Appendix 5
To Rules Notice 16-0122

June 9, 2016

Re: IIROC response to public comments on Republication of Proposed Consolidation of IIROC Enforcement, Procedural, Examination and Approval Rules
(IIROC Rules Notice 13-0275)

On November 14, 2013, the Investment Industry Regulatory Organization of Canada ("IIROC") published for comment IIROC Rules Notice 13-0275 (the "Notice"), which proposed a revised version of our proposal to consolidate IIROC's enforcement, procedural, examination and approval rules (the "Revised Consolidated Rules").[1] In response to the Notice, we received one public comment letter, which was authored by the Investment Industry Association of Canada (the "IIAC").

We have considered the IIAC's comments, and we thank the IIAC for its submission. The comments are summarized and presented below, followed by IIROC staff's response.

INVESTIGATIONS *[Consolidated Rule 8100]*

A. Notice

- In its response to public comments regarding the Original Notice, IIROC stated that no changes were made to the notification provision and that Staff will continue to have discretion to give notice of an investigation when they consider it appropriate to do so.

IIROC staff response: We understand that the commenter continues to be concerned about the absence, in the Revised Consolidated Rules, of an express obligation for Enforcement staff to provide notice of an investigation to the subject of that investigation and about the impact that this could have on Dealer Members. We want to reassure all stakeholders that our decision to adopt, in the consolidated rules, the UMIR approach—which

[1] The original version of the proposed consolidation of IIROC's enforcement, procedural, examination and approval rules was published for public comment on March 23, 2012. See IIROC Rules Notice 12-0104, *Consolidation of IIROC Enforcement, Procedural, Examination and Approval Rules* (Mar. 23, 2012) (the "Original Notice").

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makes the provision of notice of an investigation optional for Enforcement staff—will not change Enforcement staff's standard practice of providing notice, at the initial stage of the investigation, to the subject of that investigation in almost all cases. However, as indicated in our response to the public comments received in connection with our original rule proposal (the "Original Response Letter"), adopting the UMIR approach to notice will give staff appropriate flexibility and discretion to withhold or postpone notice in a limited number of cases, such as where providing notice would jeopardize the integrity of the investigation.[2]

- IIROC should reconsider and adopt the approach in the current Dealer Member Rules that requires a person to be informed in writing that he or she is the subject of an investigation and of the matters under investigation. This will ensure that the Dealer Member is alerted to an employee's problematic activity and able to respond accordingly to address the issue.
- Even with adequate policies and procedures in place to identify and prevent improper conduct and to ensure ongoing supervision, it is possible that a Dealer Member will be completely unaware of improper activity by an employee. Without notice of an investigation of such activity, the Dealer Member will be unable to prohibit the employee from continuing the misconduct. By not alerting the member that one of its registrants is the subject of an investigation, IIROC would fail to allow the member to properly execute its gatekeeper responsibilities and ensure that the investing public is adequately protected.

IIROC staff response: As noted above, the Revised Consolidated Rules maintain the UMIR approach to the issue of notice of investigations, namely, to make notice optional for staff. This is consistent with a recommendation made by our recognizing regulators. As previously stated, we intend to continue to provide notice of an investigation to the subject of the investigation, at the initial stage, in the vast majority of cases, but we reserve the right under the new rules to withhold or postpone notice in exceptional cases, such as cases involving alleged fraud, in order to protect the integrity of an investigation.

B. IIROC's jurisdiction over employees and other non-approved persons

- IIROC's Original Response Letter stated that there would be no change to proposed subsections 8104(3) and 8208(3), which obligate a Regulated Person to require its non-approved employees to cooperate with an investigation and attend at a hearing, respectively. It will be challenging to ensure proper compliance with these rules. The Original Response Letter indicated that what these new rules require is for

[2] See Original Response Letter at 3. The Original Response Letter was attached as Appendix E to the Original Notice.

regulated firms to "take reasonable steps to ensure that their employees will cooperate with an investigative request or to provide testimony at a hearing". Subsections 8104(3) and 8208(3) should be modified to expressly provide that a Regulated Person must take "reasonable steps" or "act on a best efforts basis" to ensure the cooperation of their non-regulated employees.

IIROC staff response: We do not believe that it will be challenging for our regulated firms to comply with subsections 8104(3) and 8208(3). As indicated in our Original Response Letter, reasonable measures must be taken by our Dealer Members to ensure that their non-IIROC approved employees cooperate with our investigations and disciplinary proceedings.[3] Where a Dealer Member has taken such reasonable measures, this would satisfy a due diligence defence to any possible charge under subsections 8104(3) or 8208(3). Furthermore, we note that the language used in these provisions is very similar to that which appears in existing Dealer Member Rule 19.1, which provides: "A Dealer Member shall require all employees to comply with Rule 19."

C. *Confidentiality of investigations*

- IIROC should clarify whether an employee, representative, or agent of a Regulated Person who meets the conditions under clauses (i) to (iii) of proposed subsection 8106(1) "would be required" to disclose the items set forth under clauses (iv) to (vii) to the Regulated Person's compliance, legal or human resources department, as applicable.

IIROC staff response: Amendments of a non-material nature have been made to section 8106. The effect of these changes is the removal of the mandatory requirement to keep information regarding an investigation confidential and the introduction of an order issued by IIROC to the same effect. Both under the previous drafting and under the current amendments, nothing within Rule 8100 would *require* an individual to share information protected by confidentiality under the previous clauses 8106(1)(iv) through (vii) (now clauses 8106)(1)(i) through (v)), with that individual's compliance, legal or human resources department. Rather, the exceptions to confidentiality set forth in new subsection 8106(2) are permissive—they would allow (not require) an individual to share confidential information with the appropriate personnel of his or her firm under certain circumstances.

*F*or example, sub-clause 8106(2)(ii)(a) would allow a person to disclose requests made in connection with an investigation to staff, for example personnel in the information technology department of a Dealer Member firm, in order to respond to the relevant request.

[3] See Original Response Letter at 6-7.

Likewise, sub-clause 8106(iv)(b) would allow a person to confidential information to their compliance officer with compliance responsibility for the person, to the extent necessary to supervise the person or inform the board, whether or not the compliance officer is technically senior to the person.

The amendments to section 8106 appear in blackline in Appendix 2 of the Rules Notice to which these responses have been attached.

DISCIPLINARY HEARINGS

A. Standards of Conduct *[Consolidated Rule 1400]*

1. Negligence standard

- Despite OSC staff (but not the Commission itself) stating that Dealer Member Rule 29.1 was broad enough to encompass a simple negligence standard, the IIAC reiterates its objection to the continued inclusion of negligence as a possible basis for a determination that a general standard of conduct has been violated.
- Such a broad and far-reaching standard of conduct poses concerns, especially given that hearing panels will be granted the discretion to make the determination of a disciplinary action for a breach of the negligence standard. The IIAC questions how such a negligence standard will be applied and interpreted by hearing panels. A standard of negligence is one that does not include an element of intent. The IIAC strongly believes that intentional or knowing conduct is a necessary prerequisite to a finding of conduct unbecoming or detrimental to the public interest.
- Civil proceedings are the more appropriate venue for raising the issue of negligent conduct rather than under IIROC jurisdiction. Otherwise, a member's business conduct review could simply be transferred into a notice of hearing. Since negligence does not include any element of intent, it is an unrealistic standard to be met. A more appropriate standard is recklessness or wil[l]ful blindness.

IIROC staff response: The comments set forth above repeat comments made by the IIAC in response to the Original Notice, which we responded to in our Original Response Letter. Please refer to pages 20 to 24 of that document. For the reasons set forth in those responses, we have retained clause 1402(2)(i) as originally proposed.

In responding to the commenter's concerns, we would emphasize that IIROC determines which cases to pursue based upon a comprehensive case selection process that includes various levels of internal review to ensure that the cases selected send strong regulatory messages and contribute to IIROC's investor protection mandate. The criteria applied include such factors as the scope of the misconduct, the harm to investors, the impact on the market,

and whether the misconduct is ongoing. Consideration of these criteria will inform Enforcement management's assessment of whether negligent conduct is worthy of investigation and, where appropriate, prosecution pursuant to the consolidated standards-of-conduct rule.

- The IIAC is not aware of other forms of professional discipline that are based upon a standard of simple negligence.

IIROC staff response: As stated in our Original Response Letter, recognition of a negligence standard as a potential basis for liability is consistent with the catch-all provision that applies to persons regulated by FINRA, the self-regulatory organization for the U.S. securities industry.[4] It is also consistent with similar obligations imposed on members of the Canadian securities industry by provincial law, as noted in our Original Response Letter. Finally, we are aware of jurisprudence from other self-regulatory organizations that recognizes a simple negligence standard under equivalent ethical conduct rules. See e.g. *Law Society of Saskatchewan v. McLean*, [2009] L.S.D.D. No. 130 (QL) at paras. 93-94 ("[C]onduct unbecoming may be established through intentional conduct, negligent conduct or total insensibility to the requirements of acceptable practice (as in professional incompetence). [...] Thus, a breach of the lawyer's duty of competency may constitute "conduct unbecoming" without a negative moral element and, where it otherwise meets the definition. While a disgraceful or dishonest moral component contributes to the seriousness of conduct unbecoming a charge can be sustained in its absence.").

2. Failure to comply with legal, regulatory, contractual or other obligations

- Proposed clause 1402(2)(ii), as revised, provides that any business conduct that fails to comply with a legal, regulatory, contractual or other obligation may contravene the standards of conduct. In contrast with existing UMIR 2.1 and Dealer Member Rule 29.1, the scope of the proposed rule is overly broad and subjective. While IIROC indicated that the emphasis is placed on "business" conduct, we are concerned that the provision as drafted would subject a Regulated Person's personal dealings and obligations of any nature to this requirement. In this regard, we strongly suggest

[4] See *ibid.* at 23 (citing *Department of Enforcement v. Pellegrino*, 2008 NASD Discp. LEXIS 10 at *13-14 (N.A.C. January 4, 2008) (misleading statements about risks of certain securities were "at least negligent and violated NASD Rule 2110"); *Paul Joseph Benz*, SEC, Exchange Act Release No. 34-51,046, 2005 SEC LEXIS 116 (January 14, 2005) (president of firm violated Rule 2110 by permitting firm to operate with insufficient net capital, despite good faith effort to comply); *Department of Enforcement v. Bullock*, 2009 FINRA Discp. LEXIS 18, at *18 (Office of the Hearing Officers, April 17, 2009) ("negligent conduct may violate Rule 2110")).

that IIROC remove the reference to "other" obligations or alternatively, provide clear guidance on IIROC's interpretation of "other obligation".

IIROC staff response: We do not believe that any changes to the most recently published version of clause 1402(2)(ii) are necessary. That clause—an interpretive provision—is permissive and, therefore, deliberately broad. It is intended to provide hearing panels with express authority to take into account the myriad obligations imposed on securities professionals—including legislative, regulatory, contractual, and other obligations—when articulating the general standard of conduct expected of a Regulated Person under IIROC rules in a particular case and assessing whether a given respondent has lived up to that standard. The phrase "other obligations" was meant to allow, for example, a determination that a respondent's failure to abide by a policy of his or her firm amounts to "conduct unbecoming" (or conduct that is not in accordance with "just and equitable principles of trade" or that is "detrimental to the public interest"), where circumstances warrant such a result. Indeed, a firm policy may be found to be extremely important, for investor protection or market integrity reasons, even though it is not legally binding on an Approved Person (namely, because it is neither a statute-based, nor a contract-based obligation *per se*). This will provide hearing panels with sufficient interpretive latitude to ensure that our rules evolve over time in accordance with changes in securities laws, regulations, firm policies, and industry knowledge and practices.

3. Unreasonable departure from expected standards

- The standard set forth in clause 1402(2)(iii) ("displays an unreasonable departure from standards that are expected to be observed by a Regulated Person") should be removed because it is unclear how this standard is defined and how it differs from other IIROC rules and guidance. Who measures what this standard actually is in practice? Are industry standards higher and more comprehensive than the standards articulated in the prescribed IIROC requirements? It is quite likely that a new and higher standard could be established through expert evidence or other avenues thereby creating a new industry best practice that is a departure from the minimum IIROC requirements and creating a higher threshold against which member firms might be measured. This is problematic as it sets the bar where industry members will not have advance knowledge of what is expected of them. Further, member firms will likely be unaware of what other firms are doing with respect to, for example, supervisory system best practices. If this standard is not removed, in the alternative, it should be clarified that the standard to be applied is a securities industry standard, by revising the term "standard" to read "securities industry standard".

- It is also concerning that a hearing panel may make a determination of what an appropriate industry standard is without the benefit of a cross examination. It is questionable whether a hearing panel should have the ability to create an industry standard in this manner.

IIROC staff response: As previously stated in the Original Response Letter, clause 1402(2)(iii) is an interpretive rule that codifies statements in decisions of hearing panels relating to industry expectations, in terms that make it clear that the standard is based on reasonableness. See e.g. *Re Ng*, [2007] I.D.A.C.D. No. 47, para. 20 ("wide divergence from the conduct to be reasonably expected of a registered representative"); *Re Deeb*, 2013 IIROC 8, para. 99 ("falling below the standard of conduct reasonably accepted in the securities industry in order to maintain the public trust" in members). The reasonableness requirement emphasizes that the standard is an objective standard.[5]

4. Investor Confidence

- The proposed amendment to proposed clause 1402(2)(iv) would include consideration of investor confidence in the integrity of the securities, "commodities or derivatives" markets. The addition of the commodities and derivatives markets would appear to broaden IIROC's jurisdiction over marketplaces that are not regulated by IIROC. The phrase "commodities or derivatives" markets should be removed.

IIROC staff response: IIROC's responsibility is to regulate the business conduct of our Regulated Persons, regardless of the specific investment product to which that business conduct relates in any given case. Moreover, references to "commodities" and "derivatives" appear in existing IIROC rules (see e.g. Dealer Member Rules 19.1, 20.30(1), 20.33, and 20.34).

Additional Revised Consolidated Rule Changes

Applicability – Consolidated Rule 1403

- Incorporating the IIAC's suggestion to include language from UMIR 10.3 (i.e. the phrase "may be found liable") would provide comfort and greater clarity and avoid concerns with the creation of absolute vicarious liability on the part of Regulated Persons for all acts and omissions of their employees. Even the IIROC response states that if "those individuals violate IIROC rules, their employer or principal may, in appropriate circumstances, be liable for the violations." It is recommended that similar language be incorporated in proposed section 1403.

[5] See Original Response Letter at 26.

IIROC staff response: As previously alluded to in our Original Response Letter, proposed section 1403 reflects the reality that Regulated Persons are non-natural persons (i.e. Dealer Members and non-Dealer Member firms that are users of or subscribers to a marketplace regulated by IIROC), which can only act through their employees and other representatives.[6] If the actions or omissions of those individuals result in a violation of an IIROC rule, then the firm that they represent may be liable for the violation. Section 1403 is simply codifying this reality.

Deemed Undertakings – Consolidated Rule 8420(6)

- In the normal course, information produced in a disciplinary proceeding may only be used for the purposes of that particular proceeding. Therefore, if privilege was waived on a document in connection with a particular regulatory investigation or hearing, that document may be produced and used only in that investigation or hearing; it may not be produced during a civil case. Nevertheless, plaintiffs in civil cases often wish to obtain access to documents produced in a regulatory proceeding. However, where the plaintiff has attempted in the past to subpoena regulatory files, access has not been granted to these records. Now, under proposed subsection 8420(6), a hearing panel may permit the use of information that is subject to this rule for purposes other than those of the proceeding in which it was disclosed. This new provision was not highlighted in the Notice, and it would give plaintiffs in civil cases access to evidence and information produced in IIROC proceedings. This provision should be removed or, in the alternative, clarification should be provided on the criteria that might be used by hearing panels to permit the use of information for a purpose other than the proceeding in which the information was disclosed or provided.
- IIROC's Original Response Letter states that generally "a party will not be permitted to use information that is subject to this undertaking for purposes of an action other than the one in which it was required to be provided." If this is the case, under what circumstances would the information be permitted to be disclosed? Furthermore, exactly how is it intended that the information be used?

IIROC staff response: The issue of the impact of proposed subsection 8420(6) was previously addressed in our Original Response Letter. As indicated there, proposed subsection 8420(6) is based on the deemed undertaking rule in Rule 30.1(6) of the Ontario Rules of Civil Procedure. Generally, a party is not permitted to use information that is subject to this

[6] See Original Response Letter at 27.

undertaking for purposes of an action, other than the one in which it was required to be provided. It is expected that hearing panels will follow court precedents on this issue.[7]

The intent of the proposed rule is to ensure the confidential treatment of the documents and other information exchanged in connection with an IIROC disciplinary proceeding. The exception to this rule, as set forth in subsection 8420(6), was intended to deal with the regulatory needs of our Dealer Members.

We believe that a third-party litigant, such as a plaintiff in a civil proceeding against a securities dealer, would have no standing to request a hearing panel to order disclosure of documents protected by section 8420. However, even if such a third-party litigant were found to have standing, the rule would preclude disclosure in almost all cases, consistent with the case law under Rule 30.1(6) of the Ontario Rules of Civil Procedure—and under equivalent procedural rules from other jurisdictions—as well as under the "public interest" exception of subsection 17(1) of the Ontario *Securities Act* (and similar provisions in other jurisdictions). See e.g. *Re X and A Co.*, (2007) 30 OSCB 327, 2007 LNONOSC 7 (January 8) (dismissing application by receiver of respondent company for order under s. 17(1) to permit receiver, as plaintiff in civil proceeding against another party, to use transcripts of examinations conducted under s. 13 of the Ontario *Securities Act*); cf. *Lince-Mancilla v. Garcia*, 115 O.R. (3d) 314, 2013 ONSC 1388, para. 19 (QL) (allowing relief from deemed undertaking, pursuant to Rule 30.1(6), where material at issue was to be used for related action involving same or similar parties, "especially where it is alleged that the deponent may give contradictory testimony about the same matters in successive or different proceedings").

As regards waiver of privilege, it is not clear to IIROC staff that a waiver is always restricted to a given proceeding; the scope of the waiver depends on the circumstances. In any event, privilege, including the waiver of privilege, is a well-settled area of law, and we expect that hearing panels will refer to applicable case law when deciding such matters under subsection 8420(6).

GENERAL COMMENTS

Trading or Advising Activities of Regulated Person in Commodities Contracts or Derivatives

- The Revised Consolidated Rules provide that IIROC may investigate, impose sanctions, and conduct examinations relating to a Regulated Person's trading or advising in respect of securities, commodities contracts or derivatives (for example, proposed sections 8102, 8201, 8209, 8210, 9103 of the Revised Consolidated Rules). In the context of an IIROC Dealer Member and its representatives, the IIAC seeks

[7] Original Response Letter at 39-40.

confirmation that IIROC's jurisdiction is limited to a Regulated Person's registerable activities, in accordance with IIROC rules, that are conducted through the books of the IIROC Dealer Member.

IIROC staff response: As noted above, references to "commodities" and "derivatives" appear in our existing rules,[8] and the use of these words in the Revised Consolidated Rules do not expand IIROC's jurisdiction. As has always been the case, the Revised Consolidated Rules reflect the reality that the business conduct of individuals who are regulated by IIROC—especially business conduct that can be characterized as trading or advising—is subject to our rules, regardless of the specific investment product being traded or for which advice is being given to a client.

Harmonization of Definitions

- The Revised Consolidated Rules contain definitions for a number of terms that are defined in existing National Instruments. For example, we note that (i) the definitions of "securities legislation" and "securities regulatory authority" differ from the definitions of those terms under National Instrument 14-101 National Definitions, and (ii) the definition of "ultimate designated person" ("UDP") contrasts with the responsibilities of UDP which are clearly outlined in NI 31-103. To ensure consistency in the interpretation and application of defined terms, the IIAC suggests the Revised Consolidated Rules should incorporate by reference definitions of terms that already exist in other securities laws, similar to the approach under UMIR 1.2, by referring to the applicable National Instrument for definitions. Similarly, the definitions of the same terms should be harmonized across the Revised Consolidated Rules, UMIR and Dealer Member Rules.

IIROC staff response: We agree with the substance of this comment and have begun the work of harmonizing, to the extent possible, all defined terms under all IIROC rules, including the Revised Consolidated Rules, UMIR, and the Dealer Member Rules, with defined terms that exist under provincial securities legislation and regulation. However, this work will take some time, and we do not wish to further delay implementation of the Revised Consolidated Rules while that work is continued. As a result, the ongoing harmonization work will be completed as a separate rule proposal at a future time.

Legal Privilege

- By introducing the term "legal privilege", the IIAC appreciates that IIROC is recognizing solicitor-client, litigation, and any other form of privilege recognized by

[8] See the response under the heading "Investor Confidence" at pages 6-7, *supra*.

law. While legal privilege is expressly incorporated in clauses 8103(3)(ii) and 9104(3)(ii) of the Revised Consolidated Rules, we strongly suggest that revisions be made throughout the Revised Consolidated Rules to clarify that the provision of any records, documents and other information under the Revised Consolidated Rules is subject to legal privilege.

IIROC staff response: Solicitor-client and similar privileges, which we had attempted to encapsulate with the term "legal privilege", exist at common law, regardless of whether our rules expressly identify them. Our existing rules regarding IIROC staff's power to compel documents and information (e.g. Dealer Member Rules 19 and 20) do not expressly refer to this type of privilege.

We have reviewed various provincial securities acts and determined that some of them refer to "solicitor-client privilege" in the context of the securities regulatory authority's investigation power (see e.g. Ontario *Securities Act*, s 13(2), Alberta *Securities Act*, s. 57(1)), while others do not (see e.g. B.C. *Securities Act*, Part 17; *Manitoba* Securities Act, Part III; Quebec *Securities Act*, Title IX, Chap. 1), although no other forms of privilege were expressly recognized in the legislation reviewed. Moreover, none of the provincial securities acts reviewed expressly refers to privilege in the specific context of enforcement proceedings.

In light of this further analysis and of the public comment above, for purposes of consistency and clarity, we have decided to remove the five references to "legal privilege" that appeared in the previously published version of the Revised Consolidated Rules. We believe the concept of privilege is so basic and well understood that there is no need to refer to it expressly within our rules. Privilege-based protections for certain documents and other information have always implicitly existed for our regulated persons, and we believe that such protections will continue to be recognized under the Revised Consolidated Rules, even without any express reference to these protections in the rules themselves.