

DRAFT FOR COMMENT

Rules Notice Guidance Note Dealer Member Rules

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Requirements and Best Practices for distribution of non-arm's length investment products

Overview

The distribution by a Dealer Member to its clients of investment products of an issuer that does not deal at arm's length with the Member raises regulatory concerns. In recent years there have been specific instances where clients of IIROC Dealer Members have suffered losses as a result of investing in such products. There have been other similar circumstances involving securities dealers, mutual fund dealers and other distributors in Canada, the United States and elsewhere. In some cases, including those involving IIROC Dealer Members, the client losses have resulted in compensation being paid by industry protection plans such as Canadian Investor Protection Fund ("CIPF").

At the core of the concerns identified is the fact that a connection between the Member and the issuer may result in conflicts of interest that are similar in substance to those that arise when a Member or its employee borrows money directly from a client. Where these conflicts of interest exist, it is difficult for the Member to meet its legal and regulatory obligations to

clients. These obligations to protect the client include the duty to satisfy the high standards of conduct expected of an IIROC Member pursuant to IIROC Dealer Member Rule 29.1 and to comply with other specific IIROC requirements relating to trade suitability and addressing of conflicts of interest.

The investment products covered in this Notice are generally referred to for convenience as "non-arm's length" products and are intended to include products issued by the Member itself, an issuer, or a selling securityholder with which a Member does not deal at arm's length, has or is subject to an ownership interest similar to related companies, or is otherwise connected. For a more detailed description of the "Investment Products and Issues Covered by this Notice", please see the section below.

The purpose of this Notice is to alert Members to the regulatory concerns and to advise Members of IIROC's expectations in the distribution of non-arm's length investment products to their clients. Existing IIROC Dealer Member Rules and regulatory requirements, in combination with applicable securities legislation, are considered adequate to protect clients from the inappropriate sale of non arms length products. IIROC intends to increase its compliance monitoring of this practice by Dealer Members

Summary of expectations for Dealer Members

Dealer Member obligations in respect of the distribution of non-arm's length products are summarized in the sequence of steps below. The particular regulatory requirements and other considerations are described in more detail or referred to in the sections that follow.

Step 1 – Conflict of interest assessment

Inherent in non-arm's length products is the potential for conflicts of interest between the Member and its clients:

- The Member must first identify and understand the nature and extent of such conflicts of interest and assess whether they can be addressed in the client's best interest. If the Member is not satisfied such conflicts of interest can be so addressed, the products should not be sold to any client.
- If the conflicts of interest can, in the Member's view, be adequately addressed in the client's best interests, then the Member may proceed on the basis described in this Notice including product due diligence as in Step 2 below.

Step 2 – Product due diligence

As for all investment products proposed to be distributed by a Member, the Member must thoroughly understand non-arm's length products, their investment features, risks and value.

- If the analysis indicates material concerns with the product which would make it unsuitable for any client, the Member should not distribute the product.
- If the Member is satisfied that the product can be distributed following a due diligence review, the Member may proceed, subject to notice to IIROC if applicable, to distribute it to targeted clients provided that client specific suitability assessments are undertaken as in Step 3 below.
- In the case of non-arm's length products that are neither:
 - distributed pursuant to a prospectus, nor
 - eligible for margin under IIROC Rules,

then written notice to IIROC is required not less than 20 business days prior to the execution of the first trade for the purchase of the product pursuant to the distribution, unless IIROC has specifically approved the product for distribution without notice (see Section "Notice to IIROC" below).

Step 3 – Client specific suitability

Suitability assessments must be made in respect of client orders and recommendations pursuant to IIROC account supervision requirements.

- If a proposed trade in respect of a non-arm's length product to a particular client is considered to be unsuitable, the trade should not be completed.
- If a proposed trade is considered to be suitable for a particular client, the Member may complete the trade provided that the trade otherwise complies with applicable laws and IIROC Rules and that IIROC has not objected to the distribution.

Regulatory Issues

The regulatory issues that arise when Dealer Members distribute non-arm's length investment products vary according to the particular circumstances and may include the following:

- *Conduct Standards.* The expectation of Dealer Members and their personnel is that they will act in accordance with high standards of conduct as set out in Dealer Member Rule 29.1 and applicable securities legislation. The requirements to meet these standards are even higher when Members distribute non-arm's length products to their clients.

- *Conflicts of Interest.* When a Member has a direct or indirect interest (financial or otherwise) in the issuer whose securities it is distributing, the inherent conflict of interest makes it more important for the Member to apply the expected standards of ethics, fairness, good faith and honesty. In some cases these conflicts cannot be mitigated and the Member should not distribute the product.
- *Issuer Scrutiny and Product Review.* Dealer Members have a responsibility to assess investment products with full due diligence procedures, especially products that are not subject to rigorous scrutiny in the marketplace by way of a prospectus review, rating agencies, analysts or other third party intermediaries. Suitability cannot be complied with unless the Member has carefully reviewed and vetted investment products which the Member wishes to offer for sale to clients. In the case of non-arm's length products, this scrutiny by a Member is particularly critical.
- *Suitability.* The suitability rules of IIROC are a cornerstone of client protection. However, if there is an affiliation between the Dealer Member and the issuer, this conflict may make it difficult for the Dealer Member to objectively assess and advise its client in respect of the investment such that this cornerstone protection is compromised. Suitability assessments can only be made if the due diligence procedures for investment products are complied with.
- *Disclosure.* Full disclosure to a prospective investor of an investment product is important and is one of the core regulatory protections available to investors. In the case of non-arm's length products, the incentive and ability to provide full and meaningful disclosure to an investor may be impaired. In all cases, complete and full disclosure of these products to the client is mandatory.
- *Protection Fund Coverage.* The losses that may accrue to clients of Members as a result of the purchase of non-arm's length products may not be covered by the industry protection fund, Canadian Investor Protection Fund ("CIPF"). CIPF does not cover losses in respect of investments in a Member itself incurred as a result of the Member's insolvency. In the case of non-arm's length products of issuers related to the Member, the nature of the relationship and the determination of whether or not the loss is a market loss or insolvency loss (insolvency loss being the only loss covered by CIPF) may result in CIPF coverage not being available to clients.

Investment products and issues covered by this Notice

The investment products which this Notice addresses are not restricted to particular issuers or types of product. Any issuer or selling securityholder that does not deal at arm's length with a

Member, or is the Member itself, is included as a non-arm's length issuer.

In addition, the method of distribution is not determinative of the general standards to be applied, and public, private and exempt distributions are covered. The common kinds of issuers and investment products that may be affected include:

Issuers or selling securityholders:

- the Member itself
- any affiliate (i.e. parent, subsidiary or entity with common control) of the Member (IIROC Dealer Member Rule 1.1)
- associates (corporations, partnerships, trusts, etc) in which a person has an interest (IIROC By-law No. 1, Section 1.1)
- related issuers (National Instrument 33-105 of the Canadian Securities Administrators (CSA))
- connected issuers (National Instrument 33-105 of the CSA)
- entities (whether or not a securities dealer or advisor) in respect of which the Member has, or is subject to, an ownership interest as if they were related companies (IIROC Dealer Member Rule 1.1)

Products:

- debt, including promissory notes, principal protected notes and asset-backed products
- investment fund products (mutual funds, hedge funds, investment clubs etc.)
- equities
- "exempt" products such as limited partnership units, real estate ownership interests, and commodity-based products including those where the non-arm's length issuer is the counterparty on the contract.

Product due diligence

A Dealer Member must ensure that it fully understands the nature of the product it proposes to sell and all aspects of it that will be relevant to clients. Such understanding is necessary in order for Members to comply with the suitability standards referred to below in this Notice.

IIROC has published Notice 09-0087 dated March 23, 2009 relating to best practices for product due diligence. The standards and requirements in that Notice pertain to the investment products addressed in this Notice - with the caution that heightened scrutiny and discipline are expected in reviewing products of non-arm's length issuers.

In the case of investment products distributed to the public by a Member or its holding company, IIROC Dealer Member Rules 5.9 to 5.13, inclusive, may apply as well as corresponding requirements in provincial securities legislation. It is noted that for public distributions, the involvement of third parties such as a qualified independent underwriter, the prospectus review staff of securities commissions, rating agency staff, analysts and other selling syndicate members, as applicable, are intended to provide objective review. In any distribution where such third party involvement is not mandated or otherwise applicable, Members should consider arranging for substitute review or enhanced measures to ensure that the appropriate due diligence is conducted and (as referred to below in this Notice) the appropriate level of disclosure and other requirements are satisfied.

IIROC has identified best practices for Dealer Members in conducting product due diligence and addressing conflict of interest concerns. For all products these include inquiry and analysis as to:

- audited financial statements for the issuer
- independent valuations for assets
- management services and functions provided at arm's length basis
- description of ownership structure of issuer and identification of persons and entities not dealing at arm's length
- full disclosure as to the use of proceeds
- full disclosure of management fees or other compensation
- full disclosure of distribution structure including commissions, referral fees, promotions and inducements.

For funds and structured products, additional factors include:

- audited financial statements of the fund
- pricing of the investment product and valuation of the portfolio of the fund by an independent third party
- independent custody of the portfolio of the fund
- annual disclosure listing the portfolio of the fund
- where the monthly pricing and accounting functions are performed by the issuer itself or an affiliate, an independent specified compliance procedures review conducted by an

external auditor or independent party (at least every quarter) and a report of findings made available to unit holders

- commissions on underlying fund asset trades being pre-determined and competitive with street rates.

Suitability

Dealer Members and their advisors have suitability responsibilities pursuant to IIROC Dealer Member Rule 1300 including due diligence to ensure that the acceptance of orders (except in limited circumstances) and recommendations are suitable for clients. As in the case of product due diligence referred to in the preceding section of this Notice, the fact that a Member may be, or is related in some respect to the issuer, increases the burden on the Member to ensure that suitability determinations are made objectively and without improper influence as a result of the interest of the Member, direct or indirect, in the transaction.

Disclosure

Provincial securities legislation and IIROC Rules 5.9 to 5.13 rely on enhanced disclosure in the case of distribution by a Dealer Member of investment products of related issuers. IIROC is of the view that compliance by Dealer Members with the Rules referred to above in respect of business conduct standards, suitability, product vetting and avoidance of conflicts of interest require enhanced disclosure to clients who purchase non-arm's length investment products. The level and manner of disclosure, other than as specifically required in the Dealer Member Rules or in securities legislation, is not intended to be prescriptive but should be appropriate to the particular circumstances.

Notice to IIROC

Written notice

Prior to the commencement of the distribution by a Dealer Member of a non arms length investment product in respect of which this Notice applies, which is not either:

- (i) distributed pursuant to a prospectus for which a receipt is required pursuant to provincial securities legislation; or
- (ii) eligible for margin pursuant to IIROC Dealer Member Rules;

the Dealer Member shall provide written notice to IIROC of its intention to commence the distribution unless IIROC has specifically approved the product for distribution without notice. At present, securities issued by a federally regulated or provincially regulated financial

institution distributed pursuant to an exemption under securities legislation has been approved as not requiring foregoing notice to IIROC.

Such notice shall be received by IIROC not less than 20 business days prior to the execution of the first trade for the purchase of the investment product pursuant to such distribution and shall include:

- (i) a general description of the investment product and plan of distribution;
- (ii) particulars of the principal business uses from the proceeds of distribution by the issuer, including transaction expenses and commissions;
- (iii) copies of any offering materials including advertisements and/or sales literature in Rule 29.7 to be used by the Dealer Member;
- (iv) if required by IIROC, a copy of a legal opinion addressing compliance with applicable securities laws.

Enforcement

As indicated in the "Overview" section above, the purpose of this Notice is to alert Members of the particular regulatory concerns arising from the distribution of non-arm's length investment products and to advise Members of IIROC's expectations in that regard. The conduct of any Dealer Member, its approved persons or its employees and agents in respect of any such distribution not in compliance with IIROC Dealer Member Rules and the terms of this Notice may constitute grounds for enforcement action by IIROC on the basis of such non-compliance and conduct being unbecoming a Member or its personnel.