

# **IIROC NOTICE**

# Rules Notice Request for Comments

**Dealer Member Rules** 

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14-0065 March 11, 2014

# IIROC Concept Paper -Lower minimum capital requirement

#### 1. Introduction

The Investment Industry Regulatory Organization of Canada (IIROC) is seeking comment on a Concept Paper that introduces the possibility of establishing a lower minimum capital requirement for Type 1 and Type 2 introducing brokers, because these Dealer Members either: (1) do not handle or have access to client cash or securities, or (2) if they do, it is in a very limited way and therefore, there is a materially lower risk of client loss in the event of a Dealer Member insolvency. A lower minimum capital requirement would also more closely align IIROC's minimum capital requirement, for Type 1 and Type 2 introducing brokers, with the minimum capital requirements that apply to other securities industry registrants such as exempt market dealers, portfolio managers and certain types of mutual fund dealers<sup>1</sup>.

Minimum capital requirements are set by the Canadian Securities Administrators in the case of Canadian exempt market dealers and portfolio managers, and by the Mutual Fund Dealers Association in the case of Canadian mutual fund dealers.

Refer to comparison of requirements that apply to various securities industry registrants in Canada and the United States set out in Appendix 1.



#### **Reason for consultation**

Within IIROC's membership there are six categories of Dealer Members, based on the business activities a Dealer Member carries on, as well as the types of functions, or combinations of those functions, that a Dealer Member either performs itself or outsources to another Dealer Member. The six categories are as follows:

- Self-clearing Dealer Members;
- Self-clearing Dealer Members that carry the business of other Dealer Members (i.e., "carrying brokers"); and
- Four different types of introducing brokers (Types 1 through 4).

The risk profile of each category, with respect to the potential for loss of client cash or securities, varies as a result of the differing business activities undertaken. The current rules recognize these differences in risk profiles to a certain extent as there are two different minimum capital requirements, namely:

- \$75,000 for Type 1 introducing brokers; and
- \$250,000 for the other five categories of Dealer Members.

We believe there is an opportunity, in recognition of the differences between the risk profiles of certain categories of Dealer Members, to further refine the existing minimum capital rules. In addition, moving towards a further differentiation of the levels of minimum capital required, based on a Dealer Member's business model and risk, is consistent with our overall risk-based approach to compliance. Specifically, IIROC rules restrict the types of securities-related functions that Type 1<sup>2</sup> and Type 2 introducing brokers can perform for clients. As a result of these restrictions, Type 1 and Type 2 introducing brokers either do not handle or have access to client cash or securities, or if they do, their access is limited and for very brief periods of time<sup>3</sup>. For example, in order to facilitate client cash transactions, a Type 2 introducing broker is only allowed to receive cheques from clients in either the name of the introducing broker or the carrying broker, on the condition that the introducing broker immediately delivers the cheques to the carrying broker or immediately deposits the cheques into a bank account controlled by the carrying broker.

Given the comparatively lower risk profile of Type 1 and Type 2 introducing brokers that flows from these more restricted activities, we are considering whether to lower minimum capital requirement for Dealer Members that are either Type 1 or Type 2 introducing brokers. In accordance with IIROC's policy consultation process, we are seeking comment from Dealer Members and other interested stakeholders with respect to this matter.

There are currently no Dealer Members that are Type 1 introducing brokers.

Under Dealer Member Rule 35.3(p) Cash transactions, "the introducing broker may facilitate cash transactions on behalf of clients carried through the carrying broker through the use of an account in the name of either the carrying broker or the introducing broker".



#### Comparison to other securities industry registrants

IIROC staff has benchmarked IIROC's existing minimum capital requirements to those of other regulatory organizations. A summary of the comparison of IIROC requirements to those applicable to other securities industry registrants is attached as Appendix 1. Based on this comparison, it is clear that lowering the minimum capital required for Type 2 introducing brokers would more closely align IIROC's minimum capital requirements with those applicable to other securities industry registrants, such as Canadian exempt market dealers, portfolio managers and certain types of mutual fund dealers.

In comparison to MFDA members, the summary comparison shows that the current \$250,000 minimum capital requirement for IIROC Type 2 introducing brokers is:

- 10 times the \$25,000 amount required for Level 1 MFDA members;
- 5 times the \$50,000 amount required for Level 2 MFDA members; and
- 3.33 times the \$75,000 amount required for Level 3 MFDA members.

In comparison to direct CSA registrants, the summary comparison shows that the current \$250,000 minimum capital requirement for IIROC Type 2 introducing brokers is:

- 10 times the \$25,000 amount required for portfolio managers that are not also registered as investment fund managers;
- 2.5 times the \$100,000 amount required portfolio managers that are also registered as investment fund managers; and
- 5 times the \$50,000 amount required for exempt market dealers.

In comparison to U.S. FINRA firms, the summary comparison shows that the current \$250,000 minimum capital requirement for IIROC Type 2 introducing brokers is:

- Approximately 50 times the \$5,000 USD amount required for U.S. "other broker" dealers<sup>4</sup>;
- Approximately 10 times the \$25,000 USD amount required for U.S. firms selling mutual funds<sup>4</sup>; and
- Approximately 5 times the \$50,000 USD amount required for U.S. introducing brokers with clients<sup>4</sup>.

#### Framework for consultation

In assessing whether lower minimum capital requirement amounts should be introduced for Dealer Members with a certain risk profile, we will be doing so within the framework of our mandate, which is to set and enforce high quality regulatory industry standards, protect investors and strengthen market integrity while maintaining efficient and competitive capital markets.

## 2. Possible lower minimum capital requirements

#### **Current minimum capital requirements**

The exact multiple will fluctuate with changes in the U.S. dollar exchange rate. Multiples have been expressed based on the Canadian and U.S. dollars being at parity.



As part of IIROC's mandate to protect investors, IIROC sets regulatory financial requirements to ensure that Dealer Members remain financially solvent. IIROC requires each Dealer Member to maintain, at all times, a risk adjusted capital amount (RAC) that is greater than zero. RAC is equal to a Dealer Member's liquid, financial statement capital minus:

- specific provisions (mainly capital and margin requirements) that set aside liquid capital as reserves to address specific asset and liability risks assumed; and
- a general provision for future loss (i.e. the minimum capital requirement) that acts as an additional cushion to cover any unforeseen future losses.

Table 1: Examples of the relationship between minimum capital required and RAC

	Example 1 Dealer Member A	Example 2 Dealer Member B
Liquid financial statement capital	\$1,000,000	\$5,000,000
Minus: specific capital and margin requirements	\$600,000	\$3,000,000
Minus: the minimum capital requirement	\$250,000	\$250,000
Equals: RAC	\$150,000	\$1,750,000
Key regulatory safeguard: Is RAC greater than zero?	Yes	Yes

#### Remarks:

In Example 1 above, where Dealer Member A's liquid financial statement capital is \$1,000,000, its margin and capital requirements are \$600,000, and its minimum capital requirement is \$250,000, then its RAC would be \$150,000. In Example 2 above, where Dealer Member B's liquid financial statement capital is \$5,000,000, its margin and capital requirements are \$3,000,000, and its minimum capital requirement is \$250,000, then its RAC would be \$1,750,000. Both Dealer Members would have met one of IIROC's key regulatory safeguards by maintaining RAC that is greater than zero.

In addition to maintaining RAC that is greater than zero, IIROC requires each Dealer Member to pass, on an ongoing basis, a series of "early warning" tests. One of these tests requires a Dealer Member to compare its monthly losses, if any, to its RAC. If the ratio of monthly losses to RAC is below a certain threshold, the Dealer Member would fail an early warning test. This test failure would alert IIROC to the possibility that if the Dealer Member continues to experience monthly losses it will exhaust its RAC within a certain number of months and the related early warning rule provisions would give IIROC the ability to take proactive steps to try to prevent the Dealer Member from exhausting its RAC. Through the application of these early warning tests, IIROC is able to identify and take proactive steps to remedy situations where a Dealer Member is exhausting its RAC. Specifically, by closely supervising the Dealer Member to ensure that it has sufficient liquid assets for the short- to medium-term period to operate:

- (1) until its profitability improves; or
- (2) in an extreme situation, until it can transfer its client accounts in an orderly manner to another Dealer Member;

IIROC is better able to protect investors.



As previously stated, the minimum capital requirement for each category of Dealer Member is \$250,000, except for a Type 1 introducing broker, where it is \$75,000. As there are currently no Type 1 introducing brokers, all IIROC Dealer Members are currently maintaining, as a general provision against future loss, a minimum capital requirement of \$250,000.

#### Possible lower minimum capital requirement

Any proposal to lower the minimum capital requirement will not alter the capital framework outlined in Table 1 above, other than to reduce the minimum capital amount for Type 2 introducing brokers. Should any proposed amendments reduced the minimum capital requirement for Type 2 introducing brokers to an amount less than current requirement for Type 1 introducing brokers, then the same minimum capital requirement would also apply for Type 1 introducing brokers.

As indicated earlier, the concept of lowering the minimum capital requirement is being considered only for Dealer Members that have a lower risk profile, because they do not handle or have access to client cash or securities, or if they do, the access is limited and for a brief period of time. Type 1 and Type 2 introducing brokers exhibit this lower risk profile and therefore could potentially benefit. IIROC staff has analyzed the impact of reducing the minimum capital requirement for Type 2 introducing brokers from \$250,000 to either \$50,000 or \$100,000. Table 2 below shows the impact of the reduced capital levels under consideration on RAC.

Table 2: Comparative impact of a lower minimum capital requirement on Type 2 introducing brokers

	Number									
	At current \$250,000		min. capital ment of:	Change in number of Dealer Members						
Measures	min. capital requirement	\$100,000	\$50,000							
Potential number of Dealer Members that could benefit from a lower minimum capital requirement										
Type 2 introducing brokers	75	75 75 75		no change						
Risk adjusted capital position of these Dealer Members, depending on minimum capital requirement										
RAC less than zero (\$0)	0	0	0	no change						
• RAC between \$0 and \$500,000	28	17	13	reduced by 11 to 15						
RAC greater than \$500,000 and less than or equal to \$1,000,000	15	25	28	increased by10 to						
• RAC greater than \$1,000,000	32	33	34	increased by 1 to 2						



From the summary information in Table 2, which is based on Dealer Member data as at June 30, 2013, we can see that in general RAC would increase for Type 2 introducing brokers. This increase would result in more capital being available to conduct ongoing business activities than would be the case under with the existing minimum capital requirement. Specifically, reducing the minimum capital requirement for Type 2 introducing brokers to an amount in the range of \$50,000 to \$100,000 would have the following impact:

- an increased RAC for 11 to 15 Dealer Members, to a level over \$500,000; and
- an increased RAC for another 1 to 2 Dealer Members, to a level over \$1,000,000.

In addition to the potential impact on RAC, the reduction in the minimum capital requirement would also impact the calculations reported to IIROC by the Type 2 introducing brokers under IIROC's Early Warning System and whether or not certain early warning tests are passed or failed. On an ongoing basis, IIROC monitors Dealer Member solvency through the Early Warning System, which determines if a Dealer Member is in Early Warning Level 1 or Level 2. Early Warning Level 1 and Level 2 consist of a number of tests to identify a Dealer Member that may be heading into financial difficulty. If a Dealer Member fails any one of the early warning tests it will be designated to be in the respective Early Warning Level and subject to IIROC imposed restrictions, sanctions and closer supervision in order to mitigate the risk of further financial deterioration. Early Warning Level 2 is the more serious of the two levels<sup>6</sup>.

As would be expected, based on data as at June 30, 2013, lowering the minimum capital requirement to an amount between \$50,000 and \$100,000 would have resulted in fewer Dealer Members failing the Early Warning Level 1 or Level 2 tests, because their increased RAC would have reduced the likelihood of failing one or more of the early warning tests that is based on liquidity and/or profitability. In order to address the investor protection concerns relating to Dealer Members that would no longer trigger Early Warning Level 1 and Level 2 criteria under the possible new minimum capital requirements, IIROC Financial & Operations Compliance would continue to use its discretionary authority to closely monitor the capital of those Dealer Members relative to their history of profit and loss, through the monthly financial filings that firms are required to provide to IIROC. Further, IIROC rules will continue to provide IIROC staff with the discretion to impose early warning restrictions at any time, including restricting the Dealer Member from allowing the repatriation of capital, opening new accounts, hiring additional staff and/or requiring increased frequency of financial and other reporting to IIROC.

For purposes of this discussion, we have assumed that the Type 2 introducing brokers have not removed any of the increased capital amounts from their firms. Although some Type 2 introducing brokers may decide to remove some or all of the increased capital amounts from their firms, they would not be allowed to do so if the removal would put their firms in Early Warning Level 1 or Level 2.

For a detailed explanation of the early warning tests, please see Schedules 13 and 13A of IIROC Form 1: <a href="http://iiroc.knotia.ca/Knowledge/View/ViewAttachment.aspx/Form%201\_IFRS\_July2013\_En.pdf?kType=4">http://iiroc.knotia.ca/Knowledge/View/ViewAttachment.aspx/Form%201\_IFRS\_July2013\_En.pdf?kType=4</a> 45&dBID=211309341&ftID=Form%201\_IFRS\_July2013\_En.pdf.



#### 3. Other Dealer Members

Although the impact analysis above is based on current Type 2 introducing brokers, if a lower minimum capital requirement amount was to be implemented, there is a potential benefit to other Dealer Members or other dealer registrants who may wish to change their business models to become a Type 2 introducing broker, in order to take advantage of the lower minimum capital requirement amount.

### 4. Other considerations - possible lower minimum insurance coverage requirements

Consultation on the possible introduction of lower minimum insurance coverage requirements was also considered for Type 1 and Type 2 introducing brokers, but is not being pursued in this Concept Paper because our analysis indicates that Type 2 introducing brokers currently maintain insurance coverage than is significantly in excess of the required insurance coverage minimums. Based on Dealer Member data as at June 30, 2013, Type 2 introducing brokers currently maintain, on average, approximately twice the amount of insurance coverage (\$3.49 million per firm) than the coverage required under IIROC rules (\$1.74 million). We believe Dealer Members maintain excess insurance coverage because they know that the required coverage is only a minimum and based on their estimated business needs higher amounts may be more prudent. It is therefore reasonable to assume that a reduction in the insurance coverage required under IIROC Rules for Type 2 introducing brokers may not lead to a significant reduction in the average insurance coverage these firms maintain. As a result, we are not exploring the possibility of lower minimum insurance coverage requirements as part of this consultation.

#### 5. Consultation questions

While we are seeking comments on the concept of introducing a lower minimum capital requirement amount for Type 1 and Type 2 introducing brokers, we are also soliciting specific comment on the following consultation questions:

- (i) Do the existing minimum capital requirements for Dealer Members that handle client assets on a limited basis, if at all, represent an undue regulatory burden for such Dealer Members? If so, what minimum capital requirement amount would be more appropriate? Would a lower minimum capital requirement amount materially reduce that burden, or are there other issues that are more critical?
- (ii) Is it appropriate that IIROC Dealer Members, whose business activities and risk profiles are comparable to those of registrants on other platforms (e.g., MFDA and CSA), are subject to significantly higher minimum capital requirements?
- (iii) Do the existing minimum capital requirements for Dealer Members that handle client assets on a limited basis, if at all, represent an inappropriate barrier to entry for potential new IIROC Dealer Members?



(iv) Would a lower minimum capital requirement amount for Type 1 and Type 2 introducing brokers result in a greater alignment with risks associated with this category of Dealer Members?

#### 6. Comments and submissions

We invite Dealer Members and other interested stakeholders to provide input on the issues outlined in this public concept paper and to the specific questions posed in the consultation. Comments should be made in writing and delivered by July 9, 2014 (120 days from the publication date of this Notice). Please address your comments to:

Answerd Ramcharan Specialist, Member Regulation Policy Investment Industry Regulatory Organization of Canada 121 King Street West, Suite 2000 Toronto, Ontario, M5H3T9 Fax: (416) 943-6760

Email: aramcharan@iiroc.ca

Those submitting comment letters should be aware that a copy of their comment letter will be made publicly available on the IIROC website (**www.iiroc.ca** under the heading "Rule Book - Dealer Member Rules - Proposed Policy").

After considering the comments received in response to this Request for Comments, IIROC may publish proposed rules for public comment.

## Benchmarking comparison to other securities industry registrants

A summary benchmarking comparison of the general minimum capital requirements for certain securities industry registrants in Canada and the U.S.

	Canada						U.S.			
	IIROC Dealer Member		MFDA <sup>7</sup> member		Direct CSA <sup>8</sup> registrant		FINRA' firms			
	Type 1 Introducer	Type 2 Introducer	Level 1	Level 2	Level 3	Portfolio Manager	Exempt market dealer	Other Broker dealer	Firms selling mutual funds	Introducers with clients
What activities are permitted?	permitted to he client cash or segregation and client cash and the responsibilities for the responsibilities. Segregation and for very betime. Segregations are tresponsibilities.	Introducer pype 1 introducer: not permitted to handle either lient cash or securities. egregation and custody of lient cash and securities are peresponsibilities of the arrying broker.  Type 2 introducer: permitted to handle client cash or securities in a limited way and for very brief periods of me. Segregation and ustody of client cash and securities are the esponsibilities of the arrying broker.  A Level 1 member: does not hold client cash, securities legislation; and is similar to an IIROC. Type 1 introducing member where there is joint business conduct compliance responsibility.  A Level 2 member: does not hold client cash, securities or other property; and operates in a client name environment.  A Level 3 member: holds client uninvested cash in a trust account but does not hold client securities or other property in nominee name or safekeeping; and operates only in a client name environment.  Only Level 4 members can provide back-office services to Level 1, 2 and 3 MFDA dealers.  Since the MEDA's inception, no Level 4 MEDA		Manager market dealer  EMDs <sup>10</sup> are permitted to custody customer account assets but most EMDs distribute client-named exempt market securities to their accredited investor clients and deliver these securities out to the client. PMs are permitted to custody customer assets but most PMs enter into custodial relationship with a third party custodian service provider. The CSA is currently studying whether or not to impose a prohibition and establish criteria for acceptable third party custodians as part of further amendments to NI 31- 103.		3				
What is the minimum capital requirement?	\$75,000	\$250,000	\$25,000	\$50,000	\$75,000	\$25,000 (increases to \$100,000 if also IFM <sup>11</sup> )	\$50,000	\$5,000 (U.S.)	\$25,000 (U.S.)	\$50,000 (U.S.)

<sup>&</sup>quot;MFDA" means Mutual Fund Dealers Association of Canada

<sup>&</sup>quot;CSA" means Canadian Securities Administrators

<sup>&</sup>lt;sup>9</sup> "FINRA" means Financial Industry Regulatory Authority

<sup>&</sup>quot;EMDs" means exempt market dealers

<sup>&</sup>quot;IFM" means Investment Fund Manager