

IIROC NOTICE

Rule Notice Guidance Note

Dealer Member Rules
UMIR

Please distribute internally to:

Corporate Finance
Institutional
Internal Audit
Legal and Compliance
Operations
Registration
Regulatory Accounting
Research
Retail
Senior Management
Trading Desk
Training

Contact:

Victoria Pinnington, SVP, Market Regulation
416-646-7231 vpinnington@iiroc.ca

Doug Harris, Vice President and General Counsel
416-646-7275 dharris@iiroc.ca

Wendy Rudd, SVP, Member Regulation & Strategic Initiatives
416-646-7216 wrudd@iiroc.ca

17-0010
January 12, 2017

IIROC Compliance Priorities

We are pleased to present IIROC's annual Compliance Priorities Report for 2016/2017. The Report deals with current issues and challenges to be addressed by Dealer Members to improve investor protection and foster market integrity. It is intended, along with our guidance notes, day-to-day contact, annual compliance conferences and other forums, to help dealers focus their supervision and risk management efforts to comply with our regulatory requirements in a way that is appropriate for their unique business models.



IIROC's compliance priorities stem from:

- new risks and trends
- concerns due to recurring/significant examination deficiencies
- results of our targeted reviews and surveys.

Of Note

This year, we are completing a comprehensive review of our risk models to ensure they remain current and achieve their intended predictive purpose. We use these risk models to inform the frequency and content of our compliance examinations, allowing us to focus on firms and areas that present the highest risk. This review may result in the recalibration of risk attributes, metrics and/or weightings.

We have also completed a detailed survey of dealers' supervision of compensation-related conflicts, and are now analyzing the results to determine whether rule amendments, additional guidance and/or enhanced BCC test processes are required. Our [December 2016 notice](#) provided an update on this initiative.

Beginning in 2017, Business Conduct Compliance will hold an annual meeting with each Dealer Member that is not subject to a compliance review that year. The meeting will help IIROC determine whether there have been any significant changes that may impact the risk-rating of the firm.

We continue to focus on and take action against dealers that fail to address significant compliance findings and/or fail to demonstrate a commitment to the development of a strong compliance culture. Section 9208 of IIROC's Consolidated Enforcement, Examination and Approval Rules (the "Consolidated Rules") now enables IIROC staff to impose terms and conditions on Dealer Members to ensure continuing compliance with IIROC's requirements.



Table of Contents

| | |
|---|----|
| 1. Financial and Operations Compliance | 4 |
| 1.1. Cybersecurity | 4 |
| 1.2. T+2 Settlement | 4 |
| 1.3. Client Relationship Model (CRM) | 5 |
| 1.4. Outsourcing Arrangements | 5 |
| 1.5. MFDA Members Offering ETFs | 5 |
| 1.6. Selling Group Allocations | 5 |
| 1.7. Free Credit Usage and Segregation | 6 |
| 2. Trading Compliance | 6 |
| 2.1. Fixed Income Trade Reporting and Surveillance..... | 6 |
| 2.2. Expanded Scope of Trading Conduct Reviews | 7 |
| 2.3. Best Execution | 7 |
| 2.4. Electronic Trading | 8 |
| 3. Business Conduct Compliance | 9 |
| 3.1. Enhanced Suitability Testing | 9 |
| 3.2. Conflicts of Interest | 9 |
| 3.3. Automated/Online Advice | 10 |
| 3.4. Order-Execution Only Platforms | 11 |
| 3.5. Seniors' Issues..... | 11 |
| 3.6. Prospectus Exemptions..... | 11 |
| 4. Registration | 12 |
| 4.1. Responsibility for Registration Compliance | 12 |
| 4.2. Notices of Termination | 13 |
| 4.3. Other Business Activities | 13 |
| 4.4. Financial Obligation and Other Material Change Updates | 14 |
| 4.5. Terms and Conditions on IIROC Membership | 14 |
| 4.6. Discretionary Exemptions for Portfolio Management..... | 15 |
| 4.7. Post-Licensing Requirements | 15 |
| 5. Membership Issues | 16 |



1. Financial and Operations Compliance

1.1. Cybersecurity

IIROC is committed to developing resources to help Dealer Members strengthen their risk-management practices and increase their cybersecurity preparedness.

As reported last October during Cybersecurity Awareness Month ([IIROC news release dated October 3, 2016](#)), a cybersecurity self-assessment survey was completed by all Dealer Members in June 2016. The results were analyzed and risk-scored, and IIROC issued a confidential Cybersecurity Report (CSR) to each Dealer Member identifying their level of cybersecurity maturity/preparedness and vulnerabilities, and setting out recommendations for high-priority attention.

This work has provided us with an understanding of industry cybersecurity preparedness and, more specifically, the adequacy of each firm's governance structure, policies and systems for cyber risk management.

Beginning in January 2017, an IIROC cybersecurity specialist will follow up with all firms that have a cybersecurity maturity level below the expected target for their industry peer group. The goal of these reviews will be to confirm the firms' self-assessment responses, and collaborate with and advise firms on how to improve their preparedness for the overall protection of customer data and market integrity.

1.2. T+2 Settlement

In 2017, Canada and the U.S. plan to shorten the normal trade settlement cycle from T+3 to T+2. This is a U.S.-led initiative intended to reduce systemic risk and inefficiencies in the investment industry. The scheduled date for the move to T+2 in both Canada and the U.S. is September 5, 2017 so that the settlement cycles for our capital markets continue to be harmonized.

We published [proposed amendments to trade settlement-related rules](#) in July 2016. The amendments signal regulatory certainty for all industry participants to plan and invest in system and process changes in preparation for the transition to T+2 settlement.

We will assess the results of industry-wide testing (planned for April and May 2017) and T+2 readiness sign-off by all Dealer Member participants of CDS.



1.3. Client Relationship Model (CRM)

Effective July 15, 2016, we completed the implementation of IIROC's CRM2 client reporting requirements. Our examinations in 2017 will focus on whether dealers have complied with the CRM2 requirements for:

- quarterly reporting on certain off-book client holdings
- annual account performance reporting
- annual account fee/charge reporting.

1.4. Outsourcing Arrangements

Outsourcing continues to be a focus as the industry trends toward more outsourcing of business functions to manage operating expenses. Due diligence is especially important to ensure that third-party IT service providers protect dealers' data against cyber threats.

We remind Dealer Members that outsourcing regulated activities in no way diminishes a registrant's responsibility to comply with IIROC rules and to supervise the service providers' performance. [IIROC Notice 14-0012](#) provides guidance on outsourcing risk management frameworks and the [2014/2015 Annual Compliance Report](#) provides industry best practices.

1.5. MFDA Members Offering ETFs

Mutual Fund Dealers (MFDs) are permitted to sell "plain vanilla" exchange-traded funds (ETFs) to their customers, but lack direct access to securities exchanges to execute ETF orders. Several MFDs have recently begun to set up trade execution, clearing and custody arrangements with IIROC Dealer Members for their customers' ETF trades.

Dealers are reminded that to facilitate the execution of ETF orders originating from a MFD, they must set up an omnibus trading account. Executing MFDs' customer orders on a fully disclosed basis would violate IIROC Rule 35 – Introducing Broker/Carrying Broker Arrangements.

1.6. Selling Group Allocations

We've observed a growing trend with some small dealers that are part of the selling group of an underwriting syndicate to borrow freely-traded securities of the issuer and short-sell their assigned allocation into the market without making any bona fide effort to solicit expressions of interest or build an order book for sales to their retail clients. On closing date of the underwriting, the newly issued securities are used to cover their short position.



IIROC examiners will monitor for this inappropriate activity and, if found, will refer it to Enforcement as conduct unbecoming of the Dealer Member.

1.7. Free Credit Usage and Segregation

In April 2016, IIROC republished [proposed amendments](#) to Dealer Member Rules 1200 and Form 1 relating to the usage limit and segregation requirements for client free credit cash.

Subject to the Canadian Securities Administrators' (CSA) approval, we expect the proposed amendments to be implemented in the first quarter of 2017. FinOps examinations will continue to focus on dealers' procedures and systems under the new rules.

2. Trading Compliance

2.1. Fixed Income Trade Reporting and Surveillance

Phase 2 of IIROC's Debt Transaction Reporting Rule became effective on November 1, 2016. All dealers must report their fixed income trades to IIROC by 2:00 p.m. ET on the day after the trade.

IIROC uses alerts and reports to assist in monitoring debt trading. We have seen issues with trades that are outside the context of the market and trades in fee-based accounts where additional commissions have been charged. We continue to follow up on fair pricing and best execution concerns, and will soon begin looking at front running of new issues, wash trades and incorrect syndication practices.

Collection and monitoring of debt trades began in late 2015 when all Government Securities Distributors began to report their fixed income trades. Initially, we focused on problems with the quality of data submitted. We have now implemented a number of data validation controls to address the issue. Further, TCC conducted a targeted review of trade reporting and a number of deficiencies were identified and addressed:

- Transactions not reported
- Primary market trades not identified
- Yield to maturity information missing on client confirmations
- Incorrect yield reported to IIROC
- Missing order audit trails
- Incorrect trade execution time



The new data validation process and our targeted review have increased the quality of data and the effectiveness of our surveillance effort. We will continue to review all firms' supervisory policies and procedures and trade submissions for completeness, timeliness and accuracy.

2.2. Expanded Scope of Trading Conduct Reviews

As noted in our previous Compliance Priorities Report, IIROC has rationalized sections of its TCC and BCC examination modules. All dealers' activities related to market integrity are now covered by the TCC examination program, leaving BCC to focus on business conduct matters. Any firm that conducts secondary market trading will be subject to a TCC examination, regardless of whether they access markets directly or through another dealer, although our expectations will be different in each case. Reviews at firms without direct access will be integrated with either FinOps or BCC examinations when possible to minimize their impact. Dealers that access Canadian equity marketplaces directly will notice a broader scope of TCC review as additional asset classes are reviewed.

We noted earlier that we are reviewing our compliance risk models. During the review, any changes to the TCC risk model to include non-Participant dealers will be done. In the interim, all non-Participant dealers are being assigned an initial risk rating of "low" and placed on a 3-year review cycle. Each firm's risk ranking may change as the model is revised and reviews are conducted.

Some firms have undergone their first TCC review; as resources and experience increase, more reviews will be scheduled.

2.3. Best Execution

On October 1, 2016, National Instrument (NI) 23-101 was amended and some marketplace quotes are no longer protected due either to low market share or the implementation of systematic order processing delays (speed bumps). These markets include:

- Lynx ATS
- Canadian Securities Exchange (for securities other than CSE-listed securities)
- Aequitas Lit (for securities other than Aequitas-listed securities)
- Aequitas Neo
- Alpha Exchange



Orders that are entered on unprotected marketplaces have the potential to be locked, crossed or even traded through by other marketplaces.

Some smart order routers (SOR) are designed to ignore bids and offers on unprotected marketplaces and a number of them do not access dark marketplaces at all. While use of these routers ensures compliance with order protection rules, it does not necessarily follow that best execution will be achieved.

Dealers must consider all available sources of liquidity, including dark and unprotected lit marketplaces when developing their best execution policies and procedures. Ignoring sources of liquidity solely on the basis that an SOR is not designed to access those liquidity pools is not consistent with best execution requirements. TCC examination staff will be reviewing dealers' decisions and rationale for including or excluding certain marketplaces to ensure that those decisions are in their clients' interest. This is reinforced in our recently republished [request for comments](#) on proposed provisions respecting best execution.

We are also looking more closely at bulk order handling and allocation. In cases where a firm executes bulk orders, including managed accounts, we will review the firm's allocation policies, procedures and supervision to ensure all clients are treated fairly and equitably, and all business lines have been considered.

2.4. *Electronic Trading*

IIROC continues to find issues with Participants' electronic trading controls. We reported in last year's Report that a number of Participants did not implement effective, pre-trade risk controls, creating the potential for market disruptions and significant financial loss.

While there have been some improvements, deficiencies continue to be recorded. We will continue to focus on pre-trade risk controls, ensuring firms have documented who is responsible for determining and setting individual limits for each of the firm's trading staff and/or each direct access client.



3. Business Conduct Compliance

3.1. Enhanced Suitability Testing

Strengthening BCC's examination of dealers' compliance with their "know your client" (KYC) and suitability obligations will continue to be a priority in the coming year.

IIROC rules for these obligations are principles-based in order to accommodate diverse investment philosophies and product/account service offerings. Whatever KYC and suitability assessment processes a firm implements, they must be proportionate to the customization/complexity of the firm's product and account service offerings, and they must be clearly explained to clients in the relationship disclosure information they receive.

For each product/account service offering, we will look at the processes used to ensure:

- KYC information collected is precise, accurate and consistent
- individual trades and overall account investment portfolio are suitable.

The extent and precision of KYC information collected must be sufficient to enable effective monitoring of the suitability of all client holdings in keeping with the suitability assessment process implemented by the firm.

The approaches used to assess whether an account's investment portfolio risk is aligned with the client's risk tolerance vary across firms. Some use a basic "risk-bucketing" approach, which identifies client risk tolerances based on an allocation of low-risk, medium-risk and high-risk securities. Many firms, however, are implementing methods that are more sophisticated. BCC examiners will focus on this process when testing for compliance with the fundamental obligations of Rule 1300.1 (p), (q) and (r).

3.2. Conflicts of Interest

IIROC's [April 2016 notice](#) affirmed our intention to strengthen compliance with the best interest requirements of our Conflicts of Interest rule, with particular focus on the management of compensation-related conflicts. Dealer Member Rule 42 requires a firm's representatives to address material conflicts of interest – whether existing or potential – in a manner that is consistent with the best interest of the client. Recognizing that firms must balance the interests of multiple clients simultaneously, our rule requires them to address such conflicts in a manner that considers the best interest of the client.



As we committed under next steps, BCC has conducted an in-depth survey to gain greater insight into the quality of supervision of compensation-related conflicts. The survey included questions about:

- product shelf
 - breadth of product offerings (third-party and proprietary)
 - the process for approving products
 - strategic partnerships with affiliates or third-party product manufacturers
- compensation practices
 - compensation grids
 - performance bonuses
 - non-monetary incentives
 - controls to test the appropriateness of fee-based accounts versus commission-based accounts
- supervisory oversight.

As we indicated in our [December 2016 update notice](#), we have followed up with survey respondents to clarify the responses, and we're now analyzing the results to determine whether rule amendments, additional guidance and/or enhanced BCC test processes are required.

3.3. Automated/Online Advice

During the past three years, there has been significant growth in the number of firms offering online advice. Many recent entrants are CSA-regulated Portfolio Managers, but we are seeing growing interest by IIROC Dealer Members in offering online advice, either through the development of proprietary technology, or through strategic alliances and/or licensing arrangements with other firms.

The automated nature of online advice offerings introduces various regulatory challenges, including:

- clear disclosure about the limited products and services being offered
- the adequacy of online KYC (including risk tolerance) assessment relative to the complexity of the products offered
- the sufficiency of registrant oversight.

As this business activity continues to evolve and grow, BCC will closely monitor developments to identify the need for rule amendments and/or guidance that clarifies IIROC's expectations.



3.4. Order-Execution Only Platforms

In 2015, IIROC established an order-execution only (OEO) working group of compliance and legal staff from OEO firms and full-service firms. The group met to consider the products and tools offered by OEO firms in the context of the current regulatory framework, and provided IIROC staff with detailed information and valuable insight. We also engaged an independent research firm to survey OEO clients on their views regarding some of the tools OEO firms make available to them.

In November 2016, IIROC published [proposed guidance](#) to provide our views on the scope of tools, services, products, and account types that we consider consistent with the OEO regulatory framework, and to update our expectations.

Once the guidance is finalized, OEO firms will need to determine whether their business activities are consistent with the guidance. BCC examiners will likewise be looking for consistency.

3.5. Seniors' Issues

The number of seniors receiving financial advice and other investment-related services from Dealer Members has increased significantly in recent years. Further, our complaints and inquiries data show that, each year, seniors consistently represent a significant portion of all regulatory and service complaints.

In 2016, we published [Guidance Notice 16-0114](#) on how best to deal with the specific challenges that can arise with clients who are retired or about to retire.

When testing for account suitability, BCC examiners will continue to select a percentage of seniors' accounts. Our reviews will focus on their investment objectives and time horizon, and the adequacy of supervisory processes to ensure their investments are suitable.

3.6. Prospectus Exemptions

Various jurisdictions in Canada have introduced changes to the types of prospectus exemptions that are available to issuers. In general, these exemptions are based on limiting the class of investors to whom the security is being offered and/or limiting the amount that can be invested. Examples include:

- Existing Security Holder exemption
- Offering Memorandum exemption
- Investment Dealer exemption



- Crowdfunding exemption.

Dealer Members selling exempt securities must verify that their clients qualify to purchase the securities in question, and that the amounts invested do not exceed the prescribed limits. Furthermore, under the Companion Policy to NI 45-106, the seller of exempt securities must take “reasonable steps” to verify the representations made by the purchaser.

In addition to looking for basic suitability, BCC will ensure that sales of exempt securities are compliant with all applicable regulatory limits and restrictions.

4. Registration

4.1. Responsibility for Registration Compliance

IIROC’s Registration function is a critical element of our public interest mandate. Registration requirements ensure that all partners, directors, officers and executives of Dealer Members and all their staff who conduct or supervise regulated activities meet minimum standards of proficiency, integrity, experience, conflict management and client service.

Ultimate Designated Persons and Chief Compliance Officers (CCOs) share the responsibility to ensure that dealers comply with IIROC’s registration requirements.

This section highlights significant deficiencies that we have identified with specific filings. However, we also encounter:

- dealers with repeated and persistent deficiencies in the timeliness, accuracy and completeness of routine filings
- personnel who do not respond promptly or cooperatively to our requests for additional information or corrected filings.

We have therefore begun a pilot project to require the Authorized Firm Representatives (AFRs) and CCOs of firms with repeated deficiencies to attend a training session with our Registration team to ensure they understand their obligations. We will review basic Registration functions, as well as issues specific to the dealer, in order to ensure that our expectations are clear, and to outline the consequences of future non-compliance.

Once we have met with a Dealer Member, we will take a strict approach to compliance with our requirements, and may take any or all of the following steps:



- reject deficient filings in their entirety, with the attendant delays that this will cause for the filing firm
- conduct a fit and proper review of the Dealer Member and the individual(s) responsible for regulatory filings if the deficiencies continue
- refer the matter for potential disciplinary action.

4.2. Notices of Termination

Incomplete Notices

Many dealers are not making reasonable efforts to provide true and complete information in their Notice of Termination (NOT) filings. We remind dealers to carefully consider the questions contained in the NOT and to accurately state the reason(s) for the cessation/termination of employment. Dealers that continually provide incomplete information in their NOT filings may be referred to the training session pilot program outlined above.

Automatic Acceptance

The National Registration Database (NRD) now automatically accepts a NOT filed by a Dealer Member in all jurisdictions across Canada except than Nova Scotia, Prince Edward Island and Northwest Territories. This ensures that the public record (e.g., Advisor Report) provides timely and accurate information on an individual's status. Dealers' obligation to provide true and complete information has not changed, nor has their obligation to file the NOT within the prescribed period in order to avoid late-filing fees.

We continue to review NOTs filed and will contact the dealer if the filing is deficient.

4.3. Other Business Activities

Dealers must disclose all other business activities (OBAs) as there may be a potential for conflicts of interest, even if the OBA is not securities-related. Many dealers are not disclosing OBAs or changes to previously disclosed OBAs within the 10-day filing deadline. Guidance on what constitutes a reportable OBA is provided in the Companion Policy to NI 31-103, [IIROC Notice 13-0163](#) and CSA Staff Notice 31-326. Dealers should require Approved Persons to provide periodic attestations regarding OBAs, and to notify them of any material change to their OBAs.

Dealers must also provide sufficient detail when describing the nature of the OBA and must address the potential for conflicts of interest or client confusion that arise in the specific case (instead of providing "boilerplate" disclosure). If an OBA is not seen to result



in any conflicts of interest or client confusion, the dealer must provide the basis for this conclusion.

4.4. Financial Obligation and Other Material Change Updates

Dealers must disclose material changes concerning items 13 (regulatory disclosure), 14 (criminal disclosure), 15 (civil disclosure) and 16 (financial disclosure) on a timely basis, and provide timely updates to their disclosures when more information becomes available.

We find that firms often only file supporting documentation at our request rather than with the material change notice, particularly for financial disclosure updates. These delays affect our ability to conduct a “fit and proper” review.

In addition to periodic attestations, dealers should require Approved Persons to immediately notify them of any material change to their information.

4.5. Terms and Conditions on IIROC Membership

Section 9208 of the Consolidated Rules provides that IIROC may impose terms and conditions on a Dealer Member’s membership – such as business restrictions on opening new accounts or hiring additional staff – to ensure continuing compliance with IIROC’s requirements.

We will use this new authority primarily to address situations in which there are outstanding compliance issues that clearly require regulatory action, but may not be best addressed through an enforcement proceeding (although the imposition of terms and conditions does not preclude the initiation of an enforcement proceeding against the dealer).

Before imposing terms and conditions, we will provide notice to the dealer, together with information regarding the dealer’s opportunity to be heard. Specific IIROC senior officers have the authority to make a decision for the purposes of section 9208.

If IIROC decides to impose terms and conditions on a dealer’s membership, we will provide written reasons for the decision. The Consolidated Rules also provide for a review of the decision by an IIROC hearing panel.

Once all review periods have expired and/or appeal decisions have been finalized, we will publish the terms and conditions on our website under the tab “Who we regulate”. The text of the terms and conditions will appear beside the Dealer Member’s name. If we remove the terms and conditions or they expire, we will remove the reference to them.



4.6. Discretionary Exemptions for Portfolio Management

We have updated our review standards for applications seeking exemptive relief from the course requirements for approval to conduct discretionary portfolio management activities on managed accounts. This approval category has the most onerous proficiency requirements because of the discretion it affords. Individuals who seek an exemption must demonstrate a high level of experience that is clearly relevant to discretionary portfolio management activities.

An individual who wishes to be approved in this category may either (a) meet IIROC's current requirements under Rule 2900, or (b) seek exemptive relief from Rule 2900 on the basis that he or she has both:

- a CIM (either the Canadian Investment Manager or Chartered Investment Manager) designation in good standing
- 48 months of Relevant Investment Management Experience (RIME), with 12 months gained in the 36-month period before applying for registration.

In September 2016, we sent details to all Dealer Members of the information we require to assess an exemption application on this basis. Dealers should review these requirements carefully before submitting an application. Registration staff would be pleased to discuss these requirements with firms generally, or in connection with specific applications, to provide additional guidance.

We also remind dealers that IIROC has arranged a 50% enrolment price discount for certain people rewriting courses within ten years of previously writing. For more information, please visit the applicable course enrolment page at www.csi.ca.

4.7. Post-Licensing Requirements

Registered Representatives (RRs) must complete the Canadian Securities Course, Conduct and Practices Handbook Course and 90-Day Training Program to be eligible for approval. RRs have 30 months after approval to complete the Wealth Management Essentials course; IIROC will automatically suspend any RR who does not complete the course within this period.

Similarly, Supervisors have 18 months to attend the Effective Management Seminar. Dealers and Supervisors should schedule attendance at a seminar well in advance of the expiration of 18 months, as IIROC will automatically suspend anyone who does not



complete the requirement. This is particularly critical for dealers that do not have other Supervisors to cover the functions of a suspended Supervisor.

Approved Persons have more than enough time to complete these requirements, and dealers have more than enough time to ensure that they do so. However, we receive an unacceptable number of applications for extensions without compelling reasons. We are unlikely to grant extensions unless there are extreme extenuating circumstances. For example, we will not grant extensions simply because a firm does not have another Supervisor to assume the functions.

If compliance with these post-licensing requirements continues to be an issue, we will consider making them pre-licensing requirements.

5. Membership Issues

We continue to see deficiencies in filings relating to the matters we highlighted in [last year's Compliance Report](#).

Specifically, we continue to receive late and incomplete filings requesting approval of:

- significant equity interests in a Dealer Member
- related and associated companies.

If we continue to see deficiencies in these areas, we will consider taking stronger measures to ensure compliance, including but not limited to requiring dealers to unwind transactions that were completed without the required approvals, and/or imposing terms and conditions.