

13.1.2 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**

January 7, 2011

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 9 comment submissions [8 comment letters and the minutes of a CRM roundtable discussion held on August 12, 2009] 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

Consistency between IIROC and other proposals

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

IIROC staff response

IIROC has and continues to consult 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 further enhance consistency in the approaches where applicable. Where inconsistencies in the approach taken have arisen, these are generally because of differences in the business models / account offerings typically employed by registrants under each registration category.

Cost versus benefits of proposed amendments

We received two comments which relate to potential costs versus benefits of the proposed amendments.

IIROC staff response

IIROC staff has consulted with Dealer Members and Approved Persons extensively prior to publishing the proposal and received considerable input on cost issues throughout the rule-making process. We are 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 will accrue important benefits in enhancing investor protection.

Furthermore, to minimize potential costs, wherever possible, staff has revised the proposal to provide greater flexibility to Dealer Members in complying with the new requirements without compromising the investor protection goals of the project.

Transition periods

We received three comments requesting 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, IIROC staff has consulted with Dealer Members and other industry participants in developing the transition plan below. The proposed transition periods for each element of the CRM amendments are included in the latest version of the CRM amendments which has been republished for public comment. The following is a summary of the transition periods that have been proposed:

Relationship disclosure requirements	
New clients	6 months
Existing clients	3 years
Conflicts of interest management / disclosure requirements	
Provisions relating to conflict identification and avoiding and addressing conflicts	Immediate
Provisions relating to conflict disclosure:	
(i) prior to opening an account	Immediate
(ii) inclusion of conflicts disclosure in relationship disclosure information provided to new clients	6 months
(iii) inclusion of conflicts disclosure in relationship disclosure information provided to existing clients	3 years
(iv) prior to entering into a transaction	Immediate
Account suitability requirements	
Trigger event suitability assessment requirements	6 months
Account performance reporting requirements	
Security position cost disclosure	1 year
Account activity disclosure	1 year
Account percentage return disclosure	
(i) Where percentage return information is currently, provided, an IIROC approved calculation method must be used or the information may not be provided to any client	6 months
(ii) Mandatory percentage return reporting for all retail clients	2 years

Need for further consultation

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

IIROC staff 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 CSA approved direction documents, which included industry representation, that set out the basis for the proposed changes. Joint SRO/industry committees were also consulted in the drafting of the actual proposed rule amendments.

Further, the proposed amendments have been published for public comment on two previous occasions and the revised proposals will be re-published for a further 60 days. Commenters are encouraged to provide input on the anticipated operational challenges associated with the proposals and how these might be addressed.

RELATIONSHIP DISCLOSURE

Prescriptive nature of disclosure requirements

We received the following comment which relates to the prescribed requirement to provide relationship disclosure:

- Two commenters suggested that the rule should be more principles-based and allow for more flexibility as opposed to establishing minimum standards mandated in the IIROC Rulebook.

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 also the need to set minimum base-line standards regarding the nature and quality of such disclosure.

To date, several changes to the previously proposed amendments have been made to address the need for greater flexibility and we believe that with these changes, the proposed rules strike an appropriate balance, setting out clear base-line standards while still allowing a sufficient degree of flexibility to accommodate differences in Dealer Members' business models.

Use of standard industry document

We received one comment suggesting that IIROC develop standard industry documentation for use by all Dealer Member firms, or at the very least, the main disclosure document should include a summary in plain language of any documents incorporated by reference.

IIROC staff response

A standard form boilerplate disclosure document does not provide clients with information particular to their advisor and Dealer Member. Despite the similarities between Dealer Members, firms differ in the specific products and services they provide and the processes they have put in place to deliver those products and services. By providing clients with this information, Dealer Members allow clients the opportunity to differentiate between firms, and educate them as to the products and service levels that are available. This objective cannot be satisfied by providing a generic disclosure document that lists products and services that the Dealer Member may or may not offer. Furthermore, although IIROC will not mandate the format of the disclosures, we require, among other things, that the information be written in plain language.

Content requirements

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

- 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 investment suitability and KYC information should be removed.

IIROC staff response

Section XX05(2)(c)(iii) of the proposal would 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.

A description of the approach used by the Dealer Member to assess investment suitability is critical information to investors. IIROC staff feels that although a Dealer Member's approach from client to client may vary, at minimum standard will be used to assess all clients' financial situation, investment objectives, risk tolerance and investment knowledge.

Delivery of documentation

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

- The requirement to issue a statement when making a recommendation is unmanageable and unnecessary.
- 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

Dealer Members are not required to issue a statement each time a recommendation is made; rather Dealer Members are required to assess suitability each time a recommendation is made. Specifically, Section XX05(c)(ii)(B) requires that the relationship disclosure contain language specifying that the Dealer Member will assess the suitability of investments in the client's account each time a recommendation is made.

IIROC believes that the relationship disclosure information must be provided to existing clients on an account level, as well as new clients, despite the challenges this will pose. Furthermore, where a client has more than one account, combined relationship disclosure information may be provided as long as this is deemed appropriate by the Dealer Member in light of the relevant circumstances. The transition plan outlined above takes into consideration the additional time required to provide existing clients with relationship disclosure information.

With regards to the third point, IIROC staff does not support the concept of an "access equals delivery" model for providing relationship disclosure information because of the relevancy and importance of this document to clients. Making information available to clients on a website is not the 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 use of the term 'client' and 'customer' is used interchangeably. A consistent term should be used throughout the Rulebook.
- The rule should be clear as to the responsibilities of introducer and carrying brokers in providing the disclosure.
- The rule should be clear regarding the level of disclosure regarding costs.
- The rule should be clear regarding the description of the products and services offered by the Dealer Member. In particular, where some advisers only offer fee-based products and not commission-based products, would the Dealer Member be required to develop different relationship disclosure documents for these advisers?
- Significant market fluctuations by themselves should have no immediate impact on account suitability where there has been no change in a client's KYC or in the risk profile of the investment, as defined in a fund's prospectus.
- Pursuant to XX06, a standardized relationship disclosure document must be approved by head office and the supervisor who approves new accounts must ensure that the correct document is used in each client circumstance. The rule should be clear regarding what is meant by 'head office'.

IIROC staff response

When there is a significant change to the relationship disclosure information, Dealer Members will be required to provide timely notice to clients of these changes. This could be accomplished by including details of the updated information with a regular client communication, such as the client statements.

The proposed rules, as revised, require Dealer Members to maintain an audit trail to evidence that the relationship disclosure information has been provided to clients. It also requires that the Dealer Member obtain a client acknowledgement that they have been provided with a copy of the "know your client" information form and the account relationship disclosure materials. The proposed rules do not specifically require that acknowledgement by obtaining a client's signature. Dealer Members may rely on other methods, such as negative confirmation, provided that compliance with the basic acknowledgement requirement can be demonstrated by the Dealer Member.

With regards to the fourth point, the introducing broker is responsible for providing the relationship disclosure documents to clients, and supervising the suitability of all trading activity.

The use of the term 'client' is now consistent throughout the proposed rules.

A description of all fees and charges incurred associated with operating the account and in making or holding investments in the account must be provided as part of the disclosure requirements. This may be done through a fee schedule which lists all the fees borne by the client. A detailed description of the specific products and services provided and the processes Dealer Members put in place to deliver those products and services is also required. A customized relationship disclosure document must be provided according to account service offering.

IIROC staff does not mandate or suggest that a suitability review should be conducted each time that the market goes up or down. We agree that a subset of products will not be impacted during market fluctuations; however, there are relatively few investments where risk profiles don't change under these circumstances. IIROC believes that considering whether a suitability review should be conducted at the time of significant market changes, and conducting a review if determined to be appropriate, could contribute to the proper maintenance of a suitable client portfolio.

XX06 has been amended and no longer requires a standardized relationship disclosure document to be approved by head office.

CONFLICTS RESOLUTION AND DISCLOSURE

Clarification of Disclosure Requirements

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

- Further guidance should be provided on how to determine 'potential conflict'.
- It is unclear how the issue of materiality has been addressed as per IIROC's previous response to comments.
- The rule should include a materiality provision which specifies that the responsibility to identify conflicts of interest only applies to material conflict.
- The Guidance Note should address how 'future conflicts of interest situations, where not resolved, will be disclosed to the client as they arise'.

IIROC staff response

Circumstances in which the interests of different parties are inconsistent or divergent, may give rise to potential conflict. This will depend on the fact of each case. The firm must establish internal systems, policies and procedures to evaluate the balance between the interests to ensure that it is managed in the best interest of the client.

The proposed rule has been amended to address the issue of materiality. Although the question of whether a conflict is material depends on the facts, the general rule is that all material conflicts must be identified, and only those where there is a reasonable likelihood that a client would consider the conflict important must be addressed and disclosed. This is consistent with the approach adopted under proposed National Instrument 31-103.

Reasonable steps must be taken by Dealer Members to identify all material conflicts, including those that in the Dealer Member's reasonable opinion may potentially arise between the client and the firm, including individuals acting on behalf of the firm. However, only those conflicts which are material must be avoided, or addressed and disclosed. This is consistent with the approach adopted under National Instrument 31-103.

Dealer Members must address situations which can directly and significantly affect a client's best interest. As discussed in the Guidance Note, the rule is not intended to require Dealer Members to identify and eliminate every conceivable conflict; instead, it is IIROC's expectation that Dealer Members will disclose both conflicts of interest known at the time of opening a securities account, or those that arise as they advise clients.

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 clear as to who is subject to conflict resolution and disclosure requirement. The rule should not apply to certain Approved Persons within the firm (i.e. institutional traders, investment bankers, as well those on the retail side of the firm including investment advisors) since they are not be in a position to know if certain potential conflicts within the firm exist between the Dealer Member and its immediate clients.

IIROC staff response

The proposed rule specifies only where applicable, are Approved persons required to use reasonable efforts to identify and address existing and potential personal conflict, to the extent they have knowledge of the conflict. This will depend on the specific facts of each case.

RETAIL CLIENT SUITABILITY

Request for Clarification

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

- Further guidance is required in determining a 'material change'
- The suitability review to be performed in circumstances where a block of clients have been transferred, should allow for the orderly continuance of automated transactions during this period.

- The proposed changes to the suitability rule are unrelated to relationship disclosure and unnecessarily complicate discussions regarding relationship disclosure.

IIROC staff response

The question of whether a change is material depends on the facts. For example a \$10,000 increase in annual income may be significant for one client but not for another client. A 'significant market fluctuation' is any change in the market that may materially affect the financial situation and any investments in the client's account.

The orderly continuance of automated transactions where a block of clients have been transferred will continue during the suitability review period. This has been addressed in the revised Guidance Note.

A suitability review ensures that your portfolio is in alignment with your investment objectives and risk tolerance. Although IIROC agrees that the changes to the suitability rule are unrelated to relationship disclosure, we do not feel that this alone justifies not proceeding with the proposed rule amendments.

Limitations on Suitability Obligations

We received 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; it will require operational systems to track and monitor advice provided further to each suitability review. A 'recommendation' or 'review the positions held and advise a client whether' is the most an advisor can provide.
- Relationship disclosure should be extended to account openings involving accredited investors and transactions involving exempt securities.

IIROC staff response

We agree that a Dealer Member cannot 'ensure' that positions transferred in are suitable for the client, and accordingly revised the proposed rule to clarify that the responsibility of the Dealer Member is to use due diligence to ensure that a review is conducted, advice is provided and the investments are suitable.

Suitability applies to all account openings, including those involving accredited investors and transactions involving exempt securities.

Timing of Reviews

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

- A reassignment of an account should not trigger a suitability review, since it was assessed at the last suitability trigger point and the KYC information has not changed.
- Further guidance is required in determining what constitutes a reasonable amount of time to conduct reviews where there has been a transfer in a block of accounts to a new advisor.
- It is an unrealistic and unworkable standard to ensure the suitability of an order is acceptable based on 'any investments in the client's account'. This is suggesting that a portfolio review be conducted for every trade; instead, a suitability review for the entire account should be implemented as a best practice.

IIROC staff response

IIROC staff maintains the position that where a change in the adviser 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. It is inappropriate to rely on previous KYC information that was collected by another Approved Person. A comprehensive, documented suitability review is necessary to adequately understand the client's financial situation, investment knowledge and objectives, risk tolerance and any existing investments in the client's account.

A reasonable time standard is an amount of time which is fairly necessary to conduct a suitability review in such circumstances, while ensuring the obligation to expediently service clients is met. The unreasonableness of time taken to conduct a suitability review will depend on the nature, purpose and circumstances of each case.

IIROC does not believe that it is unrealistic to ensure the suitability of an order is acceptable based on investments in the client's account. In order to ensure the order is aligned with the client's risk tolerance and investment objectives, a portfolio review must be conducted for every trade.

ACCOUNT PERFORMANCE REPORTING

General Issues Regarding Performance Reporting

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

- The requirement to provide performance reporting should be a principles-based approach which allows for flexibility around account performance reporting where the methods have been fully disclosed in the relationship disclosure document
- Firms should be allowed to choose their own methodology and provide the appropriate disclosure to clients that best suits their technology and business model.

IIROC staff response

IIROC's position is that it is reasonable to expect that clients be given basic position cost information and account activity and percentage return reporting to allow them to determine whether their account performance is satisfactory. Setting minimum standards regarding security position cost disclosure, account activity disclosure and account percentage return disclosure will provide the client with meaningful account performance feedback. This type of transparency allows investors to assess and monitor their investment strategy.

Issues Related to Cost Reporting

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

- "Original Cost" must be defined. In the alternative, Dealer Members should have flexibility in the definition of security position costs as long as it is fully disclosed in the relationship disclosure document.
- Provide a definition of the cumulative realized and unrealized income and capital gains/losses on the client's account annually.
- In the event a particular long security position is not readily marketable or the point in time market value for a security cannot be readily determined, there should be no requirement to report the reason why it is unavailable. This would present enormous system challenges of little or not additional value to the client.
- The operational and cost challenges regarding the collection and analysis of cost data must be considered further before any changes are implemented.
- Amendments to Rule 200.1 should be made to reflect the exemption of referrals from cost reporting requirements.

IIROC staff response

We have mandated in the proposed amendments that original cost, as well as the cumulative realized and unrealized capital gains/losses on the client's account, be reported at least annually. These reporting methods have been addressed in the revised Guidance Note.

The proposed rules would require an explanation when current market value information is reported as not determinable. Since providing market value information for each client position held is an importing existing account reporting requirement, we don't see why the Dealer Member shouldn't provide an explanation as to why, when the information is unavailable.

IIROC staff is of the view that despite the operational and cost challenges, it is not unduly onerous or unreasonable to expect that all clients be advised as to original cost of all client account positions, including information addressing why original cost information cannot be disclosed for certain securities.

Valid referrals are not subject to the cost reporting requirements since they are not costs incurred by the client. Therefore, we do not believe it is necessary to carve out referral fees from cost reporting requirements.

Issues Relating to Percentage Return Reporting

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

- Consistent methods and requirements should be mandated by IIROC which take into consideration the necessity to mitigate potential liability issues and provide clear and fair standards for all.
- Confirm whether or not the proposed rules relating to performance reporting by a Dealer Member applies to the accounts of institutional clients.
- Calculating and reporting client portfolio returns should be provided annually, if not more frequently. As well, the inclusion of returns of the relevant benchmarks should be mandated.

IIROC staff response

IIROC's 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.

The proposed rules relating applies to institutional Dealer Members if they have elected to supply account percentage return information to clients.

There is a minimum annual requirement to calculate and report client portfolio returns; however, Dealer Member may choose to provide more frequent reporting. It is recommended that an appropriate benchmark be provided; however, in situations where there is no appropriate benchmark, no benchmark information need be disclosed. For instance, complex portfolios, where no relevant reference benchmark is available and simple portfolios involving relatively few securities, where the use of a benchmark may provide no meaningful information.