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

Michelle Alexander
Director, Policy

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Mr. Louis Piergeti
Vice-President, Financial and Business Conduct Compliance
Investment Industry Regulatory Organization of Canada
121 King Street West, Suite 1600
Toronto, Ontario M5H 3T9

DELIVERED VIA EMAIL

Dear Mr. Piergeti:

RE: Request for comments on draft "Requirements and Best Practices for distribution of non-arm's length investment products" (the Notice)

The Investment Industry Association of Canada (IIAC) appreciates the opportunity to respond to the Notice issued for comment by the Investment Industry Regulatory Organization of Canada (IIROC).

The IIAC formed a Working Group to assist in developing this submission. The Working Group was comprised of numerous members from across Canada, representing a broad cross-section of firms.

To begin with, the Working Group questions the rationale for this Notice. We do not believe that IIROC has sufficiently explained the regulatory concerns arising from the distribution of non-arm's length products as compared to arm's length products. We recognize that registrants must undertake additional vigilance when recommending the former, but the standards, rules and requirements for both types of products are, and should be, the same. Has there been any risk determination with respect to non-arm's length issues and the level of that risk posed to clients?

Complying with this Notice would impose a great deal of new obligations on members and it is not clear that IIROC has assessed the costs involved or considered why current

requirements with respect to product due diligence, suitability and conflicts of interest are insufficient to address IIROC's concerns.

Consequently, the IIAC believes that this Notice need not be issued. Instead, we recommend that IIROC publish a short notice reminding registrants that the existing product due diligence guidelines apply equally to both non-arm's length and arm's length products. Additionally, IIROC may want to remind members of the conflict of interest provisions contained in National Instrument 31-103 Registration Requirements and Exemptions (NI 31-103) and the Companion Policy, which provide that conflicts can be addressed through a variety of means including avoidance, control or disclosure of the conflict.

If IIROC is not persuaded to withdraw the Notice, then the Working Group would like to highlight some areas in the Notice that should be amended or clarified. We have provided these specific comments below.

New Requirement for Notice

The IIAC Working Group wishes to highlight at the outset its concern over the newly proposed notice provision described as a "new requirement" and not a recommended best practice. New regulatory requirements should go through the required rule-making process, which includes approval by the IIROC Board of Directors, a public consultation process and revisions to the rule if necessary, with subsequent securities commission approval prior to inclusion in the IIROC Rulebook. When new requirements are introduced it is important to ensure the required processes are in place for appropriate industry review and regulatory scrutiny.

In connection with this issue, the IIAC would like to mention the letter written to IIROC on April 6, 2010. That letter generally outlines our members' concern that many prescriptive rules are being introduced through IIROC Guidance Notes rather than the normal rule-making process. In that letter, we requested that IIROC re-evaluate its processes and ensure that Guidance Notes focus on best practices rather than implementing new regulatory requirements.

We have further issues with the notice provision (which are discussed later in this submission) but felt it was important to express our grave concern regarding the inclusion of this completely new requirement in the Notice. We recommend this requirement be removed from the Notice and instead developed and reviewed under the usual rule-making process.

Overview

The Notice states that there have been "specific instances where clients of IIROC Dealer Members have suffered losses as a result of investing in such products." However, there is no evidence provided that there are proportionately more losses or complaints with respect to non-arm's length products than there are for arm's length products.

While IIROC did provide a presentation at the Compliance and Legal Section (CLS)

meeting on February 17, 2010 in Calgary, we do not see how these examples provide sufficient evidence of the need for this Notice. Three of the four examples involved securities law violations that the proposed Notice would have likely not addressed. These included offbook illegal distributions of securities in the Essex and iForum cases, and the misappropriation of fund assets in the Thompson Kernaghan case.

It is not clear to the Working Group how any amount of independent valuation or IIROC review would have affected to whom the product was actually sold or what occurred in the operation of the fund, especially where the member demonstrated a clear disregard for securities regulations. Further, in the fourth situation (Graydon Elliott), it does not appear that the non-arm's length products had any role in the insolvency of the member. Instead, investors in those products appear to have suffered legitimate investment losses.

Depending on market conditions, there could be proportionately higher losses in different sectors or in different individual companies at any given time, whether the products sold are arm's length from the member or not. As a result, highlighting non-arm's length products in such a Notice does not "alert Members to the regulatory concerns" nor provide helpful guidance.

Summary of Expectations for Dealer Members and Regulatory Issues

The Notice summarizes obligations in respect of the distribution of non-arm's length products in a sequence of steps. The Working Group believes that both the section in the Notice on Expectations and the subsequent section on Regulatory Issues apply equally to arm's length products and non-arm's length products; specifically, the steps on conflicts of interest, product due diligence and client specific suitability. Consequently, the Working Group believes that IIROC currently maintains sufficient rules with respect to suitability and disclosure to satisfy any concerns with distributions of both types of products.

Step 1 – Conflict of interest assessment

Conflicts of interests can arise for not only non-arm's length products but arm's length products as well; for example, when sales representatives have personal conflicts or compensation structure conflicts.

Furthermore, conflicts of interest are currently addressed under sections 13.4 to 13.6 of NI 31-103 and the accompanying Companion Policy, which makes additional IIROC guidelines in this area somewhat redundant. Duplicative requirements with respect to suitability, conflicts and disclosure may lead to confusion among members, especially when these requirements are found in a Notice rather than contained in the Rulebook itself. It would be helpful if IIROC could describe how it believes the provisions contained in NI 31-103 are deficient.

In addition, the provisions contained in the Notice are inconsistent with the requirements in NI 31-103. The Notice provides that a member must assess whether a conflict of interest can be addressed "in the client's best interest". The requirement in subsection 13.4(2) of NI 31-103 states that a firm "must respond to an existing or potential conflict

of interest identified under subsection (1)." Nowhere under NI 31-103 nor in the accompanying Companion Policy is there a requirement that a conflict be "addressed in the client's best interest." The Companion Policy to NI 31-103 does outline in section 13.4 that a conflict should be avoided if "it is sufficiently contrary to the interests of a client that there can be no other reasonable response." However, this test is not as strict as the test of being in "the client's best interest."

Finally, the language in the Notice is somewhat unclear as to which clients the firm should examine. Is the Notice suggesting that the firm must consider *all* clients when determining if a non-arm's length product would give rise to a conflict of interest? Does it not depend on each client separately and their individual circumstances? While there may be a conflict of interest between one member and a client, there may be absolutely no conflict between another client and the firm. The language of this section states that if the conflict of interest cannot be addressed, the "products should not be sold to *any* client." [emphasis added]. This appears to be an overly inclusive requirement. We would suggest that this section be clarified to state that if a potential conflict of interest exists with the intended targeted clients and if the conflict cannot be adequately addressed then it cannot be sold to those particular clients.

Step 2 – Product due diligence

This step requires that the member conduct an examination of the concerns with the product that "would make it unsuitable for any client" which would then require that the member not distribute the product. This provision does not seem to recognize that members have a wide variety of clients and the analysis should not be driven by the lowest common denominator. Provided that the product is suitable for some clients, the product should be permitted to be sold to those clients.

Further, our Working Group recommends that this product due diligence review should not be required if the affiliated party that is issuing or sponsoring the product is a regulated entity, as such entities would be subject to a high standard of regulatory oversight. For example, if it is a bank product that a bank-owned firm is issuing, then the bank would be subject to OSFI requirements and review. We would also suggest that the definition of regulated entity include any regulated entity that is subject to a satisfactory regulatory regime in the country in which it is located. This would thereby encompass global firms that offer products issued by global affiliates that are banking or securities licensed.

In these situations, we suggest that it would be sufficient to simply ensure that the client understands that the parties are related and that the firm is effectively selling its own product.

Step 3 – Client specific suitability

The Working Group questions IIROC's role in product and distribution reviews. The second bullet point under Step 3 states that the member may complete the trade once it is considered suitable, provided that the trade otherwise complies with applicable laws and IIROC Rules and that "IIROC has not objected to the distribution."

Again, this is yet another new requirement included in this Notice, not otherwise required under securities legislation or the IIROC Rulebook. Further, we question the authority that IIROC has to approve any distributions by a member firm. We request that this provision be removed from the Notice.

Regulatory Issues - Protection Fund Coverage

This section suggests that CIPF may not cover losses in respect of non-arm's length products. If this is the intention, it is of great concern and one that CIPF should immediately address and clarify.

The Working Group is aware that CIPF does not cover losses in customers' accounts related to the business financing purposes of a member, such as securities lending and purchase/repurchase transactions, but there is no suggestion that this limitation applies to any issuer other than a member. If CIPF takes the view that eligible customer losses might not be covered for investments in issuers related to a member, this has huge implications for dealers. Members were not aware that CIPF coverage might not include non-arm's length products. The IIAC requests immediate clarification on this issue by CIPF.

Investment Products and Issuers Covered by this Notice

This section indicates that the Notice applies to securities of related and connected issuers. Related and connected issuers to a member may frequently change depending on investment banking services or activities that the member may provide. There may be no reasonable or practical way to properly track the connected/related issuer status to ensure that all of the requirements contained in the Notice can be met.

Moreover, with respect to related and connected issuers, National Instrument 33-105 Underwriting Conflicts specifically addresses connected and related issuer conflicts of interests. Therefore, it is unclear why this Notice must address connected and related issuer conflicts.

In addition, connected issuers often arise in the underwriting context where the issuer may be borrowing from the bank, meaning that the bank-owned dealer, acting as underwriter, is connected. Such a situation does not seem to warrant the requirements outlined in the Notice. Further, if it is deemed appropriate that the product be underwritten, then why should it not be sold through the dealer channel?

The list of products found on page seven includes products such as GICs and mutual funds. Numerous regulations cover these products today and require product due diligence. Consequently, we question the rationale for including GICs and mutual funds in this Notice, especially given the due diligence review required in the Notice, such as the need for audited financial statements or for an external auditor every quarter. We believe that the additional requirements in this Notice are unnecessary and may be unrealistic where a firm is distributing its own internal funds in which case it is not likely that the firm will be able to conduct the additional reviews and audits suggested.

Further, in the bank-owned dealer setting, the result could be that some products are no longer sold by individuals who are required to be registered as they are employees of a dealer. Instead, the products will be sold at the bank branch level by employees who are not required to be registered, thereby completely circumventing the objectives of this Notice.

With respect to the obligation for the pricing of the investment product and valuation of the portfolio of the fund by an independent third party, banks do not currently conduct this inquiry for any of their PPNs or equity-linked GICs as it is not required under provincial securities laws or the regulations under the Bank Act. As such, the Working Group questions why IIROC has decided to include such products in this Notice.

Product Due Diligence

This section outlines best practices for members conducting product due diligence and addressing conflict of interest concerns. However, there are many best practices listed in this section that are not contained in the Guidance Note 09-0087 relating to best practices for product due diligence, such as inquiry and analysis of audited financial statements, independent valuation for assets, disclosure as to use of proceeds and other items. We question why, if IIROC feels these items are necessary, they were not included in the product due diligence Guidance Note. Are they only meant to address conflicts of interest? If addressing conflicts of interest is the intention, we believe that many of the items proposed will not be helpful.

Taken in their entirety, these best practices impose a significantly higher burden of due diligence expectations on non-arm's length products than on arm's length products. As noted above, this Notice does not provide any justification for this significantly higher burden beyond a vague reference to "specific instances" of client losses.

Given that conflicts of interest can arise with respect to both arm's length and non-arm's length products, the Working Group suggests that the same due diligence practices apply to both. We believe that existing Guidance Note 09-0087 is stringent enough for all products and therefore no additional steps are required.

In addition, it is not clear if IIROC intends to ensure that all these due diligence practices are in place or simply that members should consider the presence or absence of these best practices? Is IIROC going to insist, for example, on independent pricing in all situations? If not, what are the criteria for deciding when independent pricing is necessary and when it is not?

Notice to IIROC

The Working Group requests that IIROC outline the rationale for requiring notice to IIROC of the distribution of non-arm's length products. Is IIROC planning to approve or deny the proposed distribution? What will be the basis for IIROC objecting to a proposed distribution? Will IIROC at times propose changes in the product prior to approval? Will an appeal process be established if a member disagrees with the decision

of IIROC staff?

Further, it is not clear that IIROC has the mandate to conduct product reviews. IIROC's regulatory responsibility encompasses rules on proficiency, business and financial conduct and the creation and enforcement of market integrity rules regarding trading activity. Product review and approval of distributions is not part of IIROC's mandate, nor has IIROC been given the authority under either provincial securities legislation or through IIROC rules to examine a particular distribution of a particular security and determine whether or not it can occur.

IIROC's ability to review a particular distribution and determine whether or not it should occur is an extension of IIROC's authority that must be granted through the rule-making process. IIROC's authority cannot be extended through a notice.

Further, we question the process by which IIROC intends to provide an exemption from the notice provision if IIROC has "specifically approved the product for distribution without notice." How does IIROC intend to approve the product?

The Working Group is also concerned that notice must be provided to IIROC 20 days prior to the execution of the first trade, with the additional requirement to include certain documentation such as a general description of the investment product and plan of distribution, copies of any offering materials, etc. This will cause significant issues for members from a product launch/availability perspective. Specifically, it will increase the delay time between completion of the offering materials and the ability of the dealer to sell the product. The Working Group recommends that this proposed new requirement be eliminated or clarified in order to determine if the provision is intended as a notice procedure or an approval procedure. If it is the latter, it will be extremely problematic for all members.

This section also requires that notice to IIROC is necessary if the product is not eligible for margin under IIROC Rules. Does this mean that IIROC needs notice of trades in securities held by a control block holder? Does this mean that exchange-listed securities that fluctuate around $1.50 will require IIROC notice on the days when it drops below $1.50, but not on days when it rises above $1.50?

The Working Group is also somewhat concerned about the exemption for securities issued by a federally regulated or provincially regulated financial institution distributed pursuant to an exemption under securities legislation. The Working Group requests an explanation of the rationale for this broad exemption. By including such an exemption, IIROC appears to be creating two tiers of member firms, where affiliates of federally-regulated financial institutions who sell their products are exempt from this notice requirement whereas other members would have to submit to the notice process. Further, yet another tier of firms would be created for firms with global affiliates which are registered with their local securities and banking authorities but have comparable regulatory standards and practices to their Canadian counterparts.

Again, this provides further justification as to why this notice requirement should be deleted entirely.

Enforcement

The Working Group is concerned with the comment in this section that states that a distribution "not in compliance with IIROC Dealer Member Rules *and the terms of this Notice* [emphasis added] may constitute grounds for enforcement action by IIROC."

This language again raises the concern that the Notice is in fact viewed by IIROC as a regulatory requirement and can be used by the regulator as grounds for disciplinary action. This goes beyond the generally accepted idea behind the use of guidance issued by regulators and may fall in line with the *Ainsley* decision and other judicial pronouncements against the enforcement of a policy as if it were a rule or regulation. In fact, on the IIROC website the description of Guidance Notes is as follows:

> Supplements a rule with guidance on the interpretation, implementation or practice of the rule. Contents are not mandatory or enforceable and may refer to best practices.

Based on this description, we recommend that the language which states that non-compliance with this Notice can be grounds for enforcement action be removed.

Institutional Clients

The Notice does not appear to make a distinction between retail and institutional clients. The Working Group is assuming that the Notice applies only to retail clients but would suggest that IIROC clarify this point.

FINRA Rule 5122

The CLS presentation in Calgary makes reference to the Financial Industry Regulatory Authority (FINRA) Rule 5122, relating to private placements of securities issued by members. If IIROC is basing its Notice on this FINRA rule, then we suggest that IIROC include similar exemptions to those set out in section 5122(c). The closest approximation in Canada would be to exempt products sold to "permitted clients" as defined in NI 31-103, as there are fewer client protection concerns with these clients.

Further, the FINRA rule includes a simple filing requirement rather than an approval requirement as contemplated by IIROC.

The IIAC Working Group would welcome an opportunity to meet with IIROC staff to further discuss the Notice and our suggestions for its improvement, as outlined in this comment letter.

Yours sincerely,

"Michelle Alexander"