INVESTMENT DEALERS ASSOCIATION OF CANADA

notice

ASSOCIATION CANADIENNE DES COURTIERS EN VALEURS MOBILIÈRES

Contact:
L. Piergeti: (416) 865-3026 – lpiergeti@ida.ca

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ATTENTION:
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Consolidation of Back-Office Operations of a Member firm and its Affiliate

The purpose of this Notice is to provide guidance as to permissible back office activities between an IDA member and any affiliated Canadian financial institution. Common staff will be able to handle securities clearance, settlement, maintenance of records and/or other operational functions on behalf of both the IDA member and its affiliate(s).

This arrangement is exempted under the general provisions of IDA Bylaw 35.1(d), for introducing/carrying rules provided the requirements outlined in this Notice are met.

Definition

As defined in IDA Bylaw 35.1(a)(iii), **Canadian financial institution** means a Schedule 1 or Schedule II Bank pursuant to the *Bank Act* (Canada), an insurance company governed by federal or provincial insurance legislation and a loan or trust company governed by federal or provincial loan and trust company legislation.

Regulatory Issue

IDA Regulations require member firms to maintain an adequate system of books and records. These records must be separate and distinct so that customer assets are not co-mingled with another legal entity's customer assets unless the requirements of an introducing/carrying broker arrangement prescribed by By-law 35 are met.

An adequate system of books and records includes the production of a general ledger, stock record and trial balance of the member firm is "self-balancing". In other words, the accounting records of the member firm and its customer accounts are separate and distinct from any extraneous balances of customer accounts belonging to another entity.

As an example, the IDA requires a separate EDP (either external service provider or in-house proprietary system) company code be maintained for the books and records for each member firm. No two or more separate legal entities are permitted to share a **common EDP company code** unless they are SRO members for the purpose of introducing/carrying arrangements, or the SRO members are related and cross-guaranteed under the provisions of By-law 6.6. The co-mingling of customer assets of a non-SRO member firm on the same EDP company code as the member firm is strictly prohibited. This serves to protect the interests of the investing public in the event any SRO member becomes insolvent by separately identifying customer assets of the SRO member firm for purposes of CIPF insurance coverage.

Aside from the existing introducing/carrying arrangement rules, the IDA has previously taken a regulatory position that when a member firm wants to share a common EDP code with an affiliate, the EDP system must be "hard coded" to clearly identify customer accounts of the member firm and its affiliate. Specifically, the EDP system must be capable of producing self-balancing accounting records such as trial balance and stock records, and prevent any movement of customer monies or securities by journal entry between customer accounts of the member firm and its affiliate. In addition, the custody of monies and securities in the accounts of the affiliate must be maintained separately under the control and legal name of the member and its affiliate.

Requirements for Permitting Back-office Consolidation

Member firms have asked the IDA to establish the requirements for the consolidation or integration of back-office operations between a SRO member firm and its affiliate(s) as contemplated by By-law 35.1(d**). This type of arrangement involves sharing the IDA member firm's EDP service bureau company code (e.g., ISM, ADP and Dataphile) with an affiliate whereby there is no commingling of customer assets under administration between the member and its affiliate. This condition is achieved by operating separate bank and security custody accounts in the name and control of the IDA member and its affiliate.**

Back office consolidation allows the for the creation of separate customer account ranges on a common EDP company code system of books and records with offsetting "control accounts" to manage and separately track transactions between customers of the IDA member from customers of its affiliate.

The processing of customer transactions under the same company EDP code platform requires that critical preventive and detective internal controls be implemented to distinguish customer trading activity between the member and its affiliate and identify errors or irregularities in processing of customer transactions so that corrective accounting entries are made. This involves maintaining operational "control accounts" for the affiliate's customer transaction flow that is balanced and reconciled next day against customer trades, customer monies and security positions held in bank and custody accounts in the name and control of the affiliate.

Criteria for Obtaining Regulatory Approval

The Member firm must submit a written request for review of the arrangement to the IDA. The following is the criteria upon which IDA approval will be based:

1. There must be common ownership (more than 50% controlling interest) of the member and its affiliated Canadian financial institution:

2. The affiliate must be a Canadian financial institution such as a bank, insurance, loan and trust company. This excludes mutual fund dealers that are members of the Mutual Fund Dealers Association of Canada until further notice.

3. The member and its affiliate must share a common EDP company code to process customer transactions through a common back-office. A service or management agreement must be in place to identify the specific operational and functional responsibilities of back-office staff.

4. The customers of affiliates must be separately identified as a range of accounts on the EDP system of books and records of the IDA member firm. The system of books and records must be capable of producing separate customer balances and stock record positions for the range of accounts of the affiliate that are offset on the records of the IDA member firm as control accounts. Such control accounts must be reconciled daily against customer trades, bank balances and security custody positions held in the name and control of the affiliate.

5. A written contractual agreement must be in place between the Member firm and its affiliate setting out the terms and conditions for the services provided.

6. Contract arrangements must be in place with the Member firm and their EDP service provider to ensure independent third party access to books and records maintained by the member firm in respect to customer accounts of the affiliate, as would a trustee in the event of insolvency by the member firm.

7. Written policies and procedures must be in place that identifies the operation of control accounts, reconciliations of bank and custody accounts under the name and control of the member and its affiliate. This includes controls to review and approve all accounting journal entries by a designated senior management personnel between account ranges of the member and its affiliate sharing the same company code before processing.

8. Separate company customer statements must be generated for the customer accounts of the member and its affiliate. The consolidation of the portfolio of customer assets of both the IDA member and its affiliate is in addition to, but not in place of, the monthly statements required by Regulation 200.1 for the IDA member firm and the governing rules for the affiliate entity.

Internal and External Audit Requirements

Documented policies and procedures describing the transaction flow and controls must be developed and reviewed by the internal audit department and/or external auditors of the member firm as to whether they meet the specified internal control objective of generating separate customer trial balance and stock record positions, and separate custody and control of customer monies and securities between the member and its affiliate(s).

An annual audit report on the Control Objectives and Procedures is required in conjunction with the filing of the audited regulatory financial statements of the member firm. Such audit report will be prepared in adherence with CICA Handbook Section 5900.