

IIROC NOTICE

Rules Notice

Request for Comments

IIROC Rules

Comments Due By: February 19, 2020

Please distribute internally to:

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

Contact:

Richard J. Corner
Vice President and Chief Policy Advisor, Member Regulation
416-943-6908
rcorner@iiroc.ca

Phil Devault
Senior Counsel Derivatives Regulation
514-392-3412
pdevault@iiroc.ca

19-0200

November 21, 2019

Proposed Derivatives Rule Modernization, Stage 1

Background and introduction

Following the publication for comments by the Canadian Securities Administrators (**CSA**) of proposed National Instrument 93-101 – *Derivatives: Business Conduct (NI 93-101)* and National Instrument 93-102 – *Derivatives: Registration (NI 93-102)*, IIROC performed a complete review of all its Dealer Member related rules (**IIROC Rules**) to determine:

- IIROC and CSA rule inconsistencies that would be created should proposed NI 93-101 and NI 93-102 be adopted;
- areas where the derivatives-related scope of application of the IIROC Rules is either unclear or too narrow and that could benefit from rule scope clarification amendments;
- areas where the derivatives-related IIROC Rules are out of date, taking into consideration recent rule revisions announced by other jurisdictions/bodies, and that could benefit from rule enhancements; and
- areas of inconsistency within the IIROC Rules between the regulation of securities-related activities



and the regulation of derivatives-related activities that are not justified and could benefit from rule amendments to address these inconsistencies.

IIROC has also recently announced the implementation of its plain language rules¹ which has not only resulted in more clearly stated rule requirements but also helped identify inconsistencies in the regulatory treatment of both listed and over-the-counter (**OTC**) derivatives.

The objectives of the proposed amendments arising from IIROC's Derivatives Rule Modernization project are to:

- ensure our rules continue to be materially harmonized with the equivalent CSA requirements as they apply to securities and derivatives;
- more clearly specify which of the core regulatory obligations apply to securities, listed derivatives and OTC derivatives; and
- eliminate inconsistencies in the regulatory treatment of securities, listed derivatives and OTC derivatives, where justified.

Due to the extent and the nature of these proposed amendments we are publishing them for public comment in two separate stages as follows:

- **Stage 1**, this set of amendments, includes all amendments we propose to make other than those relating to margin requirements; and
- **Stage 2** will include the amendments we propose to make to the margin requirements.

Within Stage 1 we are proposing to:

- expand, where appropriate, the scope of the IIROC Rules that apply only to:
 - securities-related activities to also apply to derivatives-related activities;
 - activities involving futures and listed options to also apply to OTC derivatives [including contracts for difference (**CFDs**) and foreign exchange contracts (**Forex**)]; and
- adopt, where appropriate, requirements/standards announced by other jurisdictions/bodies.

Stage 2 will include proposed amendments to current margin requirements in order to adequately constrain leverage and address margin requirements. Stage 2 will be published for public comment at a later date.

Two important considerations/objectives in developing these proposed amendments were that all rule amendments pursued should:

- where possible and appropriate, avoid the creation of new regulatory arbitrage situations and reduce or eliminate existing regulatory arbitrage situations; and
- result in the consistent regulation of all securities-related and derivatives-related activities occurring within a Dealer Member.

¹ IIROC Rules Notice 19-0144 and related notices were issued on August 22, 2019 to announce the implementation of IIROC's plain language rewrite of its Dealer Member Rules.



How to Submit Comments

We request comments on all aspects of the proposed amendments, including in response to the specific questions asked within this notice and on any derivatives-related matter which the proposals do not specifically address. Comments on the proposed amendments should be in writing and delivered by February 19, 2020 (90 days from the publication date of this notice) to:

Phil Devault
Senior Counsel Derivatives Regulation
Investment Industry Regulatory Organization of Canada
Suite 601, 525 Viger Avenue West
Montreal, Quebec, H2Z 0B2
Email: pdevault@iiroc.ca

Comments should also be delivered to:

Market Regulation
Ontario Securities Commission
Suite 1903, Box 55
20 Queen Street West
Toronto, Ontario M5H 3S8
Email: marketregulation@osc.gov.on.ca

Commentators should be aware that a copy of their comment letter will be made publicly available on the IIROC website at www.iiroc.ca. A summary of the comments contained in each submission will also be included in a future IIROC Notice.

Questions may be referred to:

Richard J. Corner
Vice President and Chief Policy Advisor, Member Regulation
416-943-6908
rcorner@iiroc.ca

Phil Devault
Senior Counsel Derivatives Regulation
514-392-3412
pdevault@iiroc.ca



Table of Contents

1.	Summary of proposed amendments	5
1.1	Definitions	5
1.1.1	Types of derivatives	5
1.1.2	Categories of client-facing Approved Persons.....	7
1.1.3	Inclusion of derivatives within the “securities related business” definition.....	8
1.1.4	Inclusion of derivatives legislation within the “securities laws” definition.....	8
1.1.5	Revision of “institutional client” definition	9
1.2	Business Conduct	12
1.2.1	Business continuity plan	12
1.2.2	General business conduct requirements.....	14
1.2.3	Derivatives-specific business conduct	15
1.2.4	Expectations, undertakings and conditions to offer CFDs and Forex.....	16
1.3.	Client disclosure and periodic client reporting	17
1.3.1	Risk disclosure statement.....	17
1.3.2	Pre-transaction compensation disclosure	18
1.3.3	Trade confirmation	18
1.3.4	Revisions to the “market value” definition	19
1.3.5	Monthly account statement.....	19
1.3.6	Enhanced monthly account statement	20
1.4.	Registration and proficiency	22
2.	Text of proposed rule amendments	25
3.	Policy development process	25
3.1	Regulatory purpose.....	25
3.2	Issues and alternatives considered	26
3.3	Comparison with similar provisions.....	26
3.4	Effects of the revised proposed amendments on market structure, Dealer Members, non-members, competition and costs of compliance.....	26
3.5	Development and approval process	26
3.6.	Public interest determination	27
3.7	Proposed implementation dates.....	27
3.8.	Classification of amendments and filing in other jurisdictions.....	27



1. Summary of proposed amendments

1.1 Definitions

1.1.1 Types of derivatives

The IIROC Rules include a general definition for the term “*derivative*” and specific definitions for the terms “*futures contract*”, “*futures contract option*” and “*option*” as follows:

Current terms	Current definitions
derivative	A financial instrument whose value is derived from, and reflects changes in, the price of the underlying product. It is designed to facilitate the transfer and isolation of risk and may be used for both risk transference and investment purposes. ²
futures contract	A contract to make or take delivery of the underlying interest during a designated future month on terms agreed to when the contract is entered on a commodity futures exchange. ³
futures contract option	A right to acquire a long or short position in connection with a futures contract on terms agreed to at the time the option is granted and any option that has a futures contract as its underlying interest. ⁴
option	A derivative contract that: (i) gives the purchaser the right, but not the obligation, to buy or sell an underlying asset at a certain price (exercise price) on or before an agreed upon date, and (ii) imposes on the seller an obligation, if called upon by the purchaser, to buy in the case of puts, or sell in the case of calls, at the exercise price. ⁵

We have reviewed these definitions in order to determine whether their collective scope needs to be expanded or additional definitions need to be introduced. We have also compared these definitions to those used in provincial securities, derivatives and commodity futures legislation.

We believe the scope of IIROC’s derivatives-related definitions should no longer be restricted to futures contracts, futures contract options and options. Instead, the use of a broader-scope general definition approach, through detailing the general features of a derivative rather than defining specific types of derivatives, is preferred. The use of this approach would ensure that each general defined term’s meaning could

² IIROC Rule subsection 1201(2).

³ Ibid.

⁴ Ibid.

⁵ Ibid.



continue to evolve without needing to make periodic wording revisions and would not become outdated as new derivative products are introduced.

To avoid confusion and differing interpretation, we also believe that IIROC's derivatives-related definitions should be harmonized as much as possible with the definitions set out in provincial securities, derivatives and commodity futures legislation.

Because certain proposed requirements are different for listed and OTC derivatives, we believe the definitions should differentiate between these two categories of derivatives.

To achieve these results, we are proposing that IIROC:

- repeal and replace the current definition of the term "*derivative*" with a more principles-based definition;
- repeal the current definitions of the terms "*futures contract*", "*futures contract option*" and "*option*"; and
- enact definitions for the terms "*listed derivative*" and "*over-the-counter derivative*".

The following table sets out our proposed revised definitions:

Proposed terms	Proposed definitions
derivative	An option, swap, futures contract, forward contract, contract for difference or any other financial or commodity contract or instrument whose market price, value, delivery obligations, payment obligations or settlement obligations are derived from, referenced to or based on an underlying interest, including a value, price, rate, variable, index, event, probability or thing. ⁶
listed derivative	A <i>derivative</i> that is traded on a <i>marketplace</i> pursuant to standardized terms and conditions set out by that <i>marketplace</i> and whose trades are cleared and settled by a clearing agency. ⁷
over-the-counter derivative	Any <i>derivative</i> other than a <i>listed derivative</i> . ⁸

⁶ IIROC Rule subsection 1201(2).

⁷ Ibid.

⁸ Ibid.



1.1.2 Categories of client-facing Approved Persons

The IIROC Rules include definitions for specific categories of client-facing Approved Persons as follows:

Current terms	Current definitions
Portfolio Manager	An <i>individual</i> designated by the <i>Dealer Member</i> and approved by IIROC to provide discretionary portfolio management for <i>managed accounts</i> . ⁹
Associate Portfolio Manager	An <i>individual</i> designated by the <i>Dealer Member</i> and approved by IIROC to provide discretionary portfolio management for <i>managed accounts</i> under the supervision of a <i>Portfolio Manager</i> . ¹⁰
Registered Representative	An <i>individual</i> , approved by IIROC, to trade, or advise on trades, in securities, <i>options</i> , <i>futures contracts</i> , or <i>futures contract options</i> with the public in Canada, on the <i>Dealer Member's</i> behalf, including where that <i>individual</i> deals only in mutual funds or only with <i>institutional clients</i> . ¹¹
Investment Representative	An <i>individual</i> , approved by IIROC, to trade in, but not advise on, securities, <i>options</i> , <i>futures contracts</i> or <i>futures contract options</i> , on the <i>Dealer Member's</i> behalf, including where that <i>individual</i> deals only in mutual funds. ¹²

The definitions for the terms “*Registered Representative*” and “*Investment Representative*” limit the scope of derivatives that these individuals may trade in or advise on to futures contracts, futures contract options and options.

Given the proposed revised definitions discussed in section 1.1.1 of this notice, we are proposing that IIROC amend the “*Registered Representative*” and “*Investment Representative*” terms by replacing the text “*securities, options, futures contracts, or futures contract options*” with the text “*securities or derivatives*” within each definition.

⁹ IIROC Rule subsection 1201(2).

¹⁰ Ibid.

¹¹ Ibid.

¹² Ibid.



1.1.3 Inclusion of derivatives within the “securities related business” definition

The IROC Rules include definitions for the terms “*Dealer Member*”, “*Dealer Member related activities*” and “*Securities Related Business*” as follows:

Current terms	Current definitions
Dealer Member	A Member that is an investment dealer in accordance with securities legislation. ¹³
Dealer Member related activities	Acting as a <i>Dealer Member</i> , or carrying on business that is necessary or incidental to being a <i>Dealer Member</i> . The <i>Board</i> may include or exclude any activities from this definition. ¹⁴
securities related business	Any business or activity (whether or not carried on for gain) engaged in, directly or indirectly, which constitutes trading or advising in securities or exchange contracts (including <i>futures contracts</i> and <i>futures contract options</i>) for the purposes of <i>securities laws</i> , including for greater certainty, sales pursuant to exemptions under <i>securities laws</i> . ¹⁵

Given the term “*securities related business*” is intended to only be used in the context of principal / agent relationships and the proposed revised definitions discussed in section 1.1.1 of this notice, we are proposing that IROC amend the “*securities related business*” term by:

- renaming it “*agent related activities*”
- replacing the text “*securities or exchange contracts (including futures contracts and futures contract options)*” with the text “*securities or derivatives*”.

1.1.4 Inclusion of derivatives legislation within the “securities laws” definition

The IROC Rules include a definition for the term “*securities laws*” as follows:

Current term	Current definition
securities laws	Any laws about trading, distributing, advising or any other related activities in securities, <i>futures contracts</i> , <i>futures contract options</i> or <i>derivatives</i> in Canada enacted by the government of Canada or any province or territory in Canada and all regulations, rules, orders, judgments and other regulatory directions relating to such laws. ¹⁶

¹³ IROC Rule subsection 1201(2) and General By-Law No. 1, Section 1.1.

¹⁴ IROC Rule subsection 1201(2).

¹⁵ Ibid.

¹⁶ Ibid.



We are proposing that IIROC amend the “securities laws” term by:

- replacing the text “securities, *futures contracts, futures contract options or derivatives*” with the text “securities or *derivatives*” within the definition.

1.1.5 Revision of “institutional client” definition

Generally, the IIROC Rules allow only non-individuals of a certain size or with a certain amount of financial assets under administration to qualify as a sophisticated client (“institutional client”). All other clients, both individual and non-individual, are considered unsophisticated (“retail client”). One of the drawbacks of this approach is that all individual clients are considered unsophisticated, irrespective of their level of investment knowledge and the amount of financial assets they have under administration.

In comparison:

- National Instrument 31-103, *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, allows both non-individuals and individuals to qualify as a sophisticated client (“permitted client”) but requires that to qualify:
 - a non-individual client be a regulated financial institution, dealer or advisor or have at least \$25 million in net assets
 - an individual client have at least \$5 million in financial assets
- Proposed NI 93-101 and NI 93-102 allow both non-individuals and individuals to qualify as a sophisticated client (“eligible derivatives party”) but requires that to qualify:
 - a non-individual client:
 - be a regulated financial institution, dealer or advisor or have at least \$25 million in net assets
 - OR
 - represent that it is a specified commercial hedger and has at least \$10 million in net assets
 - OR
 - has all of its derivatives contract obligations guaranteed by one or more eligible derivatives parties that is not an individual or commercial hedger
- an individual client have at least \$5 million in financial assets.

We believe it would be beneficial for market participants for IIROC to reduce the gap between the definitions used to identify sophisticated clients by conforming as much as possible the definitions used to assess client sophistication for all securities and derivatives business lines. To achieve this result within revised “institutional client”



and “retail client”¹⁷ definitions, we are proposing that within the “institutional client” definition that IIROC:

- retain the approach of using a minimum threshold amount of assets under administration as a proxy for client sophistication
- extend this “assets under administration” approach to individual clients, subject to certain conditions
- introduce a hedger concept whereby non-individuals engaging in qualifying hedging activities can be classified as an institutional client for those accounts with qualifying hedging activities and hedge positions.

The following table sets out our proposed revised definitions:

Proposed term	Proposed definition
Institutional client	(i) an <i>acceptable counterparty</i> , (ii) an <i>acceptable institution</i> , (iii) a <i>regulated entity</i> , (iv) a registrant under <i>securities law</i> , other than an <i>individual registrant</i> , or (v) a <i>non-individual</i> with total securities <u>and precious metals bullion</u> under administration or management of more than <u>exceeding</u> \$10 million ; <u>(vi) an individual with total securities and precious metals bullion under administration or management exceeding \$10 million who requests and consents to being classified as an institutional client, or</u> <u>(vii) a hedger who requests and consents to being classified as an institutional client for accounts with qualifying hedging activities and hedge positions.</u> ¹⁸
hedger	<u>A non-individual that:</u> (i) <u>is exposed to one or more risks as a necessary part of its activities,</u> (ii) <u>seeks to hedge each risk by engaging in a securities or derivatives transactions where:</u> (a) <u>the underlying interest for the transactions is the same as or materially related to the underlying interest for the risk,</u> (b) <u>the intended effect of the transactions is to:</u> (i) <u>eliminate or reduce the risk related to fluctuations in the market value of the underlying interest or position being hedged, or</u>

¹⁷ Within IIROC Rule subsection 1201(2), a “retail client” is defined to be “A client that is not an institutional client”. As a result, revisions made to expand the scope of clients that can qualify as an “institutional client” will narrow the scope of clients that are classified as a “retail client”.

¹⁸ IIROC Rule subsection 1201(2).



	<p><u>(II) substitute the risk associated with one currency for the risk associated with another currency, provided the aggregate amount of currency risk to which the hedger is exposed is not increased by the substitution,</u></p> <p><u>(c) the positions resulting from the transactions have a high degree of negative correlation with the underlying interest or position being hedged, and</u></p> <p><u>(d) there are reasonable grounds to believe that the market value changes in the positions resulting from the transactions will completely or materially offset market value changes in the underlying interest or position being hedged.</u>¹⁹</p>
--	---

The proposed guidance note found in Attachment A presents our views on how the “*hedger*” definition should be applied and interpreted and further outlines our expectations and the requirements applicable to all Dealer Members when classifying a hedger as an “*institutional client*”.

We believe these amendments would result in a reduction of the gap between the institutional client definitions used by IIROC and the CSA. This result was determined to be preferable over adopting different IIROC institutional client definitions for securities-related and derivatives-related activities, which would have in essence introduced a regulatory arbitrage situation between Dealer Members’ securities-related and derivatives-related business lines.

Question #1

We have included individuals in the proposed definition of *institutional client*. We have done so on the basis that individuals and non-individuals that meet the same conditions should be treated as equally sophisticated under our rules, provided that the individuals request and consent to waiving their retail client protections. Do you agree that we should allow certain qualifying individuals to be able to request and consent to being classified as institutional clients?

Question #2

We have included *hedgers* in the proposed definition of *institutional client* and have not:

- limited qualifying hedging activities to those involving OTC derivatives; or
- required that the hedger meet a minimum financial assets threshold.

We have done so on the basis that:

- our rules recognize numerous qualifying hedges that do not involve OTC derivatives; and

¹⁹ Ibid.



- sophisticated hedging activities are commonly undertaken by clients with limited financial resources.

Do you agree that IIROC should include a *hedger* category within its *institutional client* definition and that this category include all hedging activities rather than hedging activities involving OTC derivatives?

Do you agree that meeting a minimum financial assets threshold is unnecessary to qualify as a *hedger*? If you don't agree, at what level should IIROC set a minimum financial assets threshold for hedgers?

Question #3

Is the concept of hedger well defined? How could the definition of hedger be improved?

1.2 Business Conduct

1.2.1 Business continuity plan

The IIROC Rules require that Dealer Members establish and maintain a business continuity plan that identifies the procedures it will take to deal with a significant business disruption.²⁰

Similarly, the CSA have published proposals regarding OTC derivatives activities, which would require the establishment, maintenance and application of a written business continuity and disaster recovery plan that is reasonably designed to minimize disruption and allow a firm to continue its business operations.²¹

IIROC has recently proposed to mandate that we be notified and provided with specific information at certain points in time when a cybersecurity incident occurs.²² IIROC has no other current or proposed requirements that would mandate we be notified when any other type of business disruption occurs.

Regarding the offering of OTC derivatives to retail clients, the Quebec Derivatives Regulation requires that the Autorité des Marchés Financiers be notified if there are any material system failures that would affect trading.²³ We believe this requirement is reasonable given there is no other market for these transactions and retail clients can only close-out or offset their positions when they have access to the trading systems of the derivatives issuer and the systems are functioning properly.

Like when cybersecurity incidents and, in Quebec, OTC derivative trading system access denials occur, we believe IIROC should be informed of any firm significant

²⁰ IIROC Rule sections 4710 through 4716.

²¹ Section 43 of proposed NI 93-102.

²² IIROC Rules Notice 18-0063, March 22, 2018.

²³ Quebec Derivatives Regulation, s. 11.31.



business disruption situation and are proposing new IROC Rule sections 4710 and 4716 in order to:

- clarify that where there is impairment in client access to their derivatives or securities positions/accounts or to the client’s ability to liquidate or close-out their account positions, this would be considered to be a significant business disruption; and
- specify that the Dealer Member’s business continuity plan must be invoked and IROC must be notified when any significant business disruption occurs.

We have not specified within the proposed amendments the minimum duration and severity of an impairment that would result in it being considered to be “significant impairment”, nor have we specified the exact steps a firm must take when a significant impairment has occurred. This is because:

- assessing the severity of the impairment is very incident-specific and highly dependent on the potential for investor harm; and
- there are not always practical options available to the Dealer Member to mitigate the impairment.

To provide further clarity on what would be considered to be a “significant impairment in the client’s access to their account positions or their ability to liquidate or close-out their positions” we plan on issuing guidance setting out important considerations in determining when a “significant impairment” has occurred that requires that the firm’s BCP to be invoked.

Question #4

We have not narrowed the scope of the proposed business continuity plan requirement amendments to only apply to significant client access or liquidation impairments involving derivatives as we believe that significant impairments can occur when any type of investment product is involved. We do, however, recognize that the nature of the impairments and the dealer’s ability to resolve the impairment can vary.

To address this variability we plan to issue guidance to assist dealers in determining when their business continuity plan must be invoked in response to a significant client access or liquidation impairment. What considerations do you think this guidance should itemize in determining when a dealer should invoke their business continuity plan?



1.2.2 General business conduct requirements

The sales conduct requirements within the current IIROC Rules generally either:

- apply to securities and exchanged-traded options and futures, or
- exclusively apply to the offering of securities, or
- impose specific derivatives-related requirements that distinguish between the offering of futures contracts and listed futures contract options and options.

Given the proposed revised definitions discussed in section 1.1.1 of this notice and our objective to expand, where appropriate, the current application of:

- securities-related rules to cover both the offering of securities and derivatives
- derivatives-specific rules to cover the offering of all derivatives

we have reviewed the current sales conduct requirements to determine which ones should apply to all derivatives, listed derivatives and OTC derivatives transactions, positions and accounts. As part of this review, we have considered all of the current sales conduct requirements applicable to Dealer Members.

We are proposing that the scope of application of the current IIROC general sales conduct requirements be broadened, where appropriate, to apply to all derivatives transactions, positions and accounts. To achieve this result, we are proposing that IIROC amend:

- IIROC Rule section 2602 to require that the Dealer Member ensures that its client-facing Approved Persons understand the structure, features and risks of each derivative and security they recommend
- IIROC Rule 3100, Part C to:
 - require that the best execution obligation applies to all security and derivative orders and transactions
 - include specific:
 - best execution considerations for listed derivatives
 - fair pricing considerations for OTC derivatives.
- IIROC Rule section 3402 to require that the retail client suitability assessment obligation applies to all securities and derivatives account offerings
- IIROC Rule section 3403 to require that the institutional client suitability assessment obligation applies to all securities and derivatives account offerings
- IIROC Rule subsection 3404(1) to clarify that the exclusion of the order execution only account service offering from the suitability obligation is conditional on the firm providing no security or derivative recommendations
- IIROC Rule section 3503 to require that the client priority rule applies to all securities and derivatives orders and transactions



- IIROC Rule section 3703 to require that civil claims or arbitration notices relating to derivatives be reportable to IIROC
- IIROC Rule section 3728 to require that complaints relating to derivatives be documented in the same manner as securities-related complaints

1.2.3 Derivatives-specific business conduct

We are proposing that the scope of application of the current IIROC Rule derivatives-specific business conduct requirements be broadened, where appropriate, to apply to all derivatives transactions, positions and accounts. To achieve this result, we are proposing that IIROC amend IIROC Rule 3200 – Client Accounts – Part F – *Additional Account Opening Requirements for Options, Futures Contract and Futures Contract Options Trading* to require:

- that a Dealer Member must enter into a trading agreement (or where permissible, undertakings in lieu of a trading agreement) with the client before the client's initial trade when offering any type of derivative
- the completion of an account application and the execution of an account agreement before the client's initial trade when offering any type of derivative
- the Dealer Member to comply with the applicable rules of any exchange or clearing agency when transacting in any listed derivatives

We are also proposing that IIROC amend IIROC Rule 3900 – Supervision – Part F – *Supervision of options, futures contracts and futures contract option trading account* to:

- require that a Dealer Member designate a supervisor qualified in the relevant category to be responsible for approving customer account opening and establishing and maintaining acceptable procedures for any type of derivative account offering
- require that a Dealer Member must have systems and procedures in place to prohibit trading in any type of derivative until a trading agreement has been executed with the client
- itemize mandatory supervisor account approval considerations for all types of derivative offerings and to require account approval before the client's initial trade
- require the establishment of a risk limit (i.e. cumulative loss limit) for any type of derivative account offering other than a hedging account
- require the Dealer Member to have policies and procedures in place to provide clients with access to qualified front-line Approved Persons for all derivatives and securities account offerings
- require the establishment and maintenance of additional written policies and procedures to address issues specific to options, futures and other common types of derivatives



- require the Dealer Member to have policies and procedure in place to ensure, when applicable, the reporting of OTC derivatives data in accordance with securities laws
- require the Dealer Member to perform trading supervisory reviews to detect improper or suspicious trading activity for all derivatives transactions

1.2.4 Expectations, undertakings and conditions to offer CFDs and Forex

We are also proposing that all current IIROC and Ontario Securities Commission expectations and conditions relating to the offering of CFDs to retail clients be codified as IIROC requirements that apply to a broader range of retail client highly-leveraged securities or derivative transactions, positions and accounts.²⁴ To achieve this result, we are proposing that IIROC enact:

- additional Dealer Member account opening procedures for all derivatives account offerings to restrict the derivative trading of insiders, which would include:
 - requiring all prospective clients to disclose whether they are insiders
 - informing insiders that they are prohibited from trading derivatives with such underlying security
 - requiring clients to acknowledge that they are required to update the Dealer Member of any changes to their insider status
 - requiring the monitoring of insider accounts to ensure such prohibition is enforced
- additional Dealer Member account opening procedures for all highly-leveraged and complex derivatives product/account offerings to require a documented assessment of the depth of investment knowledge and trading experience of a potential client before an account is approved to be opened
- OTC derivative product design restrictions that prohibit the offering of OTC derivatives to retail clients that confer the right or obligation to acquire or deliver the underlying security or instrument or confer any other rights of shareholders of the underlying security or instrument, such as voting rights
- a requirement that all new highly leveraged and complex product/account offerings to retail clients and changes to existing product/account offerings to retail clients (including proposed new underlying asset classes such as cryptocurrencies) must be approved in advance by IIROC.²⁵

²⁴ Investment Dealers Association of Canada, *Regulatory Analysis of Contracts for Differences (CFDs)*, June 6, 2007; OSC Staff Notice 91-702 - *Offering of Contracts for Difference and Foreign Exchange Contracts to Investors in Ontario*.

²⁵ This requirement is already applicable in Quebec for OTC derivatives pursuant to QDA sections 82 and 83; see also recent prospectus reliefs granted to BBS Securities Inc., (2018), 41 OSCB 1137; Interactive Brokers Canada Inc., (2018), 41 OSCB 6824; CMC Markets Canada Inc., (2019), 42 OSCB 767; Oanda (Canada) Corporation ULC, (2019), 42 OSCB 4017; Friedberg Mercantile Group Ltd., (2019), 42 OSCB 6906.



1.3. Client disclosure and periodic client reporting

1.3.1 Risk disclosure statement

IIROC's current derivatives risk disclosure requirements specify that:

- clients must be provided with a risk disclosure statement in advance of trading in futures contracts, futures contract options and option contracts
- the risk disclosure statement provided must be approved by IIROC.

In 1998, a consolidated options and futures risk disclosure document was introduced by IIROC, which replaced the need to provide separate risk disclosures to futures and options clients.²⁶

Of note, even though these requirements don't technically apply to OTC derivative offerings, IIROC ensured that they do apply by obtaining undertakings from those Dealer Members who in 2009 began offering OTC derivatives to retail clients, such as CFDs and Forex. However, the disclosures provided by these CFD and Forex firms do not necessarily include a discussion of the incremental risks associated with transacting in OTC derivatives.

We believe that IIROC's consolidated derivatives risk disclosure statement should be updated to include risk disclosures specific to OTC derivatives. In doing so, the concept of one risk disclosure document for all types of derivatives should be retained to ensure continued streamlined disclosure. To achieve this result, we are proposing that IIROC:

- replace the current risk disclosure statement with the one set out in Attachment B²⁷
- enact a requirement to disclose the percentage of accounts that were profitable for clients for each of the four most recent quarters for a Dealer Member offering OTC derivatives to retail clients²⁸

²⁶ Investment Dealers Association of Canada, Compliance interpretation bulletin, C-125 Risk disclosure statement for options, December 21, 1998.

²⁷ This change would also require rule amendments by most CSA jurisdictions given that the current risk disclosure text is also prescribed through rules and regulations in those provinces.

²⁸ The addition of this requirement would be in line with requirements applicable under the QDA; see s. 11.36 of the Quebec Derivatives Regulation; Retail foreign exchange dealers, futures commission merchants and introducing brokers offering Forex to retail clients are also subject to this requirement under U.S. Commodity Futures Trading Commission regulations; see 17 CFR 1 § 5.5(e). This disclosure requirement is also part of the measures set by other jurisdictions / bodies; see OICV-IOSCO, FR17/2018: Report on Retail OTC Leveraged Products, September 2018; ESMA 35-43-1000 *Additional Information on the Agreed Product Intervention Measures relating to Contracts for Differences and Binary Options*, March 27, 2018; Financial Conduct Authority, PS 19/38: *Restricting contract for difference products sold to retail clients*, July 2019.



1.3.2 Pre-transaction compensation disclosure

We believe that pre-transaction compensation disclosure should be provided to the same population of clients for all investment product transactions (including derivatives transactions) they enter into. To achieve this result, we are proposing that IIROC:

- amend IIROC Rule section 3218 to extend the pre-transaction compensation disclosure requirement to all investment product transactions (including derivatives transactions)^{29, 30}

1.3.3 Trade confirmation

We are proposing that IIROC harmonize as much as possible the confirmation requirements for all investment product transactions, including derivatives transactions. Specific to derivative transactions, we are proposing that IIROC limit the list of specific transaction confirmation disclosure elements to information that is non-standardized or unique to each derivative transaction. To achieve this result, we are proposing that IIROC:

- expand the scope of IIROC Rule clause 3816(2)(ii) so that it applies to futures contracts, forward contracts and CFDs - *the current scope of this provision is limited to futures contracts*
- expand the scope of IIROC Rule clause 3816(2)(iii) so that it applies to option contracts and futures contract options - *the current scope of this provision is limited to futures contract options*
- expand the scope of IIROC Rule clause 3816(2)(vii) so that it applies to all OTC derivatives - *the current scope of this provision is limited to CFDs and Forex*
- introduce new IIROC Rule sub-clause 3816(2)(x)(c) to exempt a Dealer Member from having to provide a trade confirmation for a swap transaction in circumstances where the firm enters into a standard industry agreement that is acceptable to IIROC (such as the ISDA Master Swap Agreement) and the agreement confirms the key terms of the swap transaction
- expand the scope of IIROC Rule subsection 3815(1) to require the Dealer Member retain and maintain order, transaction and instruction records (e.g. order type, date, time stamp, etc.) for any type of derivative.

²⁹ IIROC currently expects Dealer Members to provide pre-transaction compensation disclosures to retail clients for all pending transactions, not just pending securities transactions. This expectation is set out in FAQ #2 of IIROC Rules Notice 16-0113, *Client Relationship Model ("CRM") Frequently Asked Questions*. Adopting this recommendation will result in the codification of this expectation.

³⁰ As new issue distributions are not transactions and are subject to separate disclosure requirements, such distributions will continue to be excluded from the pre-transaction compensation disclosure requirement.



1.3.4 Revisions to the “market value” definition

An updated approach to determining the “market value” of firm inventory and client account positions was implemented as part of IIROC’s Client Relationship Model Phase 2 amendments on December 31, 2015. The revisions made to the definition were focused on ensuring accurate periodic reporting (monthly, quarterly and annual reporting):

- to clients within the account statements and other mandated reports
- to IIROC within IIROC Form 1

In developing these revisions, there was little focus on the specific challenges associated with valuing:

- OTC derivatives
- account positions on a daily or intra-day basis.

To address these challenges, we are proposing that IIROC:

- repeal the “market value” definition that appears in IIROC Rule subsection 3802(1)
- amend the “market value” definition that appears in IIROC Rule subsection 1201(2) as follows:
 - expand the definition scope so that it applies to securities, precious metals bullion and derivatives
 - revise the specific product valuation requirements in the definition so that they consider the specific issues associated with valuing all types of derivatives (i.e. both listed and OTC derivatives)
 - introduce a definition provision requiring that firms consider the reference price for any equivalent listed derivative contract when determining the “market value” for an OTC derivative position
- further amend the “market value” definition that appears in IIROC Rule subsection 1201(2) to introduce a definition provision that allows dealers to use a more streamlined approach³¹ to determining “market value” when daily or intra-day market value information is being prepared

1.3.5 Monthly account statement

We believe IIROC should harmonize as much as possible the account statement reporting requirements for client accounts with transactions and positions in

³¹ Such as using the first two valuation steps cited in the “market value” definition rather than all four valuation steps.



investment products, including derivatives. To achieve this result, we are proposing that IIROC expand the scope of IIROC Rule:

- sub-clause 3808(2)(ii)(c) to include futures contracts, forward contracts and CFDs - *the current scope of this provision is limited to futures contracts and exchange contracts*
- sub-clause 3808(2)(ii)(d) to include options and futures contract options - *the current scope of this provision is limited to futures contract options*
- subsections 3808(6) and 3808(7) so that collectively they apply to all derivatives - *the current scope of these provisions are limited to futures contracts, exchange contracts and futures contract options*

1.3.6 Enhanced monthly account statement

Consistent with IIROC's interpretation of the scope of application of all of the other client reporting requirements, in early 2016 IIROC announced its interpretation that all account positions³² (not just security positions) must be considered when calculating and disclosing annual account compensation and performance information.³³ In reaction to this announcement, 13 investment dealers submitted applications to be exempted from the annual reporting requirements for their CFD, Forex and futures account offerings. The basic business case provided in support of these applications was that:

- the CRM2 performance and fee/charge reporting requirements were not developed with CFD, Forex or futures accounts in mind
- given the short-term trading focus of these accounts, providing monthly/quarterly information on the performance of each position in these accounts (such as realized and unrealized profit/loss information) is more relevant to clients than the 1, 3, 5 and 10-year annualized account percentage return information mandated under CRM2
- performance and fee/charge information is already being provided to clients so there is no need to provide this information again in two separate additional annual reports.

On September 13, 2016 and November 16, 2016, the IIROC Board exempted the CFD, Forex and futures account offerings of these firms from the annual reporting obligations because the monthly/quarterly "enhanced account statement disclosures" the applicants agreed to provide were felt to be more meaningful to clients that

³² The one exception would be account positions in insurance products (such as segregated funds) which are not to be sold to clients through an investment dealer but may be held in custody by the investment dealer for the client. These positions should be excluded from all client reporting other than account statement reporting, as the investment dealer is not responsible for the suitability of these account positions.

³³ IIROC Rules Notice 16-0113.



engage in the short-term trading strategies and investments that these accounts offer than the disclosures they would otherwise receive within the annual reports.³⁴

Under the “enhanced account statement disclosure” approach, clients must be provided with the following disclosures within their account statement on a monthly/quarterly basis:

- additional account performance-related disclosures that include:
 - an account cash balance roll-forward for the period that includes:
 - the opening account cash balance
 - the account cash deposit and withdrawal amounts for the period, which may be presented as a single net deposit or net withdrawal amount
 - profit/loss amounts realized on derivative positions exercised/closed during the period
 - the closing account cash balance.
 - period-end account market value information that includes:
 - the period-end account cash balance amount
 - the unrealized profit/loss amount for each remaining unexpired/open derivatives position in the account as at period-end
 - the realized profit/loss amount for each derivative position that has been exercised/expired unexercised/closed during the period
 - account statement text note disclosures explaining that the information disclosed within the account statement:
 - does not provide the client with a roll-forward of the change in account market value that occurred during the period
 - does provide the client with:
 - realized profit/loss information for derivative positions exercised/expired unexercised/closed during the period
 - unrealized profit/loss information for derivative positions that remain unexpired/open at period-end.
- additional account fee/charge-related disclosures that include:
 - itemized transaction charge and operating charge information for the period, in accordance with the requirements under IIROC Rule 3811
 - where applicable, itemized information on third-party compensation amounts received.
 - where applicable, and where any third-party compensation received relates to a bulk distribution arrangement with a product manufacturer (such as in the case of CFDs where the distributor enters into a “distribution costs plus

³⁴ IIROC Rules Notice 17-0006.



percentage profit” arrangement with the manufacturer), it would be acceptable:

- for fee/charge reports issued for periods ending no later than December 31, 2016, for the firm to provide the following note (in the case of CFDs) or a note that is substantially similar:
“For contracts for difference sold to you during the period covered by the report, we have been paid by the company that issued these contracts for the costs we have incurred in distributing these products to you, plus a profit.”
- for all fee/charge reports issued for periods ending after December 31, 2016, for the firm to disclose to the client as an annual account fee/charge report line-item³⁵ that is included in the report total either:
 - a calculated product distribution compensation amount; or
 - where the distribution compensation amount cannot be unbundled from the manufacturer compensation amount, the entire product compensation amount, along with a note explaining that the amount disclosed is the entire product compensation amount.

We believe that use of this “enhanced account statement disclosure” approach should continue be permitted for qualifying dealers. As a result, we intend to continue to allow for this alternative approach on an ongoing basis through the continuance of previously granted rule exemptive relief.

1.4. Registration and proficiency

IIROC Rule 2600, *Proficiency Requirements and Exemptions from Proficiencies*, sets out the minimum proficiency requirements for individuals requiring IIROC approval. These requirements are designed to ensure that Approved Persons are qualified to perform their job functions competently in order to meet their regulatory obligations and that a Dealer Member’s business is conducted with integrity. The requirements provide that Approved Persons must have the education, training and experience that a reasonable person would consider necessary to perform the activity competently, including understanding the structure, features and risks of each security the Approved Persons recommend. Specifically, the proficiency requirements for the following approval categories require that the Conduct and Practices Handbook Course, amongst others, be passed by:

³⁵ It is common for dealers to earn the equivalent of a trailer fee from the product manufacturer when CFDs are entered into with the client. This provision requires that firms either disclose the trailer they earn from the product manufacturer or, where the trailer cannot be unbundled from the other embedded product fees/charges, disclose all of the embedded fees/charges.



- Registered Representatives and Investment Representatives dealing with clients in futures contracts, futures contract options and options;³⁶ and
- Supervisors of Registered Representatives and Investment Representatives dealing with clients in futures contracts, futures contract options and options.³⁷

However, rule amendments are required to:

- clarify the scope of derivatives-related activities where client facing-individuals must be registered with one or more commissions and approved by IIROC; and
- clarify the related proficiencies and continuing education requirements for such individuals.

The CSA have published for public comment proposed National Instrument 93-102, *Derivatives: Registration*, which sets out registration requirements for firms and individuals engaging in OTC derivatives business. Included in these proposals are:

- a requirement to register as a derivatives dealer if a firm engages in the business of trading OTC derivatives, either as principal or agent;³⁸
- a requirement to register as both an investment dealer and a derivatives dealer if a firm engages in the business of trading OTC derivatives with retail clients;^{39, 40} and
- a requirement for client-facing individuals:
 - who trade in OTC derivatives with retail clients to register as a “derivatives dealing representative”;⁴¹
 - who advise in OTC derivatives with retail clients to register as a “derivatives advising representative”;⁴²
- itemized rule requirement exemptions for investment dealers who comply with the equivalent itemized rule requirements imposed by IIROC.⁴³

We believe that IIROC should revise its rules to clarify when an individual must be approved by IIROC to transact in any type of derivatives. To achieve these results, without significantly impacting the existing futures and options proficiency and continuing education regimes, we

³⁶ IIROC Rule clauses 2602(3)(iii) through 2602(3)(v) and 2602(3)(ix) through 2602(3)(xi).

³⁷ IIROC Rule clauses 2602(3)(xviii) and 2602(3)(xix).

³⁸ Section 6 of proposed NI 93-102.

³⁹ Section 9 of proposed NI 93-102.

⁴⁰ Retail clients are referred to as “a non-eligible derivatives party” within proposed NI 93-102.

⁴¹ Paragraph 16.(1)(a) of proposed NI 93-102.

⁴² Paragraph 16.(1)(b) of proposed NI 93-102.

⁴³ The proposed rule requirement exemptions have not yet been determined. Once determined, they will be published for public comment in a future version of proposed NI 93-102. Place-markers for these exemptions have been included in section 55 and Appendix E of proposed NI 93-102.



are proposing that IIROC amend its individual approval requirements to clarify that an individual transacting in derivatives with clients:

- in the case of Registered Representatives, must be approved as a:
 - “Registered Representative in options with retail clients”⁴⁴ in order to trade in and advise on OTC-traded options (or like OTC derivatives)
 - “Registered Representative in options with institutional clients”⁴⁵ in order to trade in and advise on OTC-traded options (or like OTC derivatives)
 - “Registered Representative in futures with retail clients”⁴⁶ in order to trade in and advise on CFDs, Forex, swaps or forwards (or like OTC derivatives)
 - “Registered Representative in futures with institutional clients”⁴⁷ in order to trade in and advise on CFDs, Forex, swap or forwards (or like OTC derivatives)
- in the case of Investment Representatives, must be approved as an:
 - “Investment Representative in options with retail clients”⁴⁸ in order to trade in OTC-traded options (or like OTC derivatives)
 - “Investment Representative in options with institutional clients”⁴⁹ in order to trade in OTC-traded options (or like OTC derivatives)
 - “Investment Representative in futures with retail clients”⁵⁰ in order to trade in on CFDs, Forex, swaps or forwards (or like OTC derivatives)
 - “Investment Representative in futures with institutional clients”⁵¹ in order to trade in CFDs, Forex, swaps or forwards (or like OTC derivatives)
- in the case of Associate Portfolio Managers, must complete the incremental proficiency requirements:
 - relevant to trading in options⁵² in order to trade in OTC-traded options (or like OTC derivatives)
 - relevant to trading in futures⁵³ in order to trade in on CFDs, Forex, swaps or forwards (or like OTC derivatives)
- in the case of Portfolio Managers, must complete the incremental proficiency requirements:

⁴⁴ IIROC Rule clause 2602(3)(iii).

⁴⁵ IIROC Rule clause 2602(3)(iv).

⁴⁶ IIROC Rule clause 2602(3)(v).

⁴⁷ Ibid.

⁴⁸ IIROC Rule clause 2602(3)(ix).

⁴⁹ IIROC Rule clause 2602(3)(x).

⁵⁰ IIROC Rule clause 2602(3)(xi).

⁵¹ Ibid.

⁵² IIROC Rule clause 2602(3)(xiii).

⁵³ Ibid.



- relevant to trading in options⁵⁴ in order to trade in OTC-traded options (or like OTC derivatives)
- relevant to trading in futures⁵⁵ in order to trade in on CFDs, Forex, swaps or forwards (or like OTC derivatives)

A detailed review of the proficiency and continuing education requirements for Approved Persons dealing in derivatives will be done at a later date as part of a comprehensive review of the adequacy of the proficiency and continuing education requirements for all securities and derivatives business lines.

2. Text of proposed rule amendments

Clean and blackline versions of the proposed Derivatives Rule Modernization Stage 1 amendments are set out in Attachments D and E, respectively.

3. Policy development process

3.1 Regulatory purpose

As previously stated, the objectives of the proposed proposed Derivatives Rule Modernization Stage 1 amendments are to:

- ensure our rules continue to be materially harmonized with the equivalent CSA requirements as they apply to securities and derivatives;
- more clearly specify which of the core regulatory obligations apply to securities, listed derivatives and OTC derivatives; and
- eliminate inconsistencies in the regulatory treatment of securities, listed derivatives and OTC derivatives, where justified.

Two important considerations/objectives in developing these proposed amendments were that all rule amendments pursued should:

- where possible and appropriate, avoid the creation of new regulatory arbitrage situations and reduce or eliminate existing regulatory arbitrage situations; and
- result in the consistent regulation of all securities-related and derivatives-related activities occurring within a Dealer Member.

We classified the proposed amendments as a public comment rule proposal due to their substantive nature and their importance in achieving the goal of ensuring consistent and materially harmonized regulatory standards across the each of the securities- and derivatives-related business lines.

⁵⁴ IIROC Rule clause 2602(3)(xiv).

⁵⁵ Ibid.



3.2 Issues and alternatives considered

In developing these proposed amendments, IIROC considered whether or not to limit the proposed amendments to rule requirements relevant to transactions and positions involving OTC derivatives. It was decided that the proposed amendments should extend to other business lines, where appropriate, in order to ensure that IIROC continues to maintain rules that are generally equivalent across each of the securities- and derivatives-related business lines.

3.3 Comparison with similar provisions

Some of the proposed amendments have been developed taking into consideration the requirements set out in proposed NI 93-101 and NI 93-102. Once these proposals are finalized, revisions may need to be made to some of the IIROC proposals to ensure IIROC Rules continue to be materially harmonized with the relevant CSA requirements.

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

In many cases, the proposed amendments seek to codify existing Dealer Member practices relating to the provision of derivative account offerings. In some cases, requirements that currently apply to a specific type of derivatives account offering will be extended to all derivative account offerings. In these cases, the proposed rules will introduce incremental costs of compliance to Dealer Members.

A benefit of the proposed amendments is the retention of relatively consistent regulatory requirements across all of the securities- and derivatives-related business lines, which would avoid significant cost of compliance increases that would otherwise occur if requirements are materially different.

A detailed assessment of the impact of these proposals has been prepared and is included as Attachment C.

Overall, we believe that the proposed Derivatives Rule Modernization Stage 1 amendments impose costs and restrictions on the activities of market participants that are proportionate to the goals of the regulatory objectives sought to be realized.

3.5 Development and approval process

The Board determined the proposed amendments to be in the public interest and on September 25, 2019 approved them for publication for public comment.

We consulted with the industry throughout the development of the proposed amendments including the Derivatives Subcommittee of the Quebec District Council, the Conduct, Compliance and Legal Advisory Section and the Financial and Operations Advisory Section.

After considering:

- the comments on the proposed amendments received in response to this Notice, together with any comments of the Recognizing Regulators; and



- any changes that are made to proposed NI 93-101 and NI 93-102,

we may recommend changes to the proposed amendments. Where changes are recommended and the recommended changes are significant, the revised proposed amendments will be published for further public comment. Once the proposals are finalized, they will be taken back to the Board to seek their approval for implementation and they will be submitted/resubmitted to the Recognizing Regulators for approval.

3.6. Public interest determination

The proposed Derivatives Rule Modernization Stage 1 amendments impose costs and restrictions on the activities of market participants that are proportionate to the goals of the regulatory objectives sought to be realized and the enhanced transparency and standards of dealing with clients that will result. The IIROC Board has determined that the proposed Derivatives Rule Modernization Stage 1 amendments are not contrary to the public interest.

3.7 Proposed implementation dates

In order to ensure the IIROC Rules remain materially harmonized with the equivalent CSA rule requirements, the finalization and implementation of some of these proposed rule amendments is dependent on the timing of the finalization and implementation of NI 93-101 and NI 93-102. As such is the case we will determine the proposed implementation date for these proposed amendments at a later date when they are closer to finalization.

3.8. Classification of amendments and filing in other jurisdictions

IIROC has determined that the proposed Derivatives Rule Modernization Stage 1 amendments are Public Comment Rules and are therefore published for public comment.

The proposed Derivatives Rule Modernization Stage 1 amendments have been filed with each of IIROC's Recognizing Regulators, in accordance with section 3 of the Joint Rule Review Protocol contained in the Memorandum of Understanding Regarding Oversight of IIROC.

Attachments

Attachment A - Draft Guidance Note - Applying and interpreting the definitions of "hedger" and "institutional client"

Attachment B - Draft Guidance Note - Derivatives Risk Disclosure Statement

Attachment C - Impact assessment

[Attachment D](#) - Clean version of proposed rule amendments

[Attachment E](#) - Blackline version of proposed rule amendments



Attachment A - Draft Guidance Note - Applying and interpreting the definitions of “hedger” and “institutional client”



IIROC NOTICE

**Rules Guidance
Guidance Note
IIROC Rules**

Please distribute internally to:

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

Contact:

Richard J. Corner
Vice President and Chief Policy Advisor, Member Regulation
416-943-6908
rcorner@iiroc.ca

Phil Devault
Senior Counsel Derivatives Regulation
514-392-3412
pdevault@iiroc.ca

20-xxxx
Xxxxxxxx xx, 2020

Applying and interpreting the definitions of “hedger” and “institutional client”

This guidance relates to the definitions of the terms “*hedger*” and “*institutional client*” set out in IIROC Rule subsection 1201(2). Pursuant to paragraph (vii) of the “*institutional client*” definition, a “*hedger*” can be classified as an institutional client for accounts with qualifying hedging activities and hedge positions if it requests and consents to being classified as an institutional client.

We are publishing this notice to describe the requirements that apply and to outline our expectations when determining:

- whether a client qualifies as a hedger,



- the circumstances under which a qualifying hedger can be classified as an institutional client.

Qualifying a client as a hedger

To qualify as a hedger, a non-individual must be exposed to one or more risks as a necessary part of its activities and seek to hedge that risk by engaging in securities or derivatives transactions where the underlying interest is the same as or materially related to the underlying interest for the risk. Such risks could include supply, credit, exchange and environmental risks as well as risks related to fluctuations in the market value of an asset, liability or position.

The underlying interest of the securities or derivatives used must be the same as or materially related to the risks to which the hedger is exposed as a necessary part of its activities. As such, cross-hedging could be considered hedging as a security or derivative may not exist in the precise underlying interest that the hedger may deal in. However, to be materially related the underlying interest of the securities or derivatives should show a historical and commercial price relationship with the hedger's underlying activities and have a reasonable level of basis risk.

To hedge, it is necessary for the hedger to intend to forgo the opportunity to realize the full effect of price level changes in its primary activities. Alternatively, a hedger may intend to substitute a risk to one currency for a risk to another currency provided the substitution does not increase its original exposure.

A significant feature of hedging is its severely restricted investment motive. However, a hedger could actually sustain a profit or loss from its hedging transactions.

Since the intended effect of the transaction is to eliminate or reduce risk, it is possible to hedge only part of an underlying interest or position and still have the transaction regarded as a hedge. However, the transaction should no more than offset price risks incidental to the hedger's exposure as a necessary part of its activities.

Finally, a hedger who requests and consents to being categorized as an institutional client is such only as to qualifying hedging activities and hedge positions.

Categorizing a qualifying hedger as an "institutional client"

Dealer Members should have reasonable basis to classify a hedger as an institutional client. For example, a Dealer Member should review with the client the nature and extent of the risk that is sought to be hedged and to confirm that the transactions are primarily for hedging purposes and not also for speculative purposes. This could include obtaining the hedging strategy/program from the client and being able to establish in a conclusive and verifiable manner that the requisite conditions to be categorized as a hedger have been met.

A Dealer Member's books and records should clearly identify all steps taken and documents obtained that are necessary to demonstrate how the Dealer Member determined the customer was a hedger.

Dealer Members should periodically verify that a client's trading activities are consistent with the requisite conditions to qualify as a hedger.



Disclosure by Dealer Members

A hedger who requests and consents to being classified as an institutional client, should be clearly explained that the Dealer Member's disclosure, suitability and supervision obligations are different for institutional clients.

Dealer Members should also provide clear examples of information they do not have to provide institutional clients (e.g. relationship disclosures and pre-trade disclosure of charges).

Question #5

Does this proposed guidance detail all of the necessary considerations for determining which clients may qualify as *hedgers*? If not, please provide details of other considerations.

Question #6

Does this proposed guidance provide enough detail regarding necessary disclosure to clients by Dealer Members? If not, please provide examples of obligations that we should discuss further.



Attachment B - Draft Guidance Note - Derivatives Risk Disclosure Statement



IIROC NOTICE

Rules Guidance Guidance Note IIROC Rules

Please distribute internally to:

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

Contact:

Richard J. Corner
Vice President and Chief Policy Advisor, Member Regulation
416-943-6908
rcorner@iiroc.ca

Phil Devault
Senior Counsel Derivatives Regulation
514-392-3412
pdevault@iiroc.ca

20-xxxx
Xxxxxxx xx, 2020

Derivatives Risk Disclosure Statement

IIROC Rule section 3254 provides that a Dealer Member must provide each client with the current derivatives risk disclosure statement approved by IIROC before accepting an initial derivatives order from a client. The text of the new derivatives risk disclosure statement approved by IIROC is found below.



Derivatives Risk Disclosure Statement

This risk disclosure statement does not disclose all of the risks and other significant aspects of trading in derivatives. In light of the risks, you should undertake such transactions only if you understand the nature of the contracts, the contractual relationships into which you are entering and the extent of your exposure to risk. Trading in derivatives is not suitable for everyone. You should carefully consider whether trading is appropriate for you in light of your experience, objectives, financial resources and other relevant circumstances.

You may lose more than the amount of funds deposited

A characteristic of many derivatives is that you are only required to deposit funds that correspond to a portion of your total potential obligations and yet your profits or losses are based on changes in the total value of the derivative. This inherent leverage characteristic means that losses incurred can greatly exceed the amount of funds deposited. A relatively small market movement will have a proportionately larger impact on the funds you have deposited or will have to deposit. Your dealer may require you to deposit additional funds on short notice to maintain your position as the value of the derivative changes. If you fail to deposit these funds, your dealer may close out your position at a loss without warning and you will be liable for any resulting deficit in your account.

Using borrowed funds carries greater risk

Using borrowed funds to finance a derivatives transaction involves greater risk than using cash resources only. If you borrow money, your responsibility to repay the loan and pay interest as required by its terms remains the same even if the value of the derivative declines.

Deposited cash and property

You should familiarize yourself with the protections accorded to money or other property you deposit for domestic and foreign transactions, particularly in the event of a firm insolvency or bankruptcy. The extent to which you may recover your money or property may be governed by specific legislation or local rules.

Commission and other charges

Before you begin to trade, you should obtain a clear explanation of all commission, fees and other charges for which you will be liable. These charges will affect your net profit (if any) or increase your loss.

Hedging and risk management strategies

Hedging transactions may require constant monitoring. A failure to adjust your hedging transaction in light of changing market conditions may result in the position becoming either under-hedged or over-hedged and losses can ensue.

The placing of certain orders (e.g. "stop-loss" or "stop-limit" orders) which are intended to limit losses



to certain amounts may not be effective because market conditions may make it impossible to execute such orders. Strategies using combinations of positions, such as "spread" and "straddle" positions may be as risky as taking simple "long" or "short" positions.

Listed derivatives

Under certain market conditions, you may find it difficult or impossible to liquidate or offset an existing position on a marketplace (e.g. buy-to-close or sale-to-close order). This can occur, for example, when the market reaches a daily price fluctuation limit ("daily price limit" or "circuit breakers").

You should ask your dealer about the terms and conditions of the specific derivatives which you are trading and associated obligations. Under certain circumstances the specifications of outstanding contracts may be modified by the marketplace or clearing house to reflect changes in the underlying interest.

Over-the-counter derivatives

Over-the-counter derivatives (OTC derivatives) trading is not done on a marketplace. Your dealer is your trading counterparty. When you sell, your dealer is the buyer and when you buy, your dealer is the seller. As a result, when you lose money trading, your dealer may be making money on such trades, in addition to any fees, commissions, or spreads it may charge.

An electronic trading platform for trading OTC derivatives such as contracts for difference and foreign exchange contracts is not a marketplace. It is an electronic connection for accessing your dealer. You are accessing that trading platform only to transact with your dealer. You are not trading with any other entities or clients of the dealer by accessing such platform. The availability and operation of any such platform, including the consequences of the unavailability of the trading platform for any reason, is governed only by the terms of your account agreement with the dealer.

You are limited to your dealer to offset or liquidate any trading positions since the transactions are not made on a marketplace. As such, it may be difficult or impossible to liquidate an existing position, to assess the value, to determine a fair price or to assess the exposure to risk. The customized nature of certain OTC derivatives may also add to illiquidity.

Question #7

In an effort to provide clients with one disclosure document that summarizes the important risks that are generally applicable to transacting in derivatives, we have eliminated the discussion of risks specific to options, futures and futures contract options and have instead included a general discussion of the important risks relevant to transacting in all types of derivatives. Have we captured all of the important risks relevant to derivatives in this proposed revised Derivatives Risk Disclosure Statement? If not, please provide details of other risks we should discuss.



Attachment C – Impact assessment

Background

As outlined elsewhere in this notice, IIROC has performed a review of its Dealer Member rules (IIROC Rules) to determine:

- inconsistencies between the IIROC and CSA rules that would be created should proposed NI 93-101 and NI 93-102 be adopted;
- areas where scope of application of IIROC's derivatives-related rules is either unclear or too narrow and could benefit from rule scope clarification amendments;
- areas where IIROC's derivatives-related rules are out of date, taking into consideration recent rule revisions announced by other jurisdictions/bodies, and could benefit from rule enhancements; and
- areas of inconsistency within the IIROC Rules between the regulation of securities-related activities and the regulation of derivatives-related activities that are not justified and could benefit from rule amendments to address these inconsistencies.

IIROC has also recently announced the implementation of its plain language rules, which has not only resulted in more clearly stated rule requirements but also helped identify inconsistencies in the regulatory treatment of both listed and over-the-counter (**OTC**) derivatives.

The objectives/intended benefits of the proposed amendments arising from IIROC's Derivatives Rule Modernization project are to:

- ensure our rules continue to be materially harmonized with the equivalent CSA rule requirements as they apply to securities and derivatives;
- more clearly specify which of the core regulatory obligations apply to securities, listed derivatives and OTC derivatives; and
- eliminate inconsistencies in the regulatory treatment of securities, listed derivatives and OTC derivatives, where justified.

Two important considerations/objectives in developing these proposed amendments were that all rule amendments pursued should:

- where possible and appropriate, avoid the creation of new regulatory arbitrage situations and reduce or eliminate existing regulatory arbitrage situations; and
- result in the consistent regulation of all securities-related and derivatives-related activities occurring within a Dealer Member.

Impact Assessment

In the attached table we have listed the major policy elements of these proposals, along with a description of the intended policy benefits of each element and an assessment of its impact on clients,



IIROC Dealer Members and IIROC itself. In summary, we have assessed that the approval of the proposed amendments will result in:

- Neutral to positive impacts on clients in all areas;
- Minor negative impacts on Dealer Members resulting from the extension of the cumulative loss limit to all derivatives accounts, the changes to the derivatives risk disclosure requirements, the formal introduction of highly-leveraged investment product approval requirements, the changes to the BCP requirements and the need to update firm policies and procedures in certain areas;
- Neutral to positive impacts on Dealer Members resulting from the simplification of the derivatives-related definitions, the expansion of clients eligible to become “institutional clients” and the streamlining to the “market value” definition for the purposes of daily account position valuation; and
- Minor negative impacts on IIROC when the proposals are implemented, our field examination programs are revised to reflect the amendments, and our field examination reviews are conducted to determine levels of compliance with the amendments.

The dollar magnitude of the collective impacts of these proposed amendments is not known and won’t be known without detailed stakeholder feedback.

Question #8

Have we identified all of the proposal provisions that will materially impact clients, Dealer Members or IIROC? If no, please list other proposal provisions that you believe will materially impact one or more parties and why.

Question #9

Overall, IIROC has qualitatively assessed that the benefits of these proposals exceed their costs. Do you agree with IIROC’s assessment? If so or if not, please provide reasons why.



Description of proposed amendment	Related intended benefits	Impact on clients	Impact on Dealer Members	Impact on IIROC
<p><i>Introduction of general defined terms relating to derivatives (i.e. derivative, listed derivative and over-the-counter derivative)</i></p>	<p>Facilitates objective of more clearly specifying which of the core regulatory obligations apply to securities, listed derivatives and OTC derivatives by moving away from product specific definitions and related regulatory requirements, where possible.</p>	<p><i>Neutral</i> - Clients are generally unfamiliar with the current definitions used within the IIROC rules for specific derivative products. As a result, simplification of these definitions will have little to no impact on clients.</p>	<p><i>Neutral to net positive</i> - While there will be some required revisions to firm policies and procedures and client documents, we believe that firms will also benefit considerably from the shift to regulating by broad product category (i.e., securities, listed derivatives and over-the-counter derivatives) rather than by specific product. This change is likely to reduce compliance costs and make our rules easier to understand and comply with.</p>	<p><i>Neutral to net positive</i> - Changes will facilitate less emphasis on product-specific examination procedures and greater emphasis on business line examination work.</p>
<p><i>Proposed new inclusions in definition of “institutional client”</i></p>	<p>Eliminate the existing inconsistent assessment of non-individual and individual client sophistication by allowing certain individual clients to qualify as an “institutional client”, if they wish to be categorized as such.</p> <p>Allows certain non-individual clients to qualify as an “institutional client” for their specific hedging activities, if they wish to be categorized as such. Qualifying hedging activities would include</p>	<p><i>Neutral to positive</i> - Two categories of clients that will benefit from the proposed changes to the “institutional client” definition are:</p> <ul style="list-style-type: none"> • sophisticated individual clients who will have the option to be treated as an “institutional client” provided their assets under management exceed a certain threshold; and • sophisticated non-individual hedgers who will 	<p><i>Neutral to net positive</i> - As firms will be given the option to categorize qualifying individual clients as “institutional clients”, these changes will only impact those firms who decide to pursue this option. These changes will also continue to allow Dealer Members to use one definition in determining client sophistication for the securities, listed derivatives and over-the-counter derivatives business lines.</p>	<p><i>Minor negative</i> - There will be some required enhancements to examination procedures to ensure that individuals that will now qualify as “institutional clients” have been properly assessed as being sophisticated for the appropriate transactions, positions and accounts.</p>



Description of proposed amendment	Related intended benefits	Impact on clients	Impact on Dealer Members	Impact on IIROC
	<p>IIROC-approved activities involving securities, listed derivatives and OTC derivatives.</p> <p>Both proposed inclusions would apply to all clients in order to ensure that client sophistication assessments are consistently applied to all dealer securities and derivatives business lines.</p>	<p>have the option of being treated as an “institutional client” for those accounts with qualifying hedging activity.</p>		
<p><i>Revised definition of “market value”</i></p>	<p>Facilitates a consistent and practical approach to daily client reporting for all of their derivative and security positions.</p> <p>Eliminates unnecessary burden elements within the current account position valuation requirements.</p>	<p><i>Net positive</i> - These changes are net positive to clients as, although it could be argued that the use of a less precise approach for valuation would negatively impact the accuracy of market value information provided to clients on a daily basis, requiring that firms use all valuation approaches on daily basis would:</p> <ul style="list-style-type: none"> • not be practical as it normally takes longer than a day to exhaust all valuation approaches; and • be prohibitively expensive for firms to do and clients would end up bearing these expenses. 	<p><i>Positive</i> - These changes are positive to Dealer Members as they will allow the use of a more practical/streamlined valuation approach when determining “market value” on a daily or intra-day basis thereby reducing compliance costs.</p>	<p><i>Neutral</i> – IIROC already considers the practical challenges of determining position market values on a daily basis as part of the market value testing work that is done within its examination work.</p>



Description of proposed amendment	Related intended benefits	Impact on clients	Impact on Dealer Members	Impact on IIROC
		It has therefore been concluded that permitting the use of a more practical/streamlined valuation approach to determining “market value” on a daily or intra-day basis is a net positive for clients.		
<i>Extension of existing sales conduct requirements to derivatives</i>	Facilitates the consistent regulation of all securities-related and derivatives-related activities. Clarifies that core regulatory obligations are generally derived from the type of account offering the client receives and not derived from the types of products made available within each account offering.	<i>Positive</i> - Making it clear that the core regulatory requirements that are applicable to a particular account service offering apply all account transactions and positions, irrespective of whether they are security or derivative transactions or positions, provides important increased clarity to the clients regarding the firm obligations that are owed to them.	<i>Minor negative to neutral</i> - Some revisions to policies and procedures, supervisory responsibilities, and client documents/disclosures. Dealer Members already apply the core regulatory requirements that are applicable to the account service offering to all transactions and positions that occur/are maintained within the account.	<i>Neutral</i> - IIROC already examines Dealer Members for compliance with the applicable core regulatory requirements on an account basis rather than by type of product.
<i>Extension of existing derivative sales conduct requirements to over-the-counter derivatives</i>	Facilitates the consistent regulation of all derivatives-related activities. Standardizes derivatives loss limit restrictions and risk disclosures to ensure that all derivative products offered to retail clients are subject to the same regulatory protections.	<i>Positive</i> – The extension of the cumulative loss limit to all derivatives accounts is an important investor protection enhancement. As the new Derivatives Risk Disclosure Statement will cover issues relevant to all derivative transactions and positions, the document will	<i>Minor negative</i> - Some revisions to policies and procedures, supervisory responsibilities, and client documents/disclosures. The extension of the cumulative loss limit to all derivatives accounts will impose a new obligation on firms not currently required	<i>Minor negative</i> - IIROC will need to examine for compliance with the cumulative loss limit restriction for all derivatives accounts (rather than just futures accounts). IIROC will need to finalize the drafting of the new Derivatives Risk Disclosure



Description of proposed amendment	Related intended benefits	Impact on clients	Impact on Dealer Members	Impact on IIROC
		<p>be more relevant to clients transacting in all types of listed and over-the-counter derivatives.</p>	<p>to impose this restriction on accounts other than futures accounts.</p> <p>A new Derivatives Risk Disclosure Statement (covering listed and over-the-counter derivatives) will need to be provided to clients. This statement will replace the existing Risk Disclosure Statement for Options and Futures that was implemented by the IDA in 1999. Adequate time will be given to Dealer Members to distribute this statement to existing clients in order to mitigate the negative impacts of this new requirement.</p> <p>Dealer Members already apply the other changes to over-the-counter derivatives.</p>	<p>Statement. The initial drafting work for this new statement has already been performed.</p> <p>IIROC already examines Dealer Members for compliance with the applicable core regulatory requirements for both listed and over-the-counter derivatives.</p>
<p><i>Codification of requirement to obtain IIROC approval before offering highly-leveraged products</i></p>	<p>Harmonizes IIROC requirements with product approval requirements introduced in Europe that resulted in the ban of offering of binary options and the introduction of leverage restrictions on the offering of contracts for difference.</p>	<p><i>Positive</i> - IIROC already has been granted this power by certain CSA jurisdictions for contracts for difference products offered to retail clients by our Dealer Members.</p> <p>The codification of this power and the broadening of its</p>	<p><i>Minor negative</i> - IIROC already has approval authority over the introduction of highly-leveraged over-the-counter derivatives to retail clients. Because the proposed amendments would extend to authority to cover all highly-leveraged listed and</p>	<p><i>Net positive</i> - Will provide IIROC a tool to prevent in extremely rare cases the offering of a highly-leveraged investment product that has been determined to be unsuitable for all retail clients.</p>



Description of proposed amendment	Related intended benefits	Impact on clients	Impact on Dealer Members	Impact on IIROC
		<p>scope to include all highly-leveraged products introduces an important regulatory check that can help ensure that highly-leveraged products with little to no likelihood of profitability aren't offered to retail clients.</p> <p>While it is anticipated that IIROC will rarely use this power, it is important that IIROC has this power to intervene, particularly in situations where no other domestic regulator has the power to intervene (such as where a firm is proposing to offer a foreign-produced highly-leveraged product to retail clients).</p>	<p>over-the-counter products, even though IIROC intends to use this power extremely rarely, this new requirement may on occasion delay or prevent the offering of certain highly-leveraged domestic and foreign-based investment products to retail clients.</p>	
<p><i>Extension of existing financial and operational requirements to derivatives</i></p>	<p>Facilitates the consistent regulation of all securities-related and derivatives-related activities. Clarifies that baseline client reporting obligations apply where the account transacts in and holds derivative positions, security positions or both derivative and security positions.</p>	<p><i>Neutral to minor positive</i> – The amendments result in greater clarity of the client reporting obligations for all derivative transactions and positions; the current requirements focus only on the client reporting obligations for options and futures transactions and positions.</p>	<p><i>Minor negative to neutral</i> - Dealer Members already maintain records and report to clients on all derivatives transactions, positions and accounts.</p>	<p><i>Neutral</i> – IIROC has noted no significant situations where Dealer Members are not currently providing adequate client reports. As a result, we do not anticipate having to perform additional examination work once these amendments are implemented.</p>



Description of proposed amendment	Related intended benefits	Impact on clients	Impact on Dealer Members	Impact on IIROC
<p><i>Modification of existing financial and operational requirements (other than margin)</i></p>	<p>Facilitates ongoing investor access to their derivative and security account positions.</p>	<p><i>Neutral to minor positive</i> – Requiring that a Dealer Member’s BCP must be invoked when a “significant impairment” to client access to their assets or ability to liquidate their assets occurs is a positive as it helps ensure that any such impairments in client access or ability to liquidate their assets are rectified as soon as possible/practical.</p>	<p><i>Minor negative</i> - It could be argued that the proposed changes to the BCP requirements represent a significant negative to Dealer Members, due to the introduction of a specific requirement for the firm to invoke their BCP when a “significant impairment” to client access to their assets or ability to liquidate their assets occurs; we’ve assessed this impact as “minor negative” as we believe that Dealer Members are already hyper-sensitive to these types of business disruption events for both firm reputational risk and ongoing business viability risk reasons.</p>	<p><i>Neutral</i> - IIROC already follows up with firms when significant business disruption events occur.</p>
<p><i>Extension of existing registration requirements to over-the-counter derivatives</i></p>	<p>Facilitates the maintenance of consistent proficiency levels for all individuals dealing in or advising on derivatives.</p>	<p><i>Positive</i> – Amendments clarify that registration/approval is required where the individual is conducting any type of securities or derivatives business with clients.</p>	<p><i>Neutral</i> - Dealer Members that transact in over-the-counter derivatives are already subject to these registration and approval requirements as a condition of their membership.</p>	<p><i>Neutral</i> – IIROC already expects client facing individuals be approved and meet specific proficiency requirements when offering over-the-counter derivatives.</p>