FAIR | Canadian Foundation *for* Advancement *of* Investor Rights

July 11, 2011

Sherry Tabesh-Ndreka, Senior Policy Counsel
Investment Industry Regulatory Organization of Canada
121 King Street West, Suite 1600
Toronto, ON M5H 3T9

Delivered via e-mail to: stabesh@iiroc.ca

Dear Ms. Tabesh-Ndreka:

Re: IIROC Rules Notice 11-0150 - Request for comments on draft Guidance Note "Disclosure and approval of outside business activities"

FAIR Canada is pleased to offer a submission to the Investment Industry Regulatory Organization of Canada ("IIROC") in response to its notice and request for comments in respect of the draft Guidance Note "Disclosure and approval of outside business activities" ("Guidance Note").

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

The Guidance Note sets out a non-exhaustive list of considerations that Dealer Members should take into account when determining whether to approve an outside business activity of a Rep and provides additional requirements beyond those set out in National Instrument 31-103 and Companion Policy CP31-103.

FAIR Canada sets out five recommendations below to ensure that the objectives of the Guidance Note – reduce conflicts of interest and client confusion – are achieved in order that investors are better protected.

FAIR Canada Comments and Recommendations – Executive Summary:

1. FAIR Canada recommends that the definition of "securities related activities" in IIROC Dealer Member Rule 1.1 and the requirements under Dealer Member Rule 18.14 be amended to ensure that all securities and investment product related activity, including marketing, selling and advising, is required to be conducted through a Dealer Member.

2. FAIR Canada recommends an obligation for Dealer Members to ensure that the distinction between their business and any approved outside business activity is properly disclosed to clients and the public.
3. FAIR Canada urges IIROC to make Dealer Members liable for harm caused by the outside business activities (both approved and unapproved) of their Reps unless it has been made expressly and explicitly clear to the affected individual that the outside business activity is not part of the Dealer Member's business and that the Dealer Member will not be responsible for those activities.
4. FAIR Canada recommends that IIROC and CSA members undertake to determine whether IIROC Dealer Members should be required to obtain insurance to compensate investors for harm caused by their representatives' outside business activities.
5. FAIR Canada proposes a duty for all registrants to report breaches or suspected breaches of securities regulation.

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1. Securities Related Business

1.1. IIROC Dealer Member Rule 1.1 defines "securities related activities" as "acting as a securities dealer and carrying on any business which is incidental to or a necessary part of such activities provided that the Board may, from time to time, include in, or exclude from this definition any activities and change those included or excluded".

1.2. FAIR Canada suggests that this definition be amended to explicitly include "any business or activity… which constitutes trading or advising in any investment product…", similar to the Mutual Fund Dealers Association of Canada's ("MFDA") definition of "securities related business" in Section 1 of MFDA By-law No. 1 and consistent with IIROC's view "…that trading or advising in any investment product is a securities related activity…"[1] Additionally, FAIR Canada suggests that the definition should be drafted as broadly as possible to ensure it covers any investment product related activities offered by an employee or agent of an IIROC Dealer Member.

1.3. IIROC Dealer Member Rule 18.15 addresses remuneration for securities related activities conducted on behalf of the Dealer Member.

> No Registered Representative or Investment Representative may accept or permit any associate to accept, directly or indirectly, any remuneration, gratuity, benefit or any other consideration from any person other than the Dealer Member or its affiliates or related companies, for the securities related activities he or she conducts on behalf of the Dealer Member or its affiliates or its related companies.

This Rule does not address securities related activities conducted outside of the Dealer Member.

[1] IIROC Notice 09-0119 – Rules Notice – Requests for Comments – Dealer Member Rules – Revisions to the definition of "securities related activities".

1.4. The final amendments to IIROC Dealer Member Rule 18.14 ("Rule 18.14") provide the conditions under which a Registered Representative or Investment Representative (collectively "Reps") may have a business activity outside of the Dealer Member. Rule 18.14 permits outside business activity, provided, among other things, that it is approved by the Dealer Member and would not bring the securities industry into disrepute.

1.5. FAIR Canada recommends that Rule 18.14 be amended to require, similar to MFDA Rule 1.1.1, that all securities related business (as provided in the definition proposed in this submission) by Reps be conducted through the Dealer Member and that all revenues, fees or consideration in any form relating to any securities related business engaged in by the Rep is recorded on the books of the Dealer Member. Reps should not be permitted to engage in the marketing or sale of any security or provide any advice relating to any investment products or securities through any entity other than the Dealer Member. As stated in IIROC Notice 09-0119, "[i]t is important that all securities related activities be recorded on the books of the Dealer in order that IIROC can effectively regulate those activities."[2]

1.6. Attention was drawn to existing gaps in compensation coverage for Canadian investors in FAIR Canada's report on financial scandals[3] and in a report issued by the MFDA entitled Regulatory Gap in Canada[4]. It is essential to investor protection that all investors are afforded protection by a compensation fund. FAIR Canada recommends that all securities related business be conducted through the Dealer Member to ensure that such activities are directly supervised by a Dealer Member, regulated by IIROC, and covered by a compensation fund.

1.7. Investors have suffered losses at the behest of unsupervised outside business activities and there exists the potential for further damaging investor losses as a result of unsupervised outside business activity. FAIR Canada believes that not permitting securities related business to be conducted outside of a Dealer Member would serve to protect the interests of retail investors. Amending the definition of securities related activities and requiring that all such activity be conducted through the Dealer Member is necessary:

- to ensure that individuals being advised by a Rep with respect to securities or being sold a security by a Rep are protected by the controls, supervision and oversight of the Dealer Member;
- to prevent client confusion;
- to appropriately address conflicts of interest; and

[2] *Supra* note 1.
[3] FAIR Canada, "A Report on A Decade of Financial Scandals" (February 2011), online: < http://faircanada.ca/wp-content/uploads/2011/01/Financial-scandals-paper-SW-711-pm_Final-0222.pdf>.
[4] Mutual Fund Dealers Association of Canada, Regulatory Gap in Canada – Part II: Fund Managers: The Need for a Compensation Fund (November 2008), online: < http://www.mfda.ca/regulation/bulletins11/Bulletin0469-P.pdf>.

- to ensure that the investments of individuals who invest with a Rep are covered by a compensation fund.

2. **Distinguish Clearly Between Dealer Member Business and Outside Business Activities**

2.1. FAIR Canada recommends that Dealer Members have an ongoing obligation to ensure that the distinction between their business and any outside business activity is properly disclosed to clients and the public, and is in accordance with Section 13.4 of NI31-103 and Companion Policy 31-103CP. Dealer Members should be liable for all acts and omissions of their Reps relating to the outside business activities of their Reps unless it has been made expressly and explicitly clear to the affected individual that the outside business activity is not part of the Dealer Member's business and that the Dealer Member will not be responsible for those activities. If there is any ambiguity as to whether the outside business activity is part of the Dealer Member's business, the Dealer Member should be liable for harm caused to investors. If all securities related activities were required to occur through the Dealer Member, this would significantly lessen the potential liability of Dealer Members.

2.2. FAIR Canada also recommends that IIROC Dealer Member Rule 18.14(1)(e) be amended to include a condition, similar to that provided in FINRA's Supplementary Material to FINRA Rule 3270 *Outside Business Activities of Registered Persons*, that any outside business activity is not activity which would be viewed by clients or the public as part of the Member Firm's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered.

2.3. Dealer Members who approve their Reps' outside business activities will have notice of the activities that will take place, and should not permit any activity which might cause consumer confusion.

3. **Dealer Members Should Be Responsible for Advisors' Unapproved Activities**

3.1. Dealer Members should have an ongoing obligation to supervise the activities of their Reps and should have a duty to monitor their Reps for unapproved outside activities. If unapproved outside activities are detected, Dealer Members should be required both to report such activities to IIROC and to advise any affected individuals and the public in order to minimize harm.

3.2. In our Financial Scandals report[5], we point out that "[a] financial firm and its compliance function is best placed to supervise its advisor, it is best placed to communicate with the clients of the advisor to ensure that client funds are always transferred to the firm and never the advisor and firms are better able to obtain fidelity insurance to cover losses by rogue brokers."

3.3. FAIR Canada submits that Dealer Members are in the best position to deter or prevent their representatives from engaging in unapproved activities and to investigate and

[5] *Supra* note 1.

report any suspect activity. The potential for harm to retail investors is too great to absolve Dealer Members of responsibility for policing unapproved outside business activities.

3.4. Further, Dealer Members should be liable for harm resulting from the acts and omissions of their Reps through unapproved outside business activities unless it has been made expressly and explicitly clear to the individual that the outside business activity is not part of the Dealer Member's business and that the Dealer Member will not be responsible for those activities. Such responsibility should be regarded as a cost of doing business for Dealer Members who profit from inducing clients and potential clients to develop relationships of trust with their Reps.

3.5. Financial industry firms derive substantial profits based on their reputation (in terms of consumer awareness) and name recognition. Retail investors take comfort in dealing with the representatives of large firms (particularly banks) because they are backed by a recognized "brand" name and they assume their money is protected. If this also induces or entices retail investors to deal with their Reps outside of the business (regardless of whether the activity is approved or not), firms should be required to internalize this cost. Not only would such responsibility provide protection to investors, but would also provide a strong incentive to Dealer Members to police unapproved outside business activities.

3.6. Dealer Members are also best positioned to insure against potential fraud or other activities that are harmful to investors. In our view, financial firms should be required to internalize the costs of financial fraud. FAIR Canada recommends that IIROC and the CSA determine whether IIROC member should be required to obtain fidelity or some other form of insurance to protect investors.

4. **Registrants' Obligation to Report**

4.1. Additionally, FAIR Canada recommends that a duty be imposed on all registrants requiring them to report breaches or suspected breaches of securities regulation. Registrants are often best placed to detect potential fraud or other misconduct by another registrant (whether an individual or firm). Reporting potential misconduct could lead to the misconduct being identified at an early stage and loss or damage to clients being reduced or eliminated.

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-572-2282/ ermanno.pascutto@faircanada.ca or Marian Passmore at 416-572-2728/ marian.passmore@faircanada.ca.

Sincerely,

Canadian Foundation for Advancement of Investor Rights