

13.1.12 IIROC Response to Comments on Client Relationship Model Rules and Amendments to IIROC Dealer Member Rules 200 and 1300

**IIROC RESPONSE TO COMMENTS ON
CLIENT RELATIONSHIP MODEL RULES AND
AMENDMENTS TO IIROC DEALER MEMBER RULES 200 AND 1300**

April 2, 2009

Re: IIROC response to comments on Client Relationship Model Rules and amendments to IIROC Dealer Member Rules 200 and 1300

We are publishing this letter in response to the comment letters received on the proposed Client Relationship Model (CRM) amendments, which include proposed amendments to IIROC Dealer Member Rules 200 and 1300.

We received 20 comment letters in response to the request for comments. We thank all of the commenters for their helpful submissions.

The comments have been summarized and grouped according to the issues raised. The response by IIROC staff follows each particular issue.

GENERAL

Costs versus benefits of proposed amendments

We received the following comments which relate to potential costs versus benefits of the proposed amendments:

- The proposed changes will lead to unnecessary costs and will have an adverse impact on the market.
- Service levels for clients should be determined by market forces, as opposed to regulation.
- The basic business conduct principles that are already in place adequately address the underlying issues.
- No justification for the proposed changes has been demonstrated.
- A cost/benefit analysis must be conducted before proceeding further on the project.

IIROC staff response

IIROC staff consulted with Dealer Members and approved persons extensively prior to publishing the proposal and received input on the cost issue throughout the rule-making process. Staff is therefore confident that we are aware of, and have properly considered the cost issues noted in the comments. Although it is difficult to quantify potential benefits with any high degree of precision, comments received from investors indicate that the proposals are a step in the right direction in enhancing investor protection.

To minimize potential costs, wherever possible, staff has revised the proposal to provide greater flexibility to Members in complying with the new requirements without compromising the investor protection goals of the CRM project. Further, as described in more detail below, IIROC will be allowing transition periods to give Dealer Members adequate time to develop and implement systems necessary to meet the new requirements.

As noted in the materials supporting the proposed rules, staff of the Canadian Securities Administrators (CSA), the Mutual Fund Dealers Association (MFDA) and IIROC also attempted to develop a more formal cost/benefits analysis. To assist in the performance of this work, an independent research company was hired to make recommendations on the investor survey approaches to be used and to perform the surveys themselves. Subsequent meetings were held with industry participants to discuss and agree upon the approach to be pursued. Dealer Members that attended the meeting were also called upon to provide new client lists for use in the investor survey process. However, as agreement as to approach was not reached with dealers and an insufficient number of client names were received, this formal analysis was not completed.

Need for Further Consultation

Two comments suggested that further consultation be conducted with respect to operational challenges that would have to be addressed in complying with the proposed requirements.

IIROC staff response

As noted in our previous response, IIROC staff has consulted extensively with Dealer Members, approved persons and other industry participants throughout the development of the proposed rules. Industry representatives were directly involved in the drafting of the direction documents that set out the basis for the proposed changes. Joint SRO/industry subcommittees were also consulted in the drafting of the actual proposed rule amendments. Finally, the materials were published for an extended 90 day comment period to ensure that industry and members of the public were provided with an ample time to digest the materials and consider their impact.

The revised proposals will be published for comment for a further 90 days. Commenters are encouraged to provide input on the anticipated operational challenges associated with the proposals and how these might be addressed.

Consistency between IIROC and Other Proposals

Seven comments were received regarding the need for consistency between the IIROC proposal and those of the CSA and MFDA.

IIROC staff response

To address consistency issues, IIROC has continued to meet and work with representatives of the CSA and the MFDA throughout the development of the proposed rules. As a result of these discussions, IIROC staff has made several changes to the previously proposed amendments to further enhance consistency in the approaches.

Differences between the relationship disclosure requirements in the IIROC proposal and those in proposed National Instrument 31-103 exist mainly because the proposed National Instrument reflects previous drafts of the IIROC and MFDA proposals.

In some cases, inconsistencies in the approach taken by IIROC and the MFDA have arisen because of differences in the business models typically employed by registrants under each registration category or because of differences in the way the IIROC and MFDA rulebooks are constructed and applied.

Alignment with Fair Dealing Model Principles

One comment stated that IIROC must ensure that the proposed amendments take a holistic approach to addressing CRM issues that maintains the values adopted under the Fair Dealing Model.

IIROC staff response

IIROC staff has been involved in the CRM rule initiative, including the preceding work on the Fair Dealing Model, since inception. As active participants, we have maintained the objective of creating industry standards that are consistent with the Fair Dealing Model principles. Staff believes that the proposed amendments achieve that goal in a way that is consistent with the best interests of both investors and industry participants.

Transition Periods

We received one comment recommending that adequate transition periods be provided prior to implementation of the proposed changes.

IIROC staff response

IIROC staff will provide sufficient transition periods to allow Dealer Members to develop and implement systems necessary to comply with the new requirements under the proposed rules. To ensure that the proposed timelines are reasonable, staff will be consulting with Dealer Members and other industry participants in developing a transition plan. The plan will also be presented to the Board for approval.

RELATIONSHIP DISCLOSURE

Prescriptive Nature of Disclosure Requirements

We received the following comments which relate to the prescribed requirement to provide relationship disclosure:

- Four commenters suggested that the rule should be more principles based and allow for more flexibility.
- One commenter suggested that the proposal still requires too much customization.

IIROC staff response

The relationship disclosure requirements are designed to address a fundamental objective of the Client Relationship Model project – to provide clients with a better understanding of what to expect from their Dealer Member and advisor when they open a securities account. However, balanced against the desire to state this objective in broad principles-based language is the need to set minimum standards regarding the nature and quality of such disclosure.

Several changes to the previously proposed amendments have been made to address the need for greater flexibility in the proposed Rule. We believe that with these changes, the proposed Rule strikes an appropriate balance, setting out clear standards while still allowing a sufficient degree of flexibility to accommodate differences in Dealer Members' business models.

Use of Standard Industry Document

We received two comments suggesting that IIROC develop standard industry documentation for use by all Dealer Member firms.

IIROC staff response

Staff does not support the introduction of a standard form boilerplate disclosure document that does not provide clients with information particular to their advisor and Dealer Member. While staff recognizes that some aspects of the disclosure may be common to all Dealer Members, we also expect that there will be a great deal of variation between firms with respect to the specific products and services they provide and the processes they have put in place to deliver those products and services. We believe that the identification of these differences is essential information, allowing clients to make informed choices as to the products and service levels that are available. IIROC staff does not believe that this objective can be satisfied by providing a generic disclosure document that lists products and services that the Dealer Member may or may not offer without giving the client a basis upon which to differentiate between firms.

Content Requirements

We received the following comments which relate to the required content for the proposed relationship disclosure information:

- The proposed required disclosure may provide too much information for many clients to digest.
- The rule should explicitly state that boilerplate language must be avoided.
- Socially responsible investing issues should be addressed as a core element in relationship disclosure.
- The requirement to define account types must be flexible enough to allow for more than the three basic business models of order execution only, advisory, or managed account services.
- The proposed rule should be clear that the relationship disclosure must include a description of types of products and services as opposed to specific products and services.
- The description of the products and services available through the Dealer Member should point out that some products may not be suitable for some clients. The requirement to disclose services not available through the Dealer Member should be removed.
- The requirement to describe the process used by the Dealer Member to assess KYC information should be removed.

IIROC staff response

On the basis of the comments received, staff has re-organized the requirements and made other substantive changes to ensure, as much as possible, that IIROC's approach is consistent with the relationship disclosure requirements proposed for other industry sectors. However, all of the elements of disclosure have been retained in the proposed requirements and no substantive additions or deletions from the required content have been made.

Section XX05(2)(c)(iii) of the proposal has been revised to require Dealer Members to disclose whether they provide percentage return reporting to clients and whether investment suitability will be reviewed at any times beyond the triggering events listed in the revised Rule 1300.1(r). In particular, Dealer Members will have to advise clients if their accounts will be reviewed in response to market fluctuations. This is important information for clients in that it facilitates direct comparison of services available from different Dealer Members on these issues.

To address the issue raised in the second comment noted above, the proposed Rule requires that the relationship disclosure be written in plain language. Staff will be reviewing the adequacy of the disclosure as part of our regular review process.

In response to the fourth comment, staff supports the position that the proposed Rule must be flexible enough to allow for Dealer Members to describe products and services beyond the three basic business models. The proposal is not intended to create such a restriction.

As noted above, staff does not expect to establish any additional disclosure requirements at this time. We will, however, provide additional guidance to Dealer Members regarding staff expectations in satisfying the disclosure requirements, to address questions noted above.

Delivery of Documentation

We received the following comments regarding issues with the delivery requirements:

- The requirement to provide the client with a copy of his or her KYC information should be limited to KYC information used to assess investment suitability.
- Documents such as fee schedules should be incorporated by reference into the relationship disclosure.
- The rule should not require that relationship disclosure information be provided to existing clients.
- The rule should contemplate an “access equals delivery” approach to allow Dealer Members to provide information to clients via their websites.

IIROC staff response

In response to the first point noted above, staff agrees that KYC information used to assess investment suitability is critical information to be provided to investors. However, we believe that carving out a subset of information from other KYC information collected for clients may lead to unnecessary additional compliance challenges and could potentially create client confusion. We have therefore not made changes to the proposed requirement.

On the issue of the incorporation of fee schedules by reference, staff agrees that the information contained in other schedules such as these may be appropriately addressed by referring the client to the existing documentation that has been provided. The IIROC proposal has been revised to stipulate that where specific information has already been provided to the client, the relationship disclosure need not duplicate this information. In such cases, we would expect the relationship disclosure to provide a general description of the relevant material and a reference to the other document containing the required information.

IIROC is of the view that the relationship disclosure information must be provided to existing clients, as well as new clients. However, staff recognizes that the requirement to deliver the information to existing clients will pose challenges and will require some time to complete. We will be consulting with Dealer Members on this point in the development of our transition plan.

Staff will also be providing additional guidance on other issues related to the delivery requirement, including electronic delivery. Dealer Members that intend to deliver the document by electronic means should look to the previous guidance provided in IDA Member Regulation Notice MR-0008.

IIROC staff does not support the concept of an “access equals delivery” model for providing relationship disclosure information. We do not believe that making information available to clients on a website is equivalent to delivering the document in paper or electronic form as it is not as effective in bringing the information to the attention of the client.

Requests for Clarification of Rule

We received the following comments requesting clarification of certain aspects of the proposed relationship disclosure requirements:

- The rule should be clear regarding the Dealer Member’s obligations to advise clients of any subsequent revisions to the relationship disclosure information previously provided.
- The rule should be clear regarding the Dealer Member’s obligations where a client fails to acknowledge receipt of information.
- The rule should be clear as to the responsibilities of introducer and carrying brokers in providing the disclosure.

IIROC staff response

Where significant changes to the relationship disclosure information have occurred, staff expects that the Dealer Member will provide timely notice to clients of any changes. This could be accomplished by including details of the updated information with a regular client communication, such as the client statements.

On the second point noted above, section XX07 of the proposed Rule requires Dealer Members to maintain an audit trail to evidence that the relationship disclosure information has been provided to clients. It does not specifically require that this be accomplished through a signed client acknowledgement. Dealer Members may rely on other methods, such as negative confirmation, provided that compliance with the basic requirement can be demonstrated by the Dealer Member.

Issues with respect to the obligations of introducer and carrier dealers will be considered and will be addressed in guidance provided by staff. We welcome further input on any specific points that Dealer Members feel should be addressed.

CONFLICTS RESOLUTION AND DISCLOSURE

Requirement to Avoid Conflicts

One commenter suggested that the requirement to avoid conflicts "where possible" is not practical or desirable.

IIROC staff response

We have amended the proposed rule so that conflicts must be avoided only if they cannot be resolved in the client's best interests.

Requirement to Resolve Conflicts

One commenter requested clarification with respect to the Dealer Member's obligation to resolve conflicts.

IIROC staff response

We have amended the proposed rule to clarify that conflicts must be "addressed" as opposed to "resolved".

Clarification of Disclosure Requirements

We received the following comments requesting clarification of the requirements relating to conflict disclosure:

- The rule should be clear as to what would be expected of Dealer Members in meeting their disclosure obligations.
- Disclosure should only be required if a conflict is not resolved.

IIROC staff response

We have amended the proposed rule so that disclosure is required only when the conflict is not avoided. Where a Dealer Member has opted to address a potential conflict by avoiding the situation entirely, disclosure is not necessary. If, however, the Dealer Member chooses to address the conflict in some other way, disclosure is required.

IIROC staff will issue guidance to Dealer Members as to staff expectations regarding compliance with the proposed new disclosure requirements.

Intended Scope of Proposed Rule

We received the following comments requesting clarification of the intended scope of application for the conflicts requirements:

- The rule should be re-drafted to include a materiality provision, so that inconsequential conflicts are not captured.
- The rule should be clear as to the types of potential conflicts that are intended to be caught by the proposed rule.

IIROC staff response

We have amended the proposed rule to address the issue of materiality. The general rule is that conflicts must be disclosed and addressed where there is a reasonable likelihood that a client would consider the conflict important. This is consistent with the approach adopted under proposed National Instrument 31-103.

As noted above, staff will issue additional guidance to Dealer Members that will expand on the application of the proposed rule.

RETAIL CLIENT SUITABILITY

Factors to be Considered in Assessing Suitability

We received two comments regarding factors that should specifically be referenced by firms when assessing the suitability of investments:

- Suitability triggers should contemplate socially responsible investing issues. The ongoing cost to hold a product should be explicitly included as a factor to be considered in investment suitability.

IIROC staff response

As part of a separate project, IIROC staff is examining the possibility of introducing further changes to the suitability rule and is in the process of drafting guidance to Dealer Members on regulatory expectations for meeting their suitability requirements. We will consider the comments noted above as we continue work on that project.

Limitations on Suitability Obligations

We received three comments with respect to limitations that should apply to the requirement to perform a suitability assessment:

- A Dealer Member cannot “ensure” that positions transferred in are suitable for the client – the Dealer Member can only ensure that a review is conducted and that the client is provided with advice. The obligation to review suitability following a change in client circumstances should be limited to material changes. The obligation to review the suitability of a client’s holdings after a material change should be limited to cases where the client advises the Dealer Member of the change.

IIROC staff response

We agree with the first comment on the issue of ensuring the suitability of positions transferred into the Dealer Member and revised the proposed rule to clarify that the responsibility of the Dealer Member is to use due diligence to ensure that investments are suitable, following the language in the current Rules 1300.1(p) and 1300.1(q).

With respect to the issue of changes to client information, staff does not expect that Dealer Members would perform reviews in situations where the change in client information is not material or the Dealer Member is not made aware of the change in circumstances. This position will be reflected in the guidance note on the proposed amendments.

Timing of Reviews

We received three comments requesting clarification of staff expectations regarding timelines for completion of suitability assessments:

- The suitability review to be performed after a change in advisor occurs should not be required until after the first transaction in the account following the change.
- The requirement to review portfolio suitability after a change in portfolio manager is excessive, as such reviews are required on a quarterly basis in any event.
- The rule should clearly allow the Dealer Member a reasonable amount of time to conduct reviews after a triggering event occurs (because, for example, transfers of positions into the Dealer Member often take time to complete).

IIROC staff response

Staff maintains the position that where a change in the portfolio manager assigned to an account occurs, it is reasonable for a client to expect that his or her account be reviewed by the individual taking over the account.

IIROC will provide guidance regarding expected timelines for completing the suitability reviews in other situations. Staff do not intend to fix a hard and fast rule for the timing of completion of the reviews, as there many different situations that can trigger a

review. As suggested, the general expectation is that the reviews will be completed in a reasonable time, factoring in the circumstances of each case (for example, the number of accounts to be reviewed where a block of clients has been transferred).

ACCOUNT PERFORMANCE REPORTING

General Issues Regarding Performance Reporting

We received two general comments regarding the proposed requirement to provide performance reporting:

- The requirement to provide any form of performance reporting should be optional – it should be left to market forces to drive such requirements rather than regulators.
- Performance reporting will encourage clients to focus their attention on short term gains and losses as opposed to long term strategy.

IIROC staff response

IIROC's position is that it is reasonable to expect that clients be given basic cost information and account activity reporting to allow them to determine whether they have gained or lost money on the investments in the account. Staff notes that many Dealer Members currently provide performance reporting to clients and this should be considered a basic service.

IIROC staff does not believe that the minimum requirements under the proposed rules will lead to undue focus on short term account returns.

Issues Related to Cost Reporting

We received a number of comments regarding the proposed requirement to provide cost reporting:

- "Cost" must be defined.
- The required cost disclosure should be in dollars and cents and in plain language.
- Operational challenges regarding the collection and analysis of cost data must be considered further before any changes are implemented.
- Cost information is difficult to determine where reorganizations or other issuer transactions have taken place.
- Cost information on positions transferred in to the Dealer Member may be unreliable. Dealer Members may have incomplete or inaccurate cost information on positions held in client name.
- Client name positions cannot be reported on statements.
- Cost information is irrelevant to certain accounts. Cost information is relevant only for individual positions and is not relevant at the account level.
- Dealer Members may have limited or no access to reliable information on investments for which compensation has been received through referral arrangements.
- The requirement to explain why certain cost information is not available is onerous and of little value to clients.

IIROC staff response

As with other issues raised in the comments, challenges regarding the recording and presentation of cost information have been pointed out on several occasions by firms and individuals involved in the rule development process.

IIROC staff is of the view that many of the issues noted above are addressed by virtue of the fact that retroactive cost information is not required under the proposed rule. In addition, the rules will be subject to transition periods to allow Dealer Members time to implement policy and systems changes before the rules become effective.

Staff will provide guidance with respect to adjustments to cost information for securities that have been subject to re-organizations.

Issues relating to reporting of client name positions on customer statements will be addressed as a transition issue. We will be working with CIPF in looking at disclosures relating to CIPF covered holdings prior to the introduction of any changes.

On the issue of referral agreements, the Rule is not intended to capture such arrangements. Valid referrals are not subject to the cost reporting requirements.

Staff takes the position that the requirement to disclose why a Dealer Member is unable to report cost on certain securities is important information for investors. For example, if a reliable market value cannot be obtained to determine a cost value for an exempt security transferred into a Dealer Member account, staff believes that the Dealer Member should advise the client that accurate information is not available. It would not be sufficient to simply report "N/A" in the cost report, without further explanation. However, staff expects that situations where reliable cost information could not be obtained would be exceptional cases and does not believe that, in practice, the requirement will impose an undue burden on Dealer Members.

Issues Related to Account Activity Reporting

We received three comments regarding the proposed requirement to provide account activity cost reporting:

- Account activity reporting on client name assets is not possible because the transaction is between the client and the issuer.
- Account activity reporting should not require reporting of income, capital gains realized or unrealized gains or losses on the account.
- Gains or losses on the account should be viewed in the context of the client's objectives and risk tolerance.

IIROC staff response

We disagree with the comment that activity reporting on client name positions held outside the firm is not possible. The proposed requirements apply only to client name positions held outside the firm on which the Dealer Member continues to receive compensation. Specific to these assets, based on our consultations with Dealer Members, it is our understanding that information required to calculate account activity information is available and account activity reporting is possible.

However, as noted above, staff has amended and simplified the proposed rule regarding activity reporting so that Dealer Members will be required only to disclose the cumulative realized and unrealized income and capital gains/losses on the customer's account. As stated above, staff is of the view that it is not unduly onerous or unreasonable to expect that all clients be advised as to total gains or losses on their accounts.

With respect to the last comment, staff agrees that gains and losses on a client's account should be viewed in the context of the client's investment objectives and risk tolerance. The proposed amendments are consistent with this view. In some ways this point relates back to the requirement to describe the Dealer Member's suitability obligation in the relationship disclosure information. Clients should understand how their risk profiles relate to the volatility of investments held in their accounts.

Issues Relating to Percentage Return Reporting

We received five comments regarding the provision of percentage return performance reporting:

- The requirement to report percentage rates of return in accordance with GIPS is too restrictive.
- The rule should be clear that Dealer Members are not required to provide percentage rate of return reporting.
- Personalized rates of return should be provided to all clients.

IIROC staff response

The proposed rule has been amended to allow for percentage rates of return to be calculated by any method acceptable to IIROC. Staff will provide guidance as to the methods that have been approved for use by Dealer Members and approved persons. These will include time-weighted and dollar-weighted methods.

Staff confirms the position that the proposed rules do not mandate percentage return reporting to clients. The intent at this time is to set basic, consistent standards to be followed where Dealer Members or approved persons elect to provide such reporting to clients.

IIROC is supportive of a move to mandate percentage return reporting in future. However, staff anticipates that extensive consultations with Dealer Members will be required before any such change is implemented.