

# FinOps Issues and Guidance

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# Agenda

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- Back-Office (“Core”) Activities Outsourced to Third Parties
- 2013/14 FinOps Examination Focus
  - Leverage and Liquidity of Self-Clearing Dealer Members
  - Control and Access of Books and Records
- Other
  - Regulatory Conditions for Approving Private Equity Funds as Non-Industry Investors of Sub-Loans
  - Regulatory Conditions for Capital Provision Relief for Lawsuits Court Decisions Under Appeal

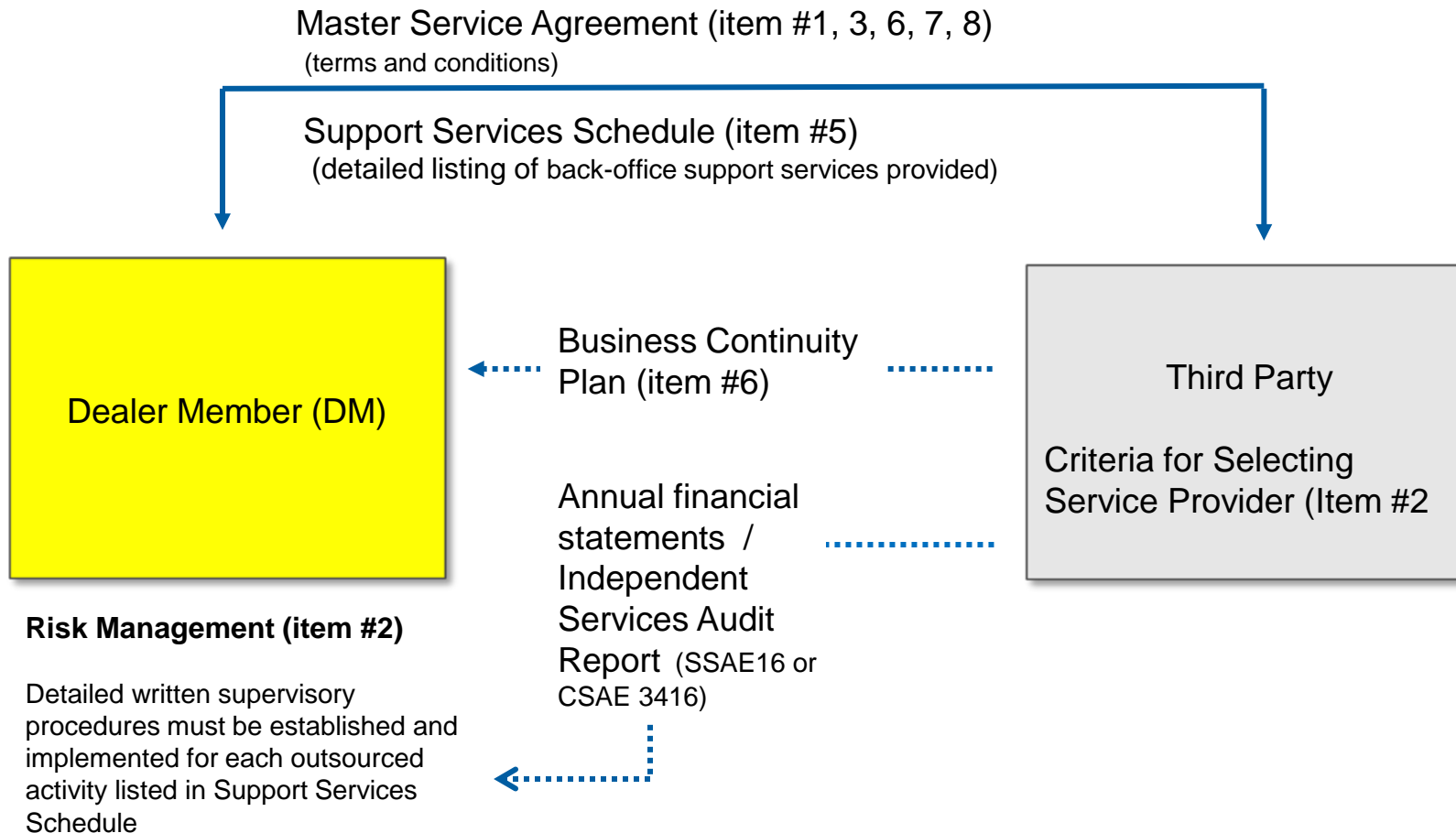
# Back-Office (“Core”) Activities Outsourced to Third Parties

# General Principles on Outsourcing

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1. Corporate governance
2. Risk management
3. No subrogation of regulatory responsibility
4. Due diligence
5. Written contract (performance measurements)
6. Business Continuity
7. Confidential Information
8. Access to books and records by external auditors and regulators

# Recommended Framework



# Master Services Agreement

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## Addresses:

- Scope of Services Provided (by reference to Supporting Services Schedule);
- Corporate Governance of Service Provider (internal controls etc);
- Governing Laws and Applicable Regulations;
- Business Continuity Plan of Service Provider;
- Data Security and Access (including ownership and access to client data);
- Confidentiality of Information;
- Termination process; and,
- External Auditor / Regulator Access to Books and Records.

# Support Services Schedule

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Example of core activities outsourced:

- Operational control (security/depository reconciliation, suspense, clearing, fail account reconciliations)
- Corporate actions (reorg, reconciliation)
- Dividends (reconciliation for cash and stock)
- Mutual fund reconciliations (Fundserv)
- Purchase & Sales (trade break reconciliations, options and equities)
- Stock loan reconciliations
- Trade settlements CDS/DTC/International (reconciliations, monitoring of fails)

# Supervisory Structure

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Written Supervisory Policies and Procedures should cover:

- Individual supervisor(s) of the Dealer Member responsible for each outsourced activity
- Description of review to conduct
- Type of documents to be used for review
- Frequency of supervisory review
- Describe how evidence of review is to be documented and maintained by Dealer Member and available for inspection
- Describe how outsourcing performance will be monitored, measured and how issues identified are escalated and resolution documented





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# Leverage and Liquidity of Self-Clearing Dealer Members

# Liquidity and Balance Sheet Leverage

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## **Past Events**

- Credit and liquidity crisis (2008);
- MF Global Canada bankruptcy (2012);
- Voluntary Wind-down of Penson Financial Services Canada Inc. (2012/13)

# IIROC Approach to Examining Liquidity Risk Management by Firms

1. Review firm's written policies and procedures over cash risk management:
  - Identify all available sources of funds (call loans, credit lines, free credits etc.)
  - Uses of funds (inventory financing, margin debits, margin deposits etc.)
  - Investment diversification (liquidity of investments)
  - Leverage limits (restrictions of balance sheet leverage)
  - Monitoring the financial status of significant counterparties holding margin deposits
  
2. Perform a walk-through of firm's daily cash management process.
  
3. Discuss what if scenarios – events that would cause a run on firm's customer free credit deposits:
  - Stress testing
  - Contingency plans (sources of new capital, liquidate inventory, unwind repos etc.)

# FINRA Approach

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- FINRA Regulatory Notice 10-44 dated September 2010 (not a rule)
- Leverage formula applied:  
$$\frac{\text{(Total Assets minus US Treasury and US government agency inventory)}}{\text{(Shareholders equity plus subordinated debt)}}$$
- Any firm whose ratio of such assets to regulatory capital exceeds **20:1 is flagged** for special regulatory reporting
- Firms may be subject to closer regulatory monitoring if liquidity is a concern

# IIROC Approach to Identifying Excessive Balance Sheet Leverage by Firms

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## Balance Sheet Leverage:

- Produce ad hoc reports from MFR filings on SIRFF to flag firms with leverage in excess of **20:1**.
- Suggested leverage formula applied for ad hoc reports:  
  
$$\frac{\text{(Total Assets minus RRSP balances minus Free Credit Segregation amount)}}{\text{divided by (Total Capital plus Subordinated loans)}}$$
- For firms flagged, follow up with CFO to identify investments held in firm inventory positions (including repo control accounts) that are highly liquid securities such as GOC and US treasuries to compute adjusted balance sheet leverage ratio.
- Engage discussion with firms still having excessive balance sheet leverage to assess their leverage and liquidity risk management practices. If necessary, close monitoring and special reporting may be required.

# Subordinated Loans and related issues

# Sources of Subordinated Loans

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- Industry Investors (most common)
  - Financial Institutions (banks)
  - Dealer Member officer, employee, shareholder (family and personal investment holding companies)
- Non-Industry Investor (not common)
  - Prospectus Issued Investment Funds
  - Non Prospectus Issued Private Equity Funds

# General Restrictions on Subordinated Loans

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- A subordinated loan is an **unsecured** loan made to an investment dealer that in the event of an insolvency, the lender subordinates its claim behind customers.
- A subordinated loan **cannot be collateralized** or guaranteed by general lien on “allowable assets”.
- **Repayment** is subject to regulatory approval – regardless of maturity term of the loan.
- The issuance of a subordinated loan by a Dealer Member is legally considered the same as an **exempt market debt distribution**.
- IIROC looks to **securities laws** that apply for exempt market distributions (such as investor sophistication, risk disclosure acknowledgment, sought professional independent investment suitability advice).



# Common Issues Encountered with Subordinated Loans

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- Seniority ranking of subordinated debt issued is not always established in the shareholder's agreement of the firm and a common cause for legal disputes when there are simultaneous departures of shareholders.
- Terms added to the agreement schedule submitted for IIROC approval sometimes include a general lien on all the assets of the firm in favor of the lender upon default. This negates the purpose why the loan is “subordinated in favor of customer claims” in the event of an insolvency.

# Common Issues Encountered with Subordinated Loans

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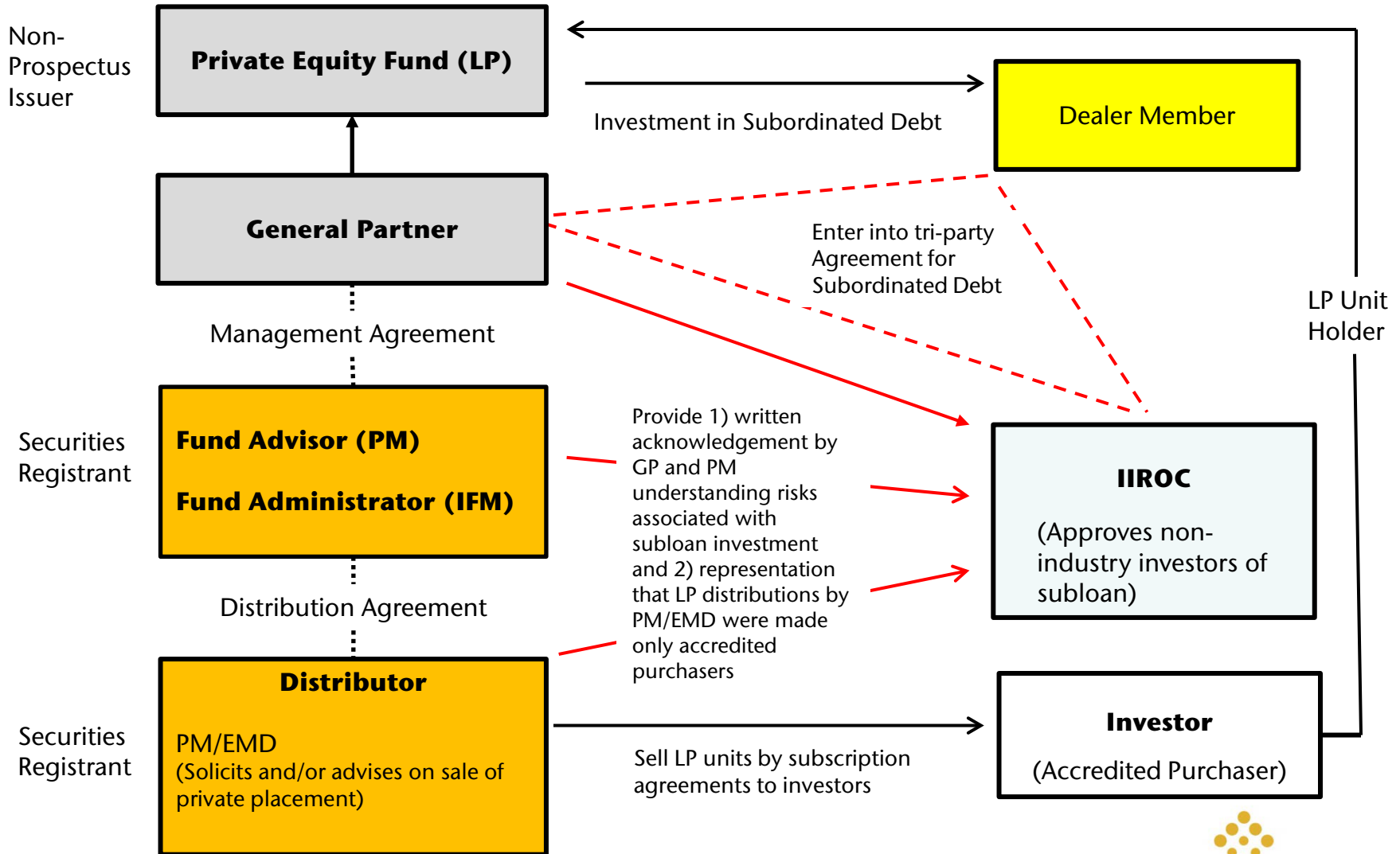
- Prescribed industry agreement provides that a bank may give notice for demand repayment. Terms of the agreement provide that if not repaid within **40 business days of demand notice** – the loan is no longer subordinated. This is a long standing clause negotiated into the agreement by Canadian Chartered Banks.
- The risk to an independent firm is that if the clause is enacted by the bank lender, the subordinated loan no longer counts as regulatory capital after 40 business days – and may jeopardize the capital position of a firm.

# IIROC Criteria for Approving Subordinated Loan “Non-Industry Investors

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- The issuance of a subordinated loan by a Dealer Member is legally considered the same as an “exempt market” debt distribution and IIROC approval is subject to performing due diligence of the investor applicant.
- IIROC requires signed representations and acknowledgment from the investor applicant that:
  - They have been provided disclosure of the financial condition and membership status of the Dealer Member
  - They identify the category of “accredited investor” definition they meet
  - They have been disclosed the specific investment risks associated with the investment
  - They have sought independent investment advice provided by a qualified professional and the investment is suitable

# IIROC Requirements for Non Industry Private Equity Fund Investor





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# Condition for Capital Provision Relief in Appealing a Lawsuit Court Decision

# IIROC MR Notice #230 - Contingent Loss Regarding Litigation

- If court judgment and the firm does **not** appeal – defending firm must fully accrue for the contingent loss or capital provision equal to the total court judgment (award, accrued interest and legal costs )
- If firm decides to appeal:
  - Firm is permitted 30 days from date of court decision to decide whether to appeal. If so, a legal opinion must be obtained from independent law firm (not associated with original trial or appeal process) opining on the errors of fact and/or law identified in the trial decision/transcripts and probability for a reversible judgment.
- Per IFRS - If more than 50% probability of successful appeal – capital or loss provision is **not** required – note disclosure **is** required.