INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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September 30, 2010

Dear Sirs/Mesdames:

Re: Proposed Amendments to National Instrument 31-103, National Instrument 33-109 and OSC Rule 33-506 (the "Amendments")

The Investment Industry Association of Canada appreciates the ability to comment on the above noted Amendments.

As the CSA Notice states, many of the Amendments are technical adjustments and codification of previously issued orders and guidance; however, a number of the Amendments introduce new requirements or raise questions for which clarification is required.

Our questions and comments are as follows:

Proficiency Requirements

In general, the IIAC supports proficiency requirements that establish a level playing field between parties subject to CSA requirements and those regulated by IIROC or other industry SROs.

Supervisor Category

It has become increasingly difficult to ascertain what the CSA and IIROC expect in respect of proficiency standards for individuals in different positions that fall under the broad category of "Supervisor". We recommend that the regulators work with the industry to establish guidelines that would be applied consistently as between regulators. This would help ensure members understand the regulatory expectations, and develop standards that are acceptable across regulatory jurisdictions.

Section 3.3 Time limits on examination requirements

We support the proposed changes. It is appropriate and practical to recognize that existing proficiencies of individuals are not negated merely by the passage of time when an individual is not registered.

Section 3.4 Proficiency – initial and on-going

The proposed requirement that a registered individual understand the structure, features and risks of each security that they recommend to clients is more appropriately characterized as a suitability requirement and should be included in that section of the regulation. Proficiency requirements can be objectively assessed using criteria such as course completion or time spent in the industry. Product knowledge is similar to suitability assessments and know-your-client evaluations in that it is more nuanced and involves judgment.

Given that product knowledge does not lend itself to such a fact-based and objective evaluation, categorizing it as a proficiency requirement will likely lead to problems in evaluating compliance and enforcing the requirement.

In addition to the categorization issues, the proposed requirement is currently drafted so broadly that it would apply to registered individuals who do not recommend securities. The scope of the requirement should be narrowed to target the appropriate registrants.

Section 4.1 Restrictions on acting for another registered firm

We are concerned with the new prohibition on a dealing, advising or associate advising representative being registered with two affiliated firms. In circumstances where a firm's operational structure necessitates multiple legal entities, it is often appropriate and necessary for firms to have individuals registered with different firms. Separate legal entities may be established for business, tax or regulatory purposes. For example, legal entities may be registered in different provinces, or discount brokerages and full service firms may operate with overlapping staff.

We are unaware of any problem that has resulted from this type of dual registration. We question the need to have firms specifically seek exemptive relief in order to continue to structure their businesses and assign responsibilities as between a firm and its affiliates. Our concerns are especially acute if the prohibition is intended to apply to a firm registered as a Canadian firm, and a related firm located in jurisdiction outside of Canada. The expansion of the prohibition to these types of cross-border arrangements would have significant unintended negative operational consequences.

Section 8.18 -International Dealer

In respect of the new content to be included in client notices, the Amendments should clarify that firms are not required to send amended notices to existing clients who have already received notice under the current requirements. Requiring retroactive application of the notice requirements would result in a significant administrative burden.

Compliance System

Section 11.1 of the Companion Policy states that "*While policies and procedures are essential, they do not make an acceptable compliance system on their own. An effective compliance system also includes internal controls, day-to day and systemic monitoring and supervision elements.*

It is unclear in the context of the above wording whether systemic monitoring responsibilities can be fulfilled through firm procedures, or whether an off-the-shelf product is required.

Conflicts of Interest

We are concerned that the proposal to delete the word "registered" before the word "adviser" in section 13.5 of NI 31-103, which would result in IIROC registered dealers that conduct advising activities being held to the same standards and restrictions on managed account transactions as registered advisors, would have significant unintended negative consequences. Further, we believe that it is unnecessary to expand the scope of the application of section 13.5 of NI 31-103, given that IIROC has an effective regulatory regime for managed and discretionary accounts which addresses conflicts of interest.

IIROC Rule 1300.19 has similar prohibitions, except that the IIROC rule allows the dealer to make the types of trade referred to in 13.5(2)(b) of NI 31-103, (purchases or sales from or to the investment portfolio to a responsible person, an associate of a responsible person or an investment fund for which the responsible person acts as an advisor) provided that the client consents. To give an example of an impact that this proposed change will have, it is worth looking at fixed income trades in accounts that are managed with discretion by an IIROC dealer.

The definition of a "responsible person" in section 13.5(1) of NI 31-103 presumably will include the dealer itself (although this is not clear from the definition section of 13.5 since a dealer is not an "adviser"). Most fixed income securities that are sold to retail clients in Canada come from the inventory account of their dealer. If the dealer's proprietary inventory account is considered to be an "investment portfolio" for the purposes of section 13.5(2)(b) of NI 31-103, then the amended section 13.5 of NI 31-103 will prohibit a dealer from selling fixed income securities from its inventory account to its discretionary managed account clients. The dealer would be limited to exchange-traded fixed income securities only, which is a relatively small portion of the universe of fixed income products, narrowing the options available to clients.

Section 13.16 - Dispute Resolution Service

We seek confirmation that the enumeration of specific types of client complaints that has been added to this section do not change IIROC members' current dispute resolution procedures, processes for regulatory breaches, or their relationship with OBSI. We also seek confirmation that this section is not intended to expand the mandate of OBSI beyond what is currently described in its Terms of Reference.

We are concerned that the wording of the provision may be seen to apply to regulatory matters, which are appropriately handled by IIROC. It should be made clear that regulatory issues are not cast as client disputes, thus creating a possible dual track for complaint resolution. The processes for dispute resolution under IIROC regulation (including OBSI) address regulatory issues and pecuniary loss. The creation of additional mechanisms under the Amendments would create overlap and confusion without affording further benefits to clients.

Account Activity Reporting

While it is accepted that Canada's adoption of International Financial Reporting Standards (IFRS) necessitates departures from current industry practice, members are of the view that the CSA proposals raise numerous investor protection concerns and will be impractical for industry to administer.

Fair value in account statements

The CSA is proposing to adopt the prescribed IFRS valuation approaches and the IFRS term "fair value" for valuing securities in account statements. The Amendments to Section 14.14 of the Companion Policy to NI 31-103 states that only where a registered dealer or advisor concludes "it is not able to determine a reliable fair value after using all reasonable efforts to apply IFRS valuation techniques", may the dealer or advisor then report in the account statement that the fair value of the security is "not determinable". The implication is that the assignment of a zero-value to a security should not be a kind of default option for hard-to-value securities. In essence, the CSA proposal would require dealers to exhaust all IFRS valuation techniques each time a valuation takes place, before dealers can reasonably conclude that a value could not be determined, and no value assigned to the security.

The IIAC has serious concerns that the CSA has underestimated the magnitude of the undertaking required by the dealer community to comply with this proposal. We are working with members to get a better measure of the number of member inventory and client account holdings for which a reliable price is currently unavailable and to which a "zero-value" has been assigned. Based on preliminary discussions, we expect this estimate to be material. For example, there are over 15,000 securities that have been cease-traded that are currently being zero-valued by dealers. It would be a fruitless exercise for dealers to attempt to document multiple valuation processes for these securities. The Amendments also imply that only in "limited circumstances" will the dealer not be able to assign a "fair value" using IFRS valuation techniques, and have to report zero-value on the client statement. While the CSA does not provide clarity as to what these "limited circumstances" are, our members are of the view that there will likely be numerous instances in which any of the various IFRS valuation techniques will fail to reasonably place a value on a client security position.

The Amendments are also silent on the use of third-party pricing providers when an observable market price is unavailable. These third-parties have developed a specialized expertise in this area, and are entrenched in the day-to-day operations of our members. We recommend that the CSA clarify that our members' continued reliance on these service providers as a source for valuing securities remain an acceptable practice under the Amendments.

There are also serious investor protection issues that arise with the Amendments. We make reference to IIROC Notice 10-0230 (*Amendments to Form 1 to adopt IFRS for regulatory reporting purposes*), issued on August 27, 2010, which states that "IIROC staff believes that the use of multiple IFRS valuation approaches of varying degrees of reliability raises investor protection concerns given that the use of multiple approaches may lead to investor confusion as to the realizable value of their holdings". We agree with this statement. The CSA proposes that dealers provide additional disclosure concerning the valuation methodology used in valuing the security, including an explanation that fair value is not market value and is not necessarily representative of the amount that the client will receive should they sell the security. Despite the additional disclosure, our members have concerns that investors may develop a "false sense of value" in the securities they hold, and will lead to serious issues when these clients try to execute at the prices communicated on their statements, only to later find out that such a market does not exist.

The Amendments to the Companion Policy state that a security shown in an account statement and also held in a dealer's inventory position is expected to be assigned the same value. Our members have indicated that this may be impractical in some circumstances. For example, it is generally understood and accepted that the functioning of over-the-counter (OTC) fixed income market necessitates different pricing considerations for inventory positions as compared to retail client positions. Those considerations were well articulated in IIROC Notice 10-0163 (*Proposed OTC Fair Pricing Rule and Confirmation Disclosure Requirements*). We recommend that the CSA allow dealers to exercise judgment when valuing identical securities held in inventory and client accounts.

The CSA is also proposing that where a dealer or adviser provides account statements more frequently than quarterly, for securities whose fair value cannot be determined by reference to an active market, it may choose to assign the same value to the security as in a previous statement that was delivered to the client no more than 3 months earlier. While this appears to imply that dealers would only have to undergo the exhaustive IFRS valuation exercise on a quarterly basis, the CSA fails to recognize that for investment dealers, monthly financial adequacy reporting is required and is expected by the client. Client experience dictates that firms cannot have statement pricing methodology change from month to month on statements, regardless of the disclosures. Furthermore, since dealer inventory and client account positions must be assigned identical values, a large number of client account positions would need to be valued using the IFRS "fair value" approach monthly.

Where an active market or reliable sources for pricing do not exist, dealers and advisor should be able to assign a zero-value to securities where it is reasonable and appropriate, and not after exhausting all possible (and possibly less reliable) valuation methods. To this end, we recommend that the CSA consider the proposed "fifth

valuation approach" referred to in IIROC Notice 10-0230, that would permit a dealer "to assign no value to an investment product position where value cannot be reliably measured (including where cost does not represent the best estimate of value…and would represent a departure from IFRS"). We recommend that the CSA work with IIROC to ensure that both securities regulatory and IIROC reporting requirements are consistent.

The CSA's proposed changes will have countless downstream impacts on our members' operations, including performance reporting, fee calculation and any realized gain / loss reporting. They will require significant systems and operational changes, including enhancements that will need to be completed with the assistance of third-party service providers. Clients and front office sales staff will also need to be educated on the initiative. We therefore recommend that an appropriate length of time is provided for implementation of these new reporting requirements. Our members estimate that, at a minimum, an implementation period of three years from the publishing of the final rules and guidance be provided.

Pricing of Mutual Funds

Members also request additional clarity from the CSA with respect to the pricing of mutual fund units held in client accounts. Currently, under National Instrument 81-106, the net asset value (NAV) of a mutual fund is calculated based on fair value as defined in NI 81-106, and not fair value in accordance with IFRS. With the implementation of IFRS fair value reporting under NI 31-103 there now exists two methods of determining fair value for securities in Canada – one for mutual funds, and one for all other securities. The requirement to value securities using two different methodologies causes the industry some concern. Notwithstanding the fundamental issue with having two different methodologies, the industry has some practical issues which require additional clarity.

As the vast majority of open-end mutual funds do not trade on an exchange and hence can be considered not to have a market observable price, industry practice is for these positions to be reported on client statements based on closing NAV calculated by the fund. It is the industry's expectation that dealers will be entitled to rely on the NAV calculated in accordance with NI 81-106 in order to satisfy their obligations to report all client assets using IFRS fair value, and will not be required to recalculate NAV using IFRS fair value. The industry would also appreciate further guidance to be issued to make it clear that where investment fund managers are calculating NAV for the funds they manage they are not subject to NI 31-103 part 1.4, as this would obviously result in a conflict between two National Instruments.

Reporting on each security position in the account

Our members also expressed serious concerns with the Amendment to include client name securities on client statements. We agree with the statement made in the Notice and Request for Comments that "including client name securities in account statements would place a burden on registered firms to collect and send information about securities that they do not hold or control". If required, this would be a very onerous burden for dealers, and maintaining accurate reporting may be practically impossible. It would be extremely difficult for dealers to update information, as they would be relying solely on the information provided by investors and issuers. Unless properly notified by the

investor or issuer, dealers may face the danger of reporting client name securities that the investor may no longer hold. Again, this Amendment raises the concern about whether this attempt to provide more fulsome information actually provides the investor with more unreliable information. Including client name securities would also require substantial planning and development work on the part of the dealers and their respective service bureaus to ensure that client name securities are properly recorded and identified on client statements and accompanied by the appropriate disclosure.

There are also several investor protection considerations. For example, the inclusion of client name securities on client statements may lead to investor confusion about which securities are covered by CIPF insurance.

We do, however, recognize that there are merits to including client name positions on client statements, and that some of our members may currently provide or are interested in providing this type of reporting to their clients. As such, we recommend that the CSA not require the reporting of client name securities on account statements, but consider issuing further guidance creating a regulatory environment to make certain that those dealers who would like to provide this type of reporting do so in a responsible manner.

Specific Responses to Questions Regarding Section 14.14 of NI 31-103

1. *Investors may not be aware that securities are held in different ways or understand the implications for account reporting of holding securities in one way or another. To what extent would investors benefit from including client name securities on their account statements? For example, would including client name securities ensure that account statements provide investors with a more complete picture of their portfolio?*

The majority of a registered firm's off-book assets consist of assets held at fund manager companies. In most instances, it is the client's decision to hold securities with the fund manager/issuer as opposed to with the registered firm for various reasons including tax reporting, creditor protection, etc. In this regard, since clients have made the choice to hold their assets with the issuer, clients may not actually want to have their off-book assets recorded on the registered firm's client account statement. Further, the client may find it confusing to have such information included on the registered firm's client account statement, as they will already be receiving a statement from the issuer. That being said, we believe that clients should be able to choose whether they wish to receive information regarding off-book assets from the registered firm and that registered firms should have the flexibility to provide this information to a client in the form of a supplementary statement on a client account statement or any other format deemed appropriate by the dealer.

2. *If client name securities were required in account statements we would require registered firms to use IFRS to determine the fair value of client name securities. Some securities held in client name are illiquid and do not have a value that can be determined by reference to an active market. Would including the fair value of illiquid securities on account statements be useful to investors*?

We do not believe that including the fair value of illiquid securities on account statements would be useful to investors. It could be difficult for registered firms to determine the fair

value of the securities, since the registered firm may not be aware of the approach used to assess the value. See section above Fair value in account statements.

3. *We understand that many registered firms that currently include client name securities in their account statements have arrangements with the issuer to regularly update them on the securities owned by a client. In what circumstances does this practice work? In what circumstances might this practice be impractical or unduly burdensome? How common are those circumstances?*

In respect of funds, while fund managers provide some information to registered firms regarding client's off-book assets in the form of a Month End Reconciliation File (AM-file), fund managers would have to provide additional information to registered firms in order for registered firms to be able to provide the requisite information on client account statements (for example, the value of the security). In addition, only fund managers who offer funds through FundSERV provide registered firms with the AM-file. Fund managers who do not offer their funds through FundSERV do not provide this information.

4. *Other than entering into an arrangement with the issuer, how else could registered firms collect information on what client name securities a client owns? How would these alternatives work and what costs would be involved?*

In respect of funds, while a registered firm could obtain information from the AM-file, as mentioned above, the AM-file does not contain all the necessary information that is required on a client account statement and not all fund managers provide registered firms with the AM-file. The only other alternative would be for registered firms and issuers to enter into an agreement whereby the issuer agrees to provide registered firms with the securities owned by a client. This type of arrangement would not only be onerous for registered firms and issuers, but we believe that it is also unnecessary as registered firms are able to provide clients with the information they need in the form of a supplemental statement as mentioned above.

5. *What changes would registered firms need to make to their account statement procedures to include client name securities? How difficult or costly would these be?*

In order to include client name securities on account statements, we believe that registered firms would be required to invest significant time and costs to implement the changes. It is difficult to provide an actual cost estimate since it would depend on whether the CSA would expect registered firms to include information regarding the holdings or transaction based activity of the client name securities on account statements. In either instance, we believe that registered firms would need more time to implement this change since it would require registered firms to: (1) build complex systems to be able to capture information relating to off-book assets on client account statements; (2) find a source to obtain data on the off-book assets held by the client; and (3) identify all accounts which hold off-book assets.

6. *Under section 14.14, registered firms are only required to provide account statements to "clients". When do you consider a client relationship to start and*

end? What factors should be considered in determining whether a client relationship has ended?

It is our view that a client's relationship with a registered firm generally begins when the client signs an account agreement and opens an account with the registered firm. Similarly, when the client closes their account with the registered firm (or the account is inactive for a certain period of time and the registered firm is unable to contact the client in accordance with unclaimed property legislation), the client's relationship with the registered firm ends.

7. *If client name securities were required in account statements, are there any circumstances where a registered firm should be exempt from the requirement to provide reporting on client name securities? For example, should certain types of clients, investment products or transactions be exempt? Why? (We would expect to exempt client name securities held in certificate form by the client, in Delivery against Payment (DAP) accounts and in Receipt against Payment (RAP) accounts*.).

We agree with the CSA's proposal to exempt client name securities held in certificate form and in DAP and RAP accounts.

8. *If client name securities were required in account statements, should there be a transition period to give registered firms time to change their account statement procedures? How long should the transition period be?*

We believe that the transition period should be a minimum of three years. This timeline is based on the assumption that the CSA would not require that registered firms record transaction based activity for client name securities on account statements. It is our view that the CSA should consider a phased-in approach if reporting client name securities becomes a requirement for registered firms.

Conclusion

Thank you for considering our comments. We would be pleased to discuss any questions or comments you may have.

Yours sincerely,

Susan Copland
Director, IIAC