

13.1.7 Request for Comments -- Amendments to IDA Regulations 100.15 and 300.25 Regarding Customer Account Guarantee Agreements

**INVESTMENT DEALERS ASSOCIATION OF CANADA –
REGULATIONS 100.15 AND 300.2 -
CUSTOMER ACCOUNT GUARANTEE AGREEMENTS**

I OVERVIEW

A Current Rules

Regulation 100.15 sets the regulatory requirements for customer account guarantee agreements. The requirements include:

- limitations on account guarantees provided by partners, directors or officers;
- a prohibition on guaranteeing accounts of partners, directors, officers, shareholders, registered representatives or employees;
- the provision of capital where a customer account guarantee agreement subject to an external auditor positive confirmation request remains unconfirmed;
- the inclusion of standard minimum terms in any customer account guarantee agreement; and
- the provision of guaranteed account liability information to the guarantor.

Regulation 300.2 requires the external auditors to obtain positive confirmation as at audit date of customer account guarantee agreements where the account(s) being guaranteed would require significant margin without the existence of the guarantee agreement.

B The Issue

We have reviewed the current requirements and have concluded that they are adequate. However, because the legal enforceability of specific customer account guarantee agreements has recently been challenged in the courts in relation to the wind-up of an insolvent Member firm, we have also concluded that requiring a Member firm to make all reasonable efforts to ensure the legal enforceability of their customer account guarantee agreements is an important and emerging issue. We are therefore proposing amendments to IDA Regulations 100.15 and 300.2 that are intended to ensure that the guarantor is aware of his/her obligations under the guarantee agreement and to minimize the legal enforcement risk associated with guarantee agreements.

C Objectives

The objective of the proposed amendments (as set out in Attachment #1) is to minimize the legal enforcement risk associated with guarantee agreements by amending:

- Regulation 100.15 to only allow that the margin requirement for the guaranteed account(s) be reduced where the guaranteed account holder has consented to providing quarterly liability information, in the form of the guaranteed account statement(s), to the guarantor. This will help ensure that the guarantor is aware of his / her potential guarantee agreement liability; and
- Regulation 300.2 to require auditors to positively confirm specific customer account guarantee agreements where the agreements have been relied upon to significantly reduce guaranteed account margin either during the year or as at year-end. The current requirement is limited to where a customer account guarantee agreement is significantly relied upon as at year-end. This will help ensure that the guarantor is aware of situations where there has been material reliance on his / her guarantee during the year.

D Effect of Proposed Rules

The proposal seeks to amend Regulations 100.15 and 300.2 to minimize the legal enforcement risk associated with guarantee agreements. It is believed that the proposed amendments will have no impact in terms of capital market structure, competition, costs of compliance and conformity with other rules.

II DETAILED ANALYSIS

A Present Rules, Relevant History and Proposed Policy

A detailed analysis of present rules, relevant rule history and the proposals themselves was considered unnecessary.

B Issues and Alternatives Considered

The IDA considered requiring the re-execution of customer account guarantee agreements on a periodic basis but concluded that the renewal of agreements provided little benefit in relation to the increase in administrative burden that would be created.

C Comparison with Similar Provisions

A comparison with similar regulations in the United Kingdom and the United States was not considered necessary.

D Systems Impact of Rule

It is believed that the proposed amendments will have no impact in terms of capital market structure, member versus non-member level playing field, competition generally, costs of compliance and conformity with other rules. The Bourse de Montréal is also in the process of passing this amendment. Implementation of this amendment will therefore take place once both the IDA and the Bourse de Montréal have received approval to do so from their respective recognizing regulators.

E Best Interests of the Capital Markets

The Board has determined that the rule is not detrimental to the best interests of the capital markets.

F Public Interest Objective

According to subparagraph 14(c) of the IDA's Order of Recognition as a self regulatory organization, the IDA shall, where requested, provide in respect of a proposed rule change "a concise statement of its nature, purposes (having regard to paragraph 13 above) and effects, including possible effects on market structure and competition". Statements have been made elsewhere as to the nature and effects of this proposal. The purpose of the proposal is to:

- Standardize industry practices where necessary or desirable for investor protection.

The proposal does not permit unfair discrimination among customers, issuers, brokers, dealers, members or others. It does not impose any burden on competition that is not necessary or appropriate in furtherance of the above purposes.

The proposal is believed to be public interest as it is intended to help to minimize the legal enforcement risk associated with guarantee agreements by making the guarantor aware of his / her potential guarantee agreement liability. The proposal will not impact the public.

III COMMENTARY

A Filing in Other Jurisdictions

These proposed amendments will be filed for approval in Alberta, British Columbia, Ontario and Quebec and will be filed for information in Manitoba, Nova Scotia and Saskatchewan.

B Effectiveness

As indicated in the previous sections, the objective of the proposal is to help to minimize the legal enforcement risk associated with guarantee agreements. It is believed that the proposal will be effective for this purpose.

C Process

These proposed amendments have been developed and recommended for approval by the FAS Capital Formula Subcommittee and have been recommended for approval by the FAS Executive Committee and the Financial Administrators Section.

IV SOURCES

References:

- Regulation 100.15 and 300.2.

V OSC REQUIREMENT TO PUBLISH FOR COMMENT

The IDA is required to publish for comment the accompanying amendments.

The Association has determined that the entry into force of the proposed amendments would be in the public interest. Comments are sought on the proposed. Comments should be made in writing. One copy of each comment letter should be delivered within 30 days of the publication of this notice, addressed to the attention of Arif Mian, Investment Dealers Association of Canada, Suite 1600, 121 King Street West, Toronto, Ontario, M5H 3T9 and one copy addressed to the attention of the Manager of Market Regulation, Ontario Securities Commission, 20 Queen Street West, 19th Floor, Box 55, Toronto, Ontario, M5H 3S8.

Questions may be referred to:

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INVESTMENT DEALERS ASSOCIATION OF CANADA
REGULATIONS 100.15 AND 300.2 - CUSTOMER ACCOUNT GUARANTEE AGREEMENTS
BOARD RESOLUTION
ATTACHMENT #1

THE BOARD OF DIRECTORS of the Investment Dealers Association of Canada hereby makes the following amendments to the By-laws, Regulations, Forms and Policies of the Association:

1. The preamble in Regulation 100.15 is amended by adding the following text at the end of the paragraph after the words "aggregated or consolidated basis":

"and provided the Member has received the written consent of the customer to provide the guarantor with the customer's account statement, at least quarterly. Where the customer objects to provide such written consent, the Member shall notify the guarantor in writing of the customer's objection.";
2. Regulation 100.15(i) is repealed and replaced as follows:

"The guarantor shall receive from the Member, at least quarterly, the customer's account statement or statements, in respect of the accounts to which the guarantee relates, provided the guarantor does not object in writing to receiving such information. The Member shall disclose to the guarantor in writing that the suitability of transactions in the customer's account will not be reviewed in relation to the guarantor.";
3. Regulation 300.2(a)(vii)(7) is amended by replacing the sentence "guarantees in cases where required to margin (protect) accounts guaranteed as at the end of the year subject to audit." by the words "guarantees in cases where required to margin (protect) accounts guaranteed either during or as at the end of the year subject to audit."; and
4. The notes that appear at the end of Regulation 300.2(a)(vii) are amended by adding in item (b) of the second paragraph the words "during the year or as at year-end" immediately after the words "and accounts that would require significant margin".

PASSED AND ENACTED BY THE Board of Directors this 26th day of June 2004, to be effective on a date to be determined by Association staff.

INVESTMENT DEALERS ASSOCIATION OF CANADA

REGULATIONS 100.15 AND 300.2 - CUSTOMER ACCOUNT GUARANTEE AGREEMENTS
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ATTACHMENT #2

Proposed revised preamble to Regulation 100.15 – Amendment #1

“The margin required in respect of the account of a customer of a Member which is guaranteed in accordance with this Regulation 100.15 may be reduced to the extent that there is excess margin in the accounts of the guarantor held by the Member calculated on an aggregated or consolidated basis and provided the Member has received the written consent of the customer to provide the guarantor with the customer’s account statement, at least quarterly. Where the customer objects to provide such written consent, the Member shall notify the guarantor in writing of the customer’s objection.”

Proposed revised Regulation 100.15(i) – Amendment #2

“The guarantor shall ~~be entitled to receive from the Member, at least quarterly, on request written confirmation~~ the customer’s account statement or statements, from time to time of the customer’s liability to the Member in respect of the accounts to which the guarantee relates, provided the Member has received the written consent of the client for such provision of guarantor does not object in writing to receiving such information. The Member shall disclose to the guarantor in writing that the suitability of transactions in the customer’s account will not be reviewed in relation to the guarantor.”

Proposed revised Regulation 300.2(a)(vii) – Amendments #3 and #4

“(vii) Obtain written confirmation with respect to the following:

- (1) Bank balances and other deposits including hypothecated securities;
- (2) Money, security positions and open commodity and option contracts including deposits with clearing houses and like organizations and money and security positions with mutual fund companies;
- (3) Money and securities loaned or borrowed (including subordinated loans) together with details of collateral received or pledged, if any;
- (4) Accounts of or with brokers or dealers representing regular, joint and contractual commitment positions including money and/or security positions and open commodity and option contracts;
- (5) Accounts of directors and officers or partners, including money and/or security positions and open commodity and option contracts;
- (6) Accounts of clients, employees and shareholders, including money and/or security positions and open commodity and option contracts;
- (7) Guarantees in cases where required to margin (protect) accounts guaranteed either during or as at the end of the year subject to audit;
- (8) Statements from the Member’s lawyers as to the status of lawsuits and other legal matters pending which, if possible, should include an estimate of the extent of the liabilities so disclosed;
- (9) All other accounts which in the opinion of the Member’s Auditor should be confirmed;

Compliance with the confirmation requirements shall be deemed to have been made if positive requests for confirmation have been mailed by the Member’s Auditor in an envelope bearing the Auditor’s return address and second requests are similarly mailed to those not replying to the initial request. Appropriate alternative verification procedures must be used where replies to second requests have not been received.

For accounts mentioned in (4), (6) and (7) above, the Member’s Auditor shall (i) select specific accounts for positive confirmation based on (a) their size (all accounts with equity exceeding a certain monetary amount, with such amount being related to the level of materiality) and (b) other characteristics such as accounts in dispute, accounts that are significantly undermargined, nominee accounts, and accounts that would require significant margin during the year or as at year-end without the existence of an effective guarantee, and (ii)

select a representative sample from all other accounts of sufficient extent to provide reasonable assurance that a material error, if it exists, will be detected.

For accounts in (4), (6) and (7) above that are not confirmed positively, the Member's Auditor shall mail statements with a request that any differences be reported directly to the auditor. Clients' accounts without any balance whatsoever and those closed since the last audit date shall also be confirmed on a test basis using either positive or negative confirmation procedures, the extent to be governed by the adequacy of the system of internal control;

Where a reply to a positive confirmation request for a guarantee in (7) above has not been received, the guarantee shall not be accepted for margin purposes in respect of the account guaranteed unless and until a written form of confirmation of the guarantee has been received by the Member's Auditor (or by the Member if subsequent to the filing of the Joint Regulatory Financial Questionnaire and Report), or a new guarantee agreement is signed by the customer. If a guarantor responds to a positive or negative confirmation disputing the validity of the guarantee or the extent of the guarantee, such guarantee shall not be accepted for margin purposes until the dispute is resolved and the confirmation of the guarantee is provided in acceptable form. In addition to the confirmation procedures, the Member's Auditor should review a sample of guarantee agreements to ensure duly executed and completed agreements exist and such agreements comply with the minimum requirements of Regulation 100.15(h);"