Re: IIROC response to comments on the proposed personal financial dealings rule and proposed amendments to the IIROC Dealer Member Rule 18.14

This summary responds to the eight comment letters received on the proposed personal financial dealing rule and the proposed amendments to IIROC Dealer Member Rule 18.14 (collectively referred to as the "Proposal") that were published for comment on May 28, 2010. We have considered the comments received and we thank all the commenters for their submissions. The comments specific to the Proposal have been summarized to correspond with the major components of the proposed amendments, followed by IIROC staff response to each specific comment. We have summarized and grouped the comments according to the Dealer Member Rule and issues raised. Our response follows each particular issue.

For ease of reference, in this response to comments, a Registered Representative, Investment Representative, director, executive, supervisor, or employee of a Dealer Member are collectively referred to as a "Dealer Member Representative".

PROPOSED PERSONAL FINANCIAL DEALINGS RULE

1. Personal Financial Dealing Situations

One commenter requested that if there are no other dealings meant to be included under the phrase personal financial dealings, then the word "include" should be changed to the word "means" under Section X.2.

IIROC staff response

The drafting of the proposal has been revised to clarify that other dealings may be considered to be personal financial dealings and the list of personal financial dealings set out in X.2 (renumbered as 43.2) is non-exhaustive.

2. Reference to 'associate'

One commenter requested further guidance regarding as to who "associate" in Section X.1 refers.

IIROC staff response

The reference to "associate" has been removed as proposed section X.1 (renumbered as 43.1) already prohibits direct or indirect personal financial dealings with clients.

3. *Private Settlement Agreements*

Mutual agreement between client and advisor setting out the terms of fee for service is a long-standing and well-accepted practice.

IIROC staff response

The private settlement agreements referred to in the Proposal relate to settlement agreements entered into directly between a Dealer Member Representative and a client in response to an actual, or potential, complaint or law suit, and not in reference to service agreements. We have amended the proposed Rule to clarify our intention. The prohibition set out in proposed section X.2(2) (renumbered as 43.2(2)) is consistent with the current requirements set out in Dealer Member Rule 3100 regarding settlement agreements without the prior consent of the Dealer Member.

With respect to service agreements, IIROC staff would like to remind Dealer Member Representatives that pursuant to IIROC Dealer Member Rule 18.15 no Registered Representative or Investment Representative may accept or permit any associate to accept, directly or indirectly, any remuneration, gratuity, benefit or any other consideration from any person other than the Dealer Member or its affiliates or related companies, for the securities related activities he or she conducts on behalf of the Dealer Member or its affiliates or its related companies. This is an existing requirement. Accordingly, any fees paid by the client pursuant to the terms of a service agreement must go through the Dealer Member. To ensure compliance with the provisions of Dealer Member Rule 18.15, the Dealer Member should be able to identify and have access to the service agreement in order to conduct supervision of fee-based accounts. It is common practice for the Dealer Members to approve and control any service agreement, or mandate standard service agreements, between a client and a Dealer Member Representative in order to ensure compliance with the above noted requirements.

4. Benefits or other consideration

(i) One commenter suggested that Section X.2(1)(i) be amended to add "unless the activity has been approved by the Member under Rule 18.14" at the end.

IIROC staff response

We have added a new provision which will clarify that compensation received from a client in exchange for services provided through an approved outside business activity would not be considered to be consideration for the purpose of paragraph X.2(1)(i) (renumbered as 43.2(1)(i)) and therefore would not be considered to be personal financial dealing with clients within the meaning of the rule.

(ii) One commenter requested further guidance on how to determine whether something is considered a material consideration.

IIROC staff response

The Proposed Rule has been amended and the reference to "material" consideration has been omitted. Any consideration received by a Dealer Member Representative from any one, other than the Dealer Member, for any activities conducted on behalf of a client is prohibited. However, consideration that is non-monetary, of minimal value and infrequent such that a reasonable person would not question whether it creates a conflict of interest or improperly influences the Dealer Member or Dealer Member Representative is set out as an exemption from the general prohibition.

(iii) One commenter suggested that it would be more conducive to ethical conduct if the value of work, such as debt management, were recognized openly, the fee disclosed and the client, the only possible source for such fee, would pay for it.

IIROC staff response

To the extent that such activities are outside the scope of activities conducted by a Dealer Member or the Dealer Member Representative, then these activities must be disclosed to and approved by the Dealer Member.

5. Borrowing from and lending to Clients

One commenter suggested that Sections X.2(3) and (4) of the Proposed Rule introduces unnecessary regulatory and administrative burdens where regulatory concerns are not present, particularly with respect to personal financial arrangements, such as a loan from a parent to a child, which may routinely occur. It is recommended that a further exemption be included so as to ensure that those situations not intended to be caught by the rule are excluded.

IIROC staff response

The provisions in question have been included based on current regulatory concerns over the potential for abuse and inappropriate use of the funds.

The Proposal does provide for an exemption for borrowing or lending arrangements involving family members. The disclosure and approval of such familial arrangements is only required when such a loan is between a client who is a related person of a Registered Representative or Investment Representative, as there is a greater risk of inappropriate conduct.

Section X. 2(3) and (4) have been renumbered as 43.2(3) and (4) respectively.

6. Discretionary and Managed Accounts

One commenter suggested that no Registered Representative or Investment Representative should act under a power of attorney over the financial affairs of a client unless it is in furtherance of a discretionary or managed account and the power of attorney specifically limits the power to the affairs directly related to that discretionary or managed account.

IIROC staff response

The exemption in paragraph X.2(5) (renumbered as 43.2(5)) is not intended to allow the use of power of attorneys for those who operate a discretionary or managed account. For further clarification, the proposed Rule has been amended to more clearly state that the general prohibition set out in section X.2(5) does not apply to discretionary or managed accounts provided that the control or authority exercised over such accounts is consistent with IIROC's requirements for such accounts.

7. Power of Attorney, Trustee, Executor and other Authorizations

(i) Four commenters suggested that IIROC investment professionals should have the same abilities as other professionals to accept power of attorney or executor and trustee appointments from all clients under the supervision of their Dealer Member firm and that rather than the proposed prohibition, supervision and control systems should be put in place to protect the clients.

IIROC staff response

IIROC believes that any personal financial dealing with a client creates an unacceptable and material conflict of interest between the Dealer Member Representative and the client that cannot be adequately addressed through disclosure, enhanced supervision and/or additional reporting requirements, and should therefore be avoided.

When a Dealer Member Representative also acts as a client's power of attorney, trustee or executor, a potential conflict of interest is created. To clarify, a conflict of interest clearly arises from the fact that a Dealer Member Representative has a profit motive, whereas a trustee or an executor has a fiduciary obligation to the granter. The profit motive is in conflict with the fiduciary duty imposed upon a trustee or executor. Furthermore, in a power of attorney relationship there is a conflict of interest between the duties of the attorney to the grantor and the duties and interests of the Dealer Member Representative in his/her role with the Dealer Member given that the Dealer Member Representative benefits directly from increasing the size of their book. For instance, if a Dealer Member Representative has authority over a client's assets elsewhere, the Dealer Member Representative would have an incentive to move those assets into the account at the Dealer Member without the client having any control, or

knowledge, over such use of the assets. This creates a clear and undeniable conflict of interest in addition to significant potential for abuse, particularly when dealing with vulnerable clients.

Having any type of control or authority over a client's assets, such as in a power of attorney relationship, creates the types of situations where there is a real potential for abuse, such as misappropriation of funds. Abuse has often occurred where a power of attorney has been granted to a Dealer Member Representative by friends or clients. It is therefore IIROC staff's position that such arrangements need to be prohibited, subject to the exemptions provided in the Proposal when dealing with related persons. It should be noted that this prohibition is consistent with current industry practices.

From a broader policy perspective, it is also important to note that allowing Dealer Member Representatives to act as power of attorney, executor or trustee would be inconsistent with other IIROC rules. Current IIROC Dealer Member rules, and other related rules (proposed plain language rule 3271) currently awaiting securities commission approval, do not allow Dealer Member Representatives to have trading authority over a client's account or operate a discretionary account on an on-going basis as such arrangements would be effectively operating a managed account without complying with the requisite requirements (proficiency, supervision, etc.). Clearly, in comparison to an on-going discretionary account or trading authority granted over a client's account, acting as a power of attorney, executor or trustee is broader in scope. As such, it would be unreasonable and inconsistent to allow a broader scope authority, such as power of attorney, over the client's overall financial affairs.

In response to the commenter's comparison to professionals such as lawyers, it is important to note that many of the other professionals cited by the commenter already owe a fiduciary obligation to their clients; Dealer Member Representatives are not necessarily subject to fiduciary standards.

(ii) What qualifications are needed for an IIROC Dealer Representative to be a trustee or executor and who is responsible for ensuring that such credentials are held by the Dealer Representative?

IIROC staff response

As set out in attached proposed Rules, a Dealer Member Representative cannot act as a power of attorney, trustee, executor or otherwise have authority or control over the financial affairs of a client, except when dealing with a related person as defined in the *Income Tax Act* or if authority of a client's accounts is consistent with the Corporation's requirements relating to discretionary accounts and managed accounts.

(iii) One commenter does not believe that this is an area that IIROC can justify regulating and questioned whether there is a demonstrated need for an outright ban by IIROC and suggested that IIROC conduct a study to determine if there is in fact a problem.

IIROC staff response

IIROC is empowered to and responsible for regulating the conduct of its Dealer Members and Dealer Member Representatives, including their business and/or personal financial dealings with clients. In light of that obligation and authority, it is incumbent on IIROC to identify and, where necessary, prohibit specific activities which create, or potentially create, material conflicts of interest between Dealer Members, including their Dealer Member Representatives, and their clients. IIROC staff is of the view that the conflict of interest and potential conflict of interest arising from the types of personal financial dealing activities set out in the rules is so significant that it is not necessary to undertake a separate study in this area.

As previously mentioned, the types of activities prohibited by the Proposal are activities which give rise to the potential for abuse, particularly when dealing with vulnerable clients.

8. General Comments

(i) One commenter suggested that the role of supervision should be emphasized in the proposals.

IIROC staff response

Dealer Members are expected to adequately supervise all activities of their Dealer Member Representatives. The requirement to supervise is set out in the current IIROC Dealer Member Rules. IIROC will further emphasize the importance of supervision in the Implementation Notice relating to this proposal.

(ii) One commenter questions what constraints should be applied to ensure that the Dealer Member Representatives are acting fairly, honestly and in good faith?

IIROC staff response

Dealer Members must design and implement policies and procedures that promote regulatory compliance and high business conduct standards. These policies and procedures must include supervision and reporting requirements. As well, they need to be clearly communicated to Dealer Member Representatives to ensure that their conduct is fair, honest and in good faith.

(iii) One commenter questions the extent to which Dealer Members will be held accountable for the decisions taken by the Dealer Member Representative?

IIROC staff response

Dealer Members have a general obligation to supervise the activities of their Dealer Member Representatives. The extent of the Dealer Member's liability will depend on the facts of the case and on whether the nature and extent of the supervision was adequate and reasonable in the circumstances.

(iv) One commenter suggested the following: (a) penalty guidelines be provided, (b) an increase in fines that are to the account of the Dealer Member, leaving the Dealer Member to effect collection, and (c) punitive damages be added to the investor protection tool kit.

IIROC staff response

All Dealer Members are monitored for compliance with IIROC Rules. Any Rule breaches are corrected and, in appropriate cases, pursued through an enforcement action. Any changes to the enforcement powers and penalty guidelines are outside the scope of this project.

(v) One commenter requested further clarification as to who IIROC is referring to when describing a "client" throughout the Guidance Notice. Is it a client of the firm or a client of the individual registrant? One commenter suggests that IIROC introduce a distinction between clients of the firm, generally and clients who are directly serviced by the individual registrant. The commenter provides an example in which an advisor makes a personal loan to a friend who has an unrelated discount brokerage account with the advisor's firm and argues that this activity should not be captured under this requirement; in contrast, a higher standard is warranted where the advisor makes a personal loan to a friend who is also a client directly serviced and advised by that advisor.

IIROC staff response

Both the Dealer Member and an individual Dealer Member Representative have obligations to the client and to that extent the client is a client of both the Dealer Member and the individual registrant. With respect to the application of the attached Proposed Rules and Guidance Note, the client is the client of the firm. As such, an Approved Person may not accept any consideration from a client of the Dealer Member, whether or not that Approved Person is the designated Registered Representative on the client's account. Although the real or perceived conflicts are more tangible where the advisor makes a personal loan to a friend who is directly serviced and advised by that

same advisor, or by another advisor in the same branch or region, it is difficult to set out all types of situations where a lower standard may be acceptable. Accordingly, a general prohibition is needed in order to create consistency and certainty.

(vi) One commenter suggested that the definition of a Related Person as defined under the Income Tax Act be included in the Proposed Rule or as an attachment to the Proposed Rule for ease of reference for members.

IIROC staff response

We have set out the relevant section number of the *Income Tax Act*, section 251(1), as well as the current definition, in our implementation notice.

DEALER MEMBER RULE 18.14

1. Outside Business Activities

(i) One commenter requested additional information as to what IIROC is attempting to capture under Proposed Rule 18.14(d) and what ultimately would need to be reported to IIROC.

IIROC staff response

Proposed Rule 18.14(c) will require a Registered Representative (RR) and Investment Representative (IR) to:

- inform his or her Dealer Member of all business activity that the RR or IR are involved in outside of the Dealer Member; and
- obtain the approval of the Dealer Member.

This would include any outside business activity for which the RR/IR expects to, or actually receives, direct or indirect benefit, payment or compensation. The Registered Representative or Investment Representative may only engage in such outside business activities upon approval by the Dealer Member.

IIROC staff is also of the view that when a Registered Representative or Investment Representative provides certain additional services to a client which are outside the scope of his/her registerable activities (for example: looking after a client's GIC business outside of the Dealer Member), these activities are subject to the disclosure and approval requirements set out in proposed Rule 18.14(c). Although there may not be any immediate compensation for those activities, they may be undertaken in an effort to generate more business (i.e. expected benefit) from the client.

(ii) One commenter explains that outside business activity is a source of many investor complaints. Off-book sales is on top of the list. The proposed amendments will require that all outside business activities be disclosed to and approved by the Dealer Member. We agree but believe that IIROC should make three points clear:

1. Any such approval requires the Dealer Member to perform post-approval monitoring and supervision.
2. Any undue losses incurred by clients as a result of the approval shall be for the account of the firm, NOT the dealer representative.
3. The firm should advise the client that outside business activity that has been approved and delineate the scope of that activity and the extent to which the firm will accept liability in the event that things go awry.

IIROC staff response:

The following is the position of IIROC staff with regards to each of the comments made above:

1. Dealer Members must supervise the activities of the Dealer Member Representative to ensure that the outside business activities do not create any real or potential conflicts of interest.
2. The facts and circumstances of the case would be a factor in determining whether the Dealer Member Representative and/or the Dealer Member is held accountable for any client losses, including whether the Dealer Member failed to properly supervise the activities of the Dealer Member Representative.
3. The requirement to address, control and/or avoid conflicts of interest is currently addressed in section 13.4 of NI 31-103 and will further be addressed under the proposed Client Relationship Model amendments.

(iii) Two commenters are concerned about the impact of the proposal on financial planning activities engaged in by some Dealer Member Representatives.

IIROC staff response

The intent of this proposal is to deal with the issue of outside business activities generally; any issues relating financial planning activities engaged in by some Dealer Member Representatives is not within the scope of this project.

(iv) One commenter requested clarification as to why Section 18.14(d) makes it the Dealer Member's responsibility to report the outside business activities within seven days, whereas under NI 33-109 it is the individual registrant's obligation to report within seven days.

IIROC staff response

For consistency with current practices, Dealer Member Rule 3100, and Member Regulation Notice 0162 - Policy 8 - *Information Regarding Reporting* ("MR0162") , it is the Dealer Member Representative's responsibility to report the activity to the Dealer Member, and the Dealer Member's responsibility to report the activity to the regulators.

(vi) One commenter requested further clarification as to whether the Proposed Amendments extend beyond the listed parties, Registered Representatives and Investment Representatives, to all positions within a Dealer Member, similar to those individuals required to complete Item 10 of National Instrument 33-109F4 ("NI 33-109 F4").

IIROC staff response

Proposed Rule 18.14 will only be applicable to Registered Representatives and Investment Representatives. However, the outside business activities of other Approved Persons will be subject to similar approval requirements in order to comply with section 13.4 of NI 31-103. As noted in the comment, such outside business activities would have to be disclosed as per NI 33-109F4.

(vii) One commenter suggested that Section 18.14(e)(ii) contain an exemption for registrants who have roles with parent companies, affiliates or subsidiaries that are not IIROC Members.

IIROC staff response

The Proposed Amendments are not a prohibition against all outside business activities, but rather simply require that the activity be disclosed to and approved by the Dealer Member in order for the Dealer Member to ensure that it is not inappropriate, detrimental to the public interest or such that it would bring the industry into disrepute. Disclosure of such activities is equally important as such a position may create a conflict of interest. Any position with a parent company, affiliate or subsidiary of a Dealer Member is presumably disclosed to and approved by the Dealer Member and we do not see the need for setting out a specific exemption. The position of IIROC staff will be clarified in the related Guidance Note; any position with a parent, affiliate or subsidiary of a Dealer Member is not prohibited, although in most cases, it can be presumed that the position has been approved by the Dealer Member, nonetheless the position must

be disclosed in order to ensure that it is disclosed to the relevant regulator.

(viii) One commenter suggested that Notice MR0434 be repealed so that Dealer Members are only required to consider the Proposed Amendments to avoid confusion.

IIROC staff response

IIROC staff has issued a new Guidance Note on disclosure and approval of outside business activities which replaces previously issued MR0434.