31-103.

### Suggested Practice

*The following are suggested practices to prepare IIROC Rule 5.4 requests for approval. Readers should note that the relevancy of each of these suggested practices will depend on the type of transaction and/or the case specific facts.*

1. *Explain the business reasons for the transaction, in detail.*
2. *Provide details concerning the Dealer Member’s operations and business plan, in the event the transaction closes. The information regarding any changes to business operations should include details required in Item 3.1 of the Form 33-109F6 Firm Registration (i.e. primary business activities, target market, and the products and services the Dealer Member provides to clients).*
3. *Provide details regarding the entities involved in the transaction, including the description of the business, corporate address, full legal name of officers, directors and investors – including their dates of birth, any other names they may be “known as” and their residential addresses for the past five years.*
4. *Provide details regarding changes to the Ultimate Designated Person (UDP), the Chief Compliance Officer (CCO), key management, directors, officers, permitted individuals and Approved Persons that may flow from the proposed transaction. If no personnel changes are contemplated, confirm this is the case.*
5. *Provide details of the Dealer Member’s policies and procedures that are in place to address conflicts of interest that may arise as a result of the transaction.*
6. *If there is a potential conflict of interest arising from the transaction, explain how this conflict of interest would be addressed.*
7. *Confirm whether the parties to the transaction have adequate resources to ensure compliance with all applicable conditions of registration and provide details supporting this conclusion.*
8. *Provide details as to whether directors, officers, partners and Approved Persons of the Dealer, if applicable, will be in compliance with section 4.1 of NI 31-103 (restrictions on acting for another registered firm) and whether any cross registrations arise from the transaction.*
9. *Provide details of all client communications that have occurred or are planned. If the Dealer does not propose to communicate with clients about the transaction, confirm that fact and explain the basis for that decision.*
10. *Provide a copy of the draft press release announcing the transaction. If the Dealer*



| <b>Changes in Dealer Member Ownership</b> |   |
|---|---|
|   | <p><i>Member does not plan on issuing a press release, confirm that fact and explain the basis for that decision.</i></p> <p>11. <i>Confirm the proposed closing date.</i></p> <p>12. <i>Provide detailed pre/post transaction corporate organization charts that include all affiliated companies and subsidiaries of the Dealer Member. The charts provided must identify all companies or affiliates which are registered under provincial/territorial/foreign securities and commodity futures legislation and specify their category of registration. Any other related entities operating in the financial services sector must also be identified.</i></p> <p>13. <i>If any individuals identified on the corporate organization charts hold an interest in a company, partnership or trust, confirm whether such holdings are held directly or through a holding company, trust or other entity (a “Holdco”) and provide details of these holdings. If ownership his held through a Holdco, provide the name of the Holdco and details regarding its ownership structure.</i></p> |

| <b>Related Companies</b> |   |
|--------------------------|---|
| Rule 6.3                 | <p>Under IIROC Rule 6.3, no Dealer Member or partner, director, officer, investor or employee of a Dealer Member shall form, maintain or have any interest in a related company or associate without the prior approval of the applicable District Council. The term “Related company” is defined in IIROC Rule 1, while the term “associate” is defined in section 1.1 of IIROC By-Law No. 1.</p> <p>Requests for District Council approval under IIROC Rule 6.3, must be filed no less than 20 days in advance of the transaction, so that IIROC has enough time to review the transaction. IIROC’s recommendation to District Council will depend on whether the transaction is:</p> <ul style="list-style-type: none"> <li>a) likely to give rise to conflicts of interest,</li> <li>b) likely to hinder the Dealer Member in complying with IIROC rules and securities legislation,</li> <li>c) inconsistent with an adequate level of investor protection, or</li> <li>d) otherwise prejudicial to the public interest.</li> </ul> <p>We often find that Dealer Members’ requests for these types of approval do not provide IIROC with sufficient information to properly assess the transaction, which may result in the final recommendation being delayed. From time to time, information requested from Dealer Members or their filing counsel is not provided on a timely basis. Failure to file the requested information on a timely basis impacts IIROC’s ability to complete their review of the transaction and may result in IIROC being unable to respond to the applicant on a timely basis.</p> <p><u><i>Suggested Practice</i></u></p> <p><i>A Dealer Member seeking Rule 6.3 approval should address the suggested practices noted above, as applicable.</i></p> |



## **5. Conclusion**

IIROC's ongoing efforts to strengthen the culture of compliance among Dealer Members, set high standards of conduct and strengthen market integrity benefit the Canadian capital markets and its stakeholders. We will continue to proactively oversee and regulate IIROC Dealer Members to protect investors and promote fair, efficient and competitive capital markets. We will continue to monitor update and enhance our compliance examination programs to reflect changes in market structure, business risks, investment products, demographics and corporate priorities. We will also continue to focus on and take action against Dealer Members that fail to address significant compliance findings and/or demonstrate a commitment to the development of a strong compliance culture.

In recognition of the diversity of IIROC Dealer Members and that there are different ways in which Dealer Members can implement an effective compliance, supervision and risk management framework, IIROC will continue to consult with its Dealer Members, investors, and other stakeholders on emerging policy issues and best practices. This Report, together with IIROC's body of guidance notes, day-to-day contact IIROC regulatory teams have with Dealer Member staff, and annual compliance conferences, are intended to help Dealer Members better understand and ensure they comply with IIROC's requirements.