Ian C.W. Russell FCSI
President & Chief Executive Officer

September 10, 2007

Mr. Ethiopis Tafara
Director, Office of International Affairs
Securities and Exchange Commission
Station Place
100 F Street, N.E.
Washington, DC 20549-9303

Dr. Eric R. Sirri
Director, Division of Market Regulation
Securities and Exchange Commission
Station Place
100 F Street, N.E.
Washington, DC 20549-9303

Dear Messrs Tafara and Sirri:

Enclosed is a submission that describes in some detail how Canadian investment dealers have structured their businesses to deal with U.S. investing clients, and assesses how these businesses would benefit from more liberal regulatory treatment. The submission reflects the input from industry professionals representing a broad cross-section of investment dealer registrants. Input has been received from our large integrated firms carrying out a wide range of business in the United States, as well as from small institutional firms specializing in private placement financing and equity capital markets trading.

We are hopeful this submission will provide you and your colleagues with a practical perspective on how the Canadian securities industry projects business into U.S. capital markets, and assist in your efforts to design a model that provides for mutual recognition of regulatory standards.

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Industry professionals who have contributed to the enclosed submission would be delighted to respond to any questions, clarifications or elaboration on any of the points raised in the enclosed submission. Further, we would be pleased to bring a small delegation to Washington to exchange views on the contents of this submission, if it would be helpful.

Yours sincerely,

Enclosure

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INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

SUBMISSION TO THE SECURITIES AND EXCHANGE COMMISSION

PROPOSAL FOR MUTUAL RECOGNITION: A CANADIAN INDUSTRY PERSPECTIVE

INVESTMENT INDUSTRY ASSOCIATION OF CANADA

SEPTEMBER 10, 2007

SUBMISSION TO THE SEC:
PROPOSAL FOR MUTUAL RECOGNITION:
A CANADIAN INDUSTRY PERSPECTIVE

Introduction

This paper has been prepared by the Investment Industry Association of Canada (IIAC) to assist the Securities and Exchange Commission (SEC) in designing a proposal for mutual recognition with the Canadian securities industry. In meetings in July between the SEC and the IIAC, SEC expressed interest in the operations of Canadian affiliates conducting business in the U.S. to measure the potential impact on U.S. investors and U.S. capital markets from mutual recognition. This submission represents the collective industry experience of the IIAC's Free Trade in Securities Committee.[1] It describes in detail how the institutional business is presently structured for broker-dealers in Canada selling Canadian securities to U.S. clients, and the benefits accruing to this business from a more liberalized regulatory regime, particularly in terms of improved efficiencies.

The IIAC believes the benefits from more liberal regulatory treatment are numerous and wide-ranging and include:

- benefits for Canadian broker-dealers
- benefits for U.S. clients
- benefits for regulators, and
- benefits for the industry.

Overview of Operations

Canadian brokerage firms are generally divided into independent and bank-owned dealers. These dealers often have different business models for projecting trading, financing and advisory businesses into the U.S. capital markets.

The independent firms in Canada that carry out business in the United States typically have a registered subsidiary of the Canadian registrant. The U.S. subsidiary is located in Canada and is a Canadian incorporated company. The subsidiary is registered with the Financial Industry Regulatory Authority (FINRA) as an Office of Supervisory Jurisdiction (OSJ). Some firms may, for example, have the OSJ located in Toronto with sub-branches in Montreal and Vancouver. The U.S. subsidiary does not have a permanent establishment in the U.S. nor does it have separate physical premises in Canada, although separate books and records are kept to book commissions, pay out

[1] The Committee consists of a cross-section of IIAC member firms from across Canada, ranging from large bank-owned firms to smaller independent and regional firms. The Committee was assembled to examine proposals surrounding removing barriers to cross-boarder securities activities. See Appendix for list of Committee members.

bonuses, expenses, etc. The FINRA subsidiary has no dedicated employees but employs the Canadian employees dually registered in both Canada and the U.S.[2]

These dually licensed individuals are registered in sales and trading, but not in research or investment banking (which are not registration categories under Canadian securities industry). From time to time, these advisors visit their clients in the U.S. but most contact occurs via electronic communication or telephone.

Most large bank-owned firms similarly have a Canadian-based U.S. subsidiary of the parent company that services U.S. institutional clients and are registered as OSJs.

The Canadian-based U.S. subsidiaries of the independent and bank-owed firms focus almost exclusively on the U.S. institutional markets. However, several bank-owned firms carry out retail business with U.S. clients through the Canadian-based U.S. affiliate firm. One firm indicated that its U.S. affiliate has 30 U.S. registered retail branches and approximately 125 registered representatives who are dually registered and based across Canada.[3]

In addition to the Canadian-based U.S. registrant, most of the bank-owned firms also have a stand-alone U.S.-based affiliate registered with the FINRA and staffed with U.S. registrants who sell primarily to U.S. clients. This U.S. affiliate based in the United States may also have registration as an “International Dealer” with the Canadian regulators to sell U.S. securities into the Canadian markets.

Some bank-owned firms have a different business structure than described above, deciding not to establish an OSJ subsidiary but have instead a registered branch of the U.S.-based broker-dealer affiliate. This Canadian branch houses dually licensed salespersons. The U.S.-based broker-dealer is often as large as the Canadian banked-owned firm and, based on its business, requires a physical presence in the U.S. to deal with their American institutional and retail clients trading in U.S. securities. For U.S. clients that wish to purchase Canadian products, the broker uses the Canadian branch to execute the order. One firm indicated that their Canadian branch of the U.S. affiliate is comprised of 139 dually-registered institutional advisors. Some of these firms are registered as International Dealers in Canada and some are not. Many would have branches in other Canadian cities.

Only one firm on our Committee indicated that they utilize Rule 15a-6 of the Securities Exchange Act of 1934.

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[2] This structure is sometimes referred to as a “dual firm” model.

[3]This section of the submission touches on retail operations of Canadian firms and U.S. based broker-dealer affiliates for the purposes of illustrating the range of Canadian investment operations in the U.S. However, the IIAC is assuming that a mutual recognition proposal would apply to Canadian (or foreign) firms effecting transactions for U.S. institutional investors in non-U.S. securities.

Products Offered

Most firms do not anticipate expanding the range of products/securities sold to clients under a mutual recognition regime. The product line would stay fairly constant: Canadian listed equities traded in the secondary market, new issue products and private placements. Some Canadian firms also execute on a limited basis transactions in U.S. securities traded in secondary markets.

Some of the larger bank-owned firms also engage in more complex securities transactions through their U.S. subsidiary, including arbitrage strategies in Canadian securities, index products, structured products, options and derivatives. These transactions complement the more traditional business in exchanged-traded and OTC Canadian equities, and fixed income products. Firms also provide research on Canadian companies to U.S. clients to facilitate investment decisions in Canadian equities. One firm provides research on 90 Canadian junior mining and energy companies. For Canadian firms with U.S. affiliates that offer services to U.S. retail clients, the products include Canadian registered retirement accounts (similar to IRAs), cash and margin accounts, "blue sky" eligible securities and government fixed income securities.

Credit and Capital Issues

One difficulty that many Canadian independent firms face, notably the many smaller institutional boutiques, is access to sufficient capital to seize U.S. business opportunities. The smaller independent firms, with limited capital resources, must allocate capital to the U.S. subsidiary. Limited available capital requires the firms to operate with flexibility and inject capital into the affiliate in response to transactional opportunities with U.S. institutional investors. Further, transactions tend to be capital-intensive involving private placement financings, often reflecting extended settlement to avoid "fails", i.e. failing to deliver transactions that remain unsettled for a specified period. These institutional boutiques must constantly monitor capital levels in the Canadian registrant and U.S. broker-dealer to ensure capital is employed efficiently. Maintaining and monitoring these capital requirements is challenging, costly and time consuming. For the bank-owned firms this is less of an issue, especially for those firms that simply operate a branch in Canada of the U.S. based firm, which is adequately capitalized.

The limited capital in the U.S. subsidiary, compared to the Canadian registrant, handicaps the smaller dealer by restricting business opportunities as many U.S. institutional investors set minimal capital thresholds for dealing with broker-dealer registrants.

Another capital issue relates to private placements under Rule 144A (which by definition is a resale of securities initially acquired by the Canadian broker-dealer with the U.S. broker-dealer acting as its agent or in a riskless principal transaction). These transactions can fail with some regularity due to administrative delays in removing restrictive securities legends. Furthermore, unlike listed securities, they can take a few weeks to settle with the custodian on the other side of the transaction. As a result, as the time period of an unsettled transaction lengthens, a serious capital charge is levied on the

dealer by the SEC. It is further exacerbated by the fact that the longer the fail, the higher the charge.

Canadian dealers have indicated that the frequency of securities "fails" requires a significant margin of excessive capital in the U.S. subsidiary.

Further complicating the capital problem is the fact that injecting capital into the subsidiary is a very inflexible process as compared to Canada. In Canada, if a firm requires an injection of capital, it can execute a subordinated loan within two or three days. Similarly, the firm can move more quickly in Canada than in the U.S. with respect to canceling the subordinated loan.

This inflexibility raises challenges regarding the allocation of appropriate capital for the U.S. subsidiary. For example, if a firm is concerned about the extended settlement of a private placement deal and likelihood of taking a capital hit, the firm can either enter into a subordinated loan for the U.S. subsidiary or draw capital into that subsidiary from the Canadian firm. However, if the capital via the loan is unnecessary, the capital remains "stuck" in the U.S. subsidiary and it will take some time to withdraw the subordinated debt.

Furthermore, if a firm is waiting for a private placement transaction to close and the capital is limited, it cannot move on to another transaction. Consequently, a smaller firm is limited in the number of private placement transactions it can undertake with institutional clients. Under a mutual recognition regime, the capital constraints for smaller institutional firms would be alleviated as Canadian firms could use the larger capital platform of the Canadian registrant to conduct certain U.S. institutional business. This may increase business with U.S. clients as U.S. institutional investors will derive more comfort from the larger capital base of the Canadian broker-dealer.

<u>Clients</u>

At present, the clients of the Canadian-based OSJ or branch are comprised of medium to large U.S. institutions, including investment managers, fund managers, pension funds, mutual fund companies and hedge funds (i.e. Fidelity, SAC, etc.). Many firms indicated that several of their clients are emerging hedge fund managers with less than $100 million but more than $10 million in securities that it owns or invests. Furthermore, they often have clients that are smaller institutions or corporations that are not designated as QIBs. This is the case for both the independent and bank-owned firms.

The smaller independent firms have indicated that, if mutual regulatory recognition becomes reality, access to new clients would broaden considerably, reflecting the ability to operate on the higher capitalized domestic registrant platform for U.S. institutional transactions. Some firms have also indicated the increased capital availability would enable a broadening of product line into the full range of products and services provided to domestic clientele.

Operational Inefficiencies

The business inefficiencies of carrying out U.S. securities business through the U.S. registered broker-dealer are significant. First, the bifurcation of scarce capital between the Canadian and U.S. registrants, and related monitoring of adequate capital, entails significant costs. Second, the required dual registration for the employees of Canadian dealers carrying out business through U.S. registered broker-dealers is costly. This duality in registration requirements results in duplication and excessive costs in respect to training, proficiency, and licensing, and ongoing continuing education requirements.

The requirement to accommodate the examination and audit of compliance standards with two regulatory bodies for a dually registered Canadian firm is costly and duplicative, given overlapping bi-annual FINRA examinations and the Investment Dealers Association of Canada (IDA) audit. Further, inefficiencies and cost increases are exacerbated as the compliance personnel of dually-registered Canadian firms expend considerable resources acquainting FINRA regulators on the features of the Canadian regulated operations.

This duality also results in dual books and records, two sets of trading tickets, dual written supervisory procedures (WSPs) and dual net capital requirements and monitoring.[4] This duality also leads to higher compliance costs as a result of having to comply with two compliance regimes in areas such as opening client accounts, client documentation requirements, compliance training, and monitoring of trading staff and client activity. Costs are further augmented as firms must hire U.S. legal counsel to ensure that U.S. requirements are properly understood and complied with. Inefficiencies also result from compliance with U.S. rules that often have no relevance (i.e. OATS requirements). Further, there are the challenges and difficulties from complex trading and operational structures and issues that result from maintaining a U.S. broker-dealer within the Canadian environment, supported by Canadian trading, operational, finance and compliance lines and management staff.

Benefits under Mutual Recognition: For Canadian broker-dealers

Under a mutual recognition regime, the removal of the duality of two firms addresses the inefficiencies described above. Canadian dealer-brokers would not have the duplication and resulting costs and time demands from maintaining and adhering to duplicate regulatory environments.

Canadian firms would also gain access to new U.S. institutional clients due to alleviating the credit and capital issues described earlier. In addition, there will be more efficient use

[4] Again, for firms with a large U.S. based affiliate that operates a branch in Canada, the infrastructure already exists in the United States to eliminate some of the duplicity. For example, the U.S. based firm would have developed WSPs that would be applicable to the Canadian located branch and the U.S. broker-dealer would conduct audits of that branch. However, dual registration, dual books and records, dual regulatory examinations and the processing of trades on two sets of books would still result in inefficiencies for firms structured in this manner.

of capital as capital can be consolidated within the Canadian registrant. This larger consolidated capital base would allow firms more flexibility to manage failed transactions.

Benefits under Mutual Recognition: For U.S. Clients

For U.S. institutional clients, there are many benefits under a mutual recognition regime. Generally, the reduction of costs and inefficiencies for the Canadian firm will translate into better service for the U.S. institutional client.

A significant benefit for the U.S. institutional market tapping into Canadian investment products and services would be greater investment choice as a mutual recognition regime enables more Canadian broker-dealers to enter the U.S. institutional market to compete for existing business and offer new product and services. Further, increased competition will improve the flow of information on Canadian market movements and Canadian investment products.

Moreover, U.S. institutional clients will gain greater insights into the Canadian markets and Canadian investment opportunities by drawing on the full range of professional resources within the firm, instead of restricting access only to dually-registered traders.

Another advantage for U.S. institutional clients is that they will be eligible for protection under the Canadian Investor Protection Fund (CIPF) with better coverage than that offered by the Securities Investor Protection Corporation (SIPC) in the United States. CIPF covers customers of member firms who have suffered or may suffer financial loss as a result of insolvency of a member, similar to the coverage offered by SIPC. However, while SIPC coverage is limited to $500,000 per customer, CIPF coverage is equal to $1 million per customer.

Finally, a mutual recognition regime will provide commonality for U.S. broker-dealer registrants conducting business in Canada, facilitating ease of access into the Canadian market. This will allow for true reciprocity between Canada and the United States. In particular, U.S. registrants may offer services in Canada through an automatic registration exemption or formal registration as an "International Dealer" registrant, the option depending on the provincial jurisdiction.

The automatic registration exemption is offered in all provinces except Ontario and Newfoundland. It is available to foreign dealers offering prescribed products and services to a prescribed set of investors. The automatic exemption grants U.S. brokers (and other foreign securities dealers) an exemption to accept trades from "accredited investors" and in other specific situations (i.e. private issues or trades with relatives, friends and business associates).

In Ontario and Newfoundland, a foreign dealer can register as an "International Dealer" where the firm simply files a notice of registration as an International Dealer in Canada. Under this category, the dealer may offer foreign and certain debt securities to certain

sophisticated investors. The category of International Dealer in these two provinces has far less registration requirements associated with it as compared to the standard registration for Canadian broker-dealers. For example, under the regular category of investment dealer a firm would have to file financial statements, have the requisite insurance, register all officers and directors, designate a compliance officer, file a statement of priorities which outlines all related and connected issuers of the firm, and become a member of the IDA with membership requirements including capital requirements, record keeping, new accounts and supervision, segregation of funds and securities, proficiency requirements, trading and other matters. On the other hand, an International Dealer does not have to meet these requirements.

Benefits under Mutual Recognition: For Regulators

There are benefits for U.S. regulators under a mutual recognition regime. Firstly, it will lead to a more efficient use of resources as regulators will not have to register, monitor and audit the thirty-plus Canadian dealers operating in the U.S. Secondly, the standard of investment protection in the U.S. markets will be higher as the mutual recognition regime will enable U.S. institutional investors to deal with the better capitalized Canadian dealer registrant.

It will also demonstrate that U.S. regulators are progressive. Further, it will provide the same recognition of other foreign regulators as they have permitted for the United States.

From a "model" standpoint, using Canada as a test case is an ideal choice for U.S. regulators due to the broad similarities in disclosure regimes and regulatory structure. The success of the MJDS disclosure regime illustrates the regulatory congruence. Furthermore, proximity, size and language are all factors that would lead to a successful launch of this initiative in Canada. Finally, in Canada, this initiative has the industry's support through the voice of the IIAC. The IIAC, on behalf of its members, is dedicated in assisting the SEC's efforts to design a model that provides for mutual recognition of regulatory standards.

Benefits under Mutual Recognition: For the Industry

While most of the benefits of mutual recognition have been described above, it is important to contemplate the benefits to the industry as a whole. Minimizing inequality between U.S. and Canadian brokers is a positive step in the global economy. In addition, the breaking down of trading barriers and the movement towards the globalization of capital markets has become a focus on the international stage as it has been a topic of discussion at the G-7 and World Trade Organization as well as the Security and Prosperity Partnership of North America (SPP). One topic on the SPP's recent agenda was mutual recognition as North America is recognized as a leader in shaping this initiative.

The Investment Industry Association of Canada believes that the benefits of mutual recognition, as this paper has outlined, are clear. The initiative will achieve benefits in

terms of reduced costs, greater efficiency, better allocation of resources and improved access, without diminishing investor protection. Consequently, co-operation and mutual recognition provides advantages for all industry participants: regulators, broker-dealers and investors alike.

APPENDIX

FREE TRADE IN SECURITIES COMMITTEE

Committee Members	Firm Name
Chris Salapoutis, Chair	Orion Securities
D. Christopher Climo	TD Securities Inc.
David Lang	RBC Dominion Securities Inc.
Gina Yee	Scotia Capital Inc.
Michael Ward	Paradigm Capital Inc
Nancy Peck	Jennings Capital Inc.
Stephen Cameron	BMO Nesbitt Burns Securities Ltd.
Terrance K. Salman	Salman Partners
Thomas Wu	Wellington West Capital Markets Inc.
Ian Russell	IIAC
Michelle Alexander	IIAC