

Financial & Operations Compliance

Current Trends & Issues

FAS Annual Conference
Niagara-on-the-Lake 2014

Agenda

Trends

- RTR cycle
- Risk model validation
- Membership status
- Part-time CFOs
- FAQ sources of capital
- Leverage monitoring
- MFDA members offering ETFs

Agenda

Issues

- Margin requirements for SBL arrangements
- Disclosure to clients of Dealer Members' financial position
- Type 2 trade away / CB credit controls
- NBPPs
- Client name MF confirmations
- Capital rental arrangements – underwriting put options
- Insurance segregated funds custody requirements

Trends

RTR cycle

- FINOPS, BCC and TCC risk models applied to all firms
- RTRs issued to all firms once every 3 years
- RTRs delivered annually to all firms rated high risk in any of the 3 IIROC risk models
- RTRs (as at Mar31/14) issued to all firms in July
- Meetings scheduled with senior executives of firms to review key risk attributes and engage in constructive discussion as to what the firm will do to reduce risk profile
- Number of high risk firms decreased in 2014

Trends

Risk model validation

- Objective of FINOPS risk model is to identify firms with highest probability of incurring a capital deficiency
- FINOPS validates its risk model every 3 years by studying risk scores of firms incurring a CD
- FINOPS model is reviewed annually for new risk attributes and/or changes in risk score weighting

Trends

Risk model validation (cont'd)

- Median risk score for all firms as at March 31, 2014 was 1.79
- Median risk score for firms with a CD occurrence between 2001-2014 was 2.60
- Firm risk scores of 2.7 and higher are categorized as high risk
- Model continues to be a good predictor of firms with highest probability of incurring a CD

Trends

Risk model validation (cont'd)

Risk Score Category/ Risk Score Range	Low <1.80	Low - Medium 1.80 - 2.34	Medium - High 2.35 - 2.69	High >2.70
Percentage distribution of risk scores (178 firms - as at March 31, 2014)	54% (97)	27% (48)	9% (16)	10% (17)
Percentage distribution of risk scores of 133 capital deficiency occurrences (2001 - March 2014)	20% (27)	12% (16)	20% (27)	48% (63)

Trends

Membership status

- Small boutique firms with institutional trading and corporate financing business models facing challenging economic environment
- These firms are introducing brokers with no custody of customer monies/securities with risk of insolvency with loss to investing public low
- Represent majority of firms that have wound down and resigned IIROC membership in past few years
- More resignations possible over next 12 months - EMD registration an option considered

Trends

Part-time Chief Financial Officers (CFO)

(IIROC Notice 14-0088 April 2, 2014)

- Part-time CFOs common amongst type 2 introducing brokers due to cost considerations
- IIROC Notice sets out regulatory expectations regarding engagement of a “part-time” CFO
 - CFO position is an Executive (mind and management) of the firm
 - Regulatory obligations the same as a full-time CFO
 - Individual cannot work remotely and must regularly attend offices and supervise work on site
 - Individual must continually evaluate time commitment relative to scale of business activities and demands of all retainers
 - Must manage conflicts of interest and confidentiality

Trends

FAQ for sources of capital

- FAQ prepared to assist in submission of approvals for regulatory capital
- Supplemented by decision tree charts to illustrate process
- Addresses various IIROC rule requirements for notice of changes in capital, ownership thresholds (10%, 20%, 50%), levels of approval such as District Council approval, supporting documents
- Addresses regulatory issues of subordinated loan providers that are not “industry investors” (registered persons or employees) of the firm

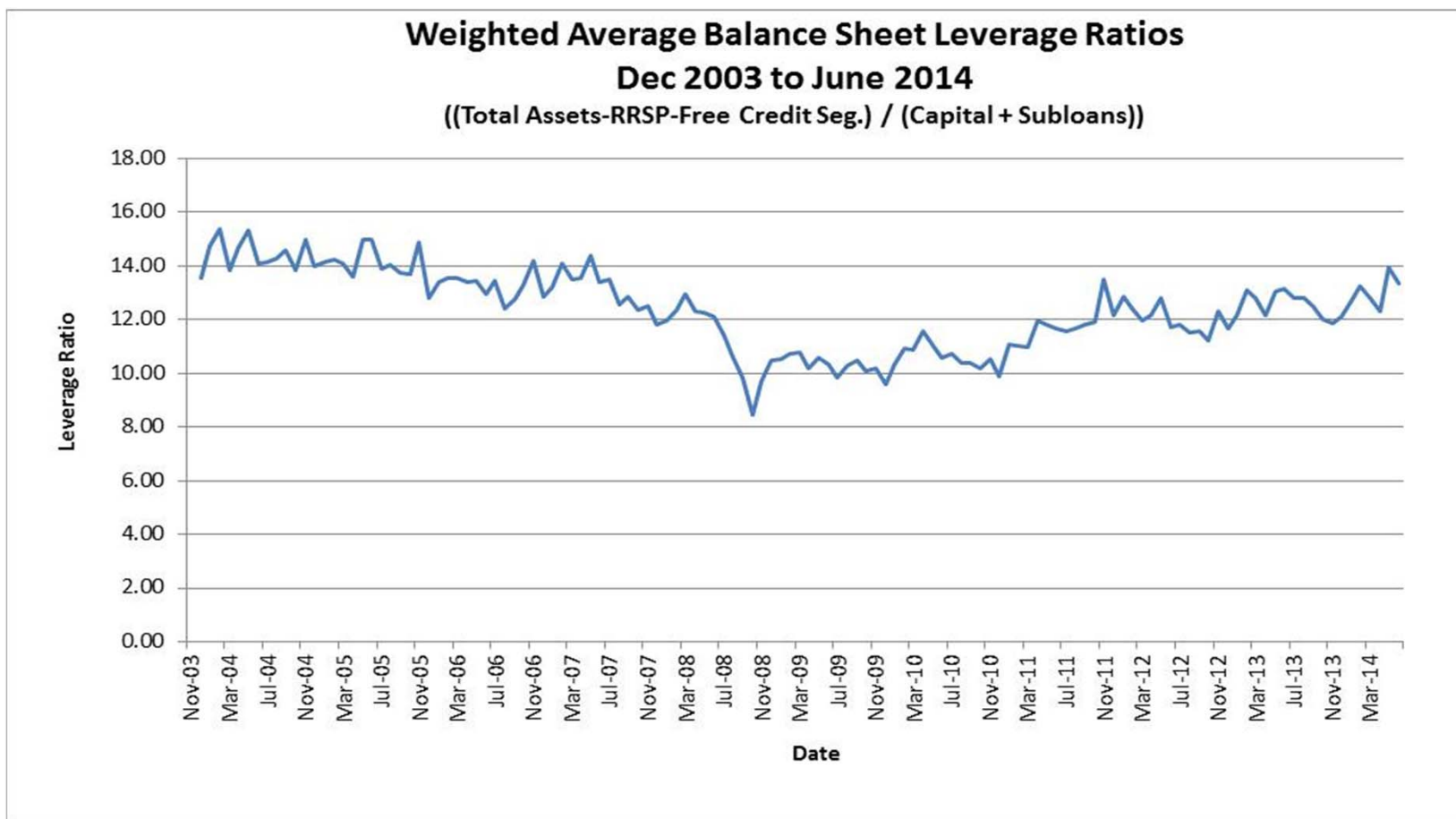
Trends

FAQ for sources of capital (cont'd)

- Increasing trend for small firms seeking non-industry investors as sources for subordinated loans or share capital
- Additional requirements for approval – must be an accredited investor, written acknowledgement regarding financial information, risks and conditions of repayment
- Below is the link to the FAQ on the IIROC website
<http://www.iiroc.ca/industry/industrycompliance/Pages/Financial-Operations.aspx>

Trends

Leverage monitoring



Trends

MFDA Members offering ETFs

- Securities Commissions now permit Mutual fund dealers to sell exchanged traded funds (ETF) no different than prospectus issued mutual funds.
- MF dealers require access to TSX to sell ETF's may only set up an “omnibus trading account” with a dealer member to execute, settle and custody the positions on a non-fully disclosed basis – otherwise Rule 35 prohibits the arrangement.

Issues

Margin requirements for SBL arrangements

(IIROC Notice 14-0066 March 13, 2014)

- Concerns with current margin requirements
- Agency agreements
- AC versus RE counterparties
- Over-collateralization
 - 102% of loan for cash provided as collateral by borrower
 - 105% of loan for securities provided as collateral by borrower

Issues

Margin requirements for SBL arrangements (cont'd) (IIROC Notice 14-0066 March 13, 2014)

Questions

- Other counterparties and non-Als acting as agents
- Underlying counterparty classification
- Lending and borrowing with the same counterparty
- Bulk collateralization

Disclosure to clients of Dealer Members' financial position

(IIROC Notice 14-0157 June 26, 2014)

- Firms must provide summary statement of financial position on request
- Audit opinion implications on summary financial position due to new CAS
- Regulatory solution is to allow summary information to be provided on either an audited or unaudited basis
- Source of unaudited summary balance sheet may be based on last audited Form 1 on SIRFF and certified by CFO
- Require SIRFF programming

Type 2 trade away/CB credit controls

- Changing marketplace with DMA and HFT clients
- New ETR rules regarding pre-trade controls and “kill switches”
- Many type 2 introducers have own PO with TSX and other marketplaces providing clients with electronic gateway to execute trades on marketplaces
- Introducers must comply with ETR and have appropriate pre-trade controls.
- CB must ensure that Type 2 IB pre-trade controls are consistent with own CB credit risk limits imposed in IB and have systems in place to monitor for credit limits (real time post trade)

Issues

NBPPs

- NBPPs represent a significant business for corporate finance firms
- If compensation paid by Issuer to Member must consider facts as to whether the trades must be recorded “on book”
- Factors to consider:
 - Nature of IIROC Dealer’s involvement?
 - What form were fees paid?
 - Was the order solicited by the registrant?
 - Was advice given by the RR?
 - If dealer involvement was incidental or minimal may not need to be recorded on book --- check facts with FINOPS manager

Client name MF confirmations

- IIROC Rule 200.1(h) requires every DM to send trade confirmations to clients for all trades
- Some DM continue to execute mutual fund trades in client name – with the trade confirmation issued by the MF company
- IIROC pursuing Rule amendment for *client name mutual fund transactions*, subject to following criteria:
 - DM procedures to evidence by reconciliation that MF trade confirmations have been issued
 - Trade confirmation issued by MF company must comply with all IIROC disclosure requirements including the DM acted as agent and future CRM disclosure requirements
 - DM must have effective procedures to supervise for suitability
 - Monthly customer statement must still be issued by the DM

Underwriting capital rental arrangements put option contract

- Type 2 IB's conducting corporate finance business and require additional capital on a bought deal
- One DM lends capital to another DM by entering into a put option contract to buy the unsold allotment at a fixed price on closing
- The Lender is required to provide margin the same as for a short put contract
- The borrower may reduce inventory margin required by offsetting the long put option versus long underwriting security position

Issues

Underwriting capital rental arrangements put option contract (cont'd)

- To use out clauses for margin reductions – lender required to add following term to put option contract:

“The Borrower hereby provides authority to the Lender to require the Borrower to act upon the out clauses in the underwriting agreement at the sole discretion of the Lender.”

Insurance segregated funds requirements

- Reporting of insurance segregated funds on client month-end statements is permitted subject to certain IIROC conditions set out in MR Notice 207
- Key condition is that any payments made by the Issuer of the contract to the beneficial holder must flow through the DM as intermediary to establish control over the “asset” holding reported in the DM’s stock record
- Customer segregated fund contract positions are subject to CRM – which raises operational issues as to future compliance with CRM in respect to valuation and performance reporting

Trends & Issues

Questions?