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

October 11, 2012

Rossana Di Lieto
Vice President, Registration & Complaints
Investment Industry Regulatory Organization of Canada
Suite 2000, 121 King Street West
Toronto, ON M5H 3T9
Sent via e-mail to: rdilieto@iiroc.ca

Richard Corner
Vice President, Dealer Member Policy
Investment Industry Regulatory Organization of Canada
Suite 2000, 121 King Street West
Toronto, ON M5H 3T9
Sent via e-mail to: rcorner@iiroc.ca

Re: Request for Comments: IIROC Concept Proposal – Restricted Dealer Member Proposal

FAIR Canada is pleased to offer comments on the Investment Industry Regulatory Organization of Canada's ("**IIROC**") request for comments regarding the creation of a new class of IIROC member, called a "Restricted Dealer Member", to be added to the IIROC platform (referred to herein as the "**Concept Proposal**"), which is proposed in response to policy concerns relating to the scope of activities being undertaken by exempt market dealers ("**EMDs**") as identified in Canadian Securities Administrators ("**CSA**") Staff Notice 31-327 *Broker-Dealer Registration in the Exempt Market Dealer Category*. The Concept Proposal aims to facilitate the migration of U.S. Financial Industry Regulatory Authority ("**FINRA**") regulated firms, currently carrying out brokerage activity on the CSA platform as EMDs or Restricted Dealers, to IIROC membership.

It is our understanding that the EMDs and Restricted Dealers that are carrying on brokerage activities in Canada do not have any physical presence in Canada and are all US securities firms that are members of FINRA.

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 protections in securities regulation. Visit www.faircanada.ca for more information.

1. Executive Summary

1.1. Given the length of time that will pass before the potential implementation of any of the proposed changes contemplated in IIROC's Concept Proposal (including the time it

may take for potential changes to IIROC's By-laws and Dealer Member Rules and changes to the CSA's National Instrument 31-103 ("**NI 31-103**")), FAIR Canada recommends that all EMDs and Restricted Dealers carrying out brokerage activities with Canadian retail clients be required by the relevant securities commissions to provide a Warning Notice to their clients, in plain language, which advises them of the limitations of the protections afforded to them under such an arrangement, including any inability:

A. To access Canadian Investor Protection Fund ("**CIPF**") compensation fund coverage in the event of insolvency (unlike an IIROC dealer member);

B. To access the Ombudsman for Banking Services and Investments ("**OBSI**") in the event there is an unresolved customer complaint; and

C. To access (or uncertainty in access) the Canadian courts in the event of wrongdoing given the lack of any physical presence by these EMDs and Restricted Dealers in Canada, the fact they are not incorporated in any jurisdiction in Canada and the lack of any attornment to the Canadian courts.

1.2. With respect to IIROC's Concept Proposal, FAIR Canada is of the view that in order to provide adequate investor protection, FINRA-regulated firms that are carrying out brokerage services whilst registered as EMDs, or in some cases, Restricted Dealers (through certain exemptive relief which has been granted by CSA members), should be required to transition to full IIROC Dealer Member status if permitted (or permitted to continue) to have retail clients who are "accredited investors" as defined under National Instrument 45-106 *Prospectus and Registration Exemptions* ("**NI 45-106**").

1.3. **FAIR Canada is of the view that if it is determined that the FINRA firms should be migrated to a new "Restricted Dealer Member" category, they should only be allowed to deal with institutional investors and retail investors who qualify as Permitted Clients as defined in NI 31-103.** In addition, the following disclosure requirements should be imposed (beyond those contained in the Concept Proposal):

A. Provide written and oral disclosure to each client confirming the extent of the coverage provided to Canadian clients by the Securities Investor Protection Corporation ("**SIPC**") and an explanation of how such coverage differs from what they would receive from the CIPF;

B. Provide a statement in plain language setting out the client's potential options for redress, including litigation rights in the US and Canada; and

C. Advise of the ability to access OBSI (or not).

1.4. FAIR Canada provides comments on other certain consultation questions in section 5 below.

2. Warning Notice Should be Sent to Clients

2.1. A considerable period of time is likely to pass between the issuance of this Concept Proposal and the implementation of the actual changes to NI 31-103 and IIROC's By-laws and Dealer Member Rules that will be required, given the necessary time for comments to be gathered, reviewed, and specific rules proposed, consulted on, approved and implemented.

2.2. **In the meantime, the FINRA firms are operating in Canada, providing brokerage activities to retail Canadian clients without all of the investor safeguards that are in place for customers of full dealer member firms of IIROC.** This poses risks to investors. In particular, these investors do not have the same level of investor protection in the event of the insolvency of a FINRA-regulated firm, do not have access to OBSI, and their ability to pursue a civil remedy in a Canadian jurisdiction is unclear and uncertain given jurisdictional issues.

2.3. While it is not disputed that the FINRA firms are legitimately conducting brokerage activities under exemptions granted by the securities commissions, for those firms that are dealing with retail clients, **we recommend that all retail clients be given a Warning Notice about any lesser protections they are afforded in the event of wrongdoing, an unresolved complaint or insolvency than customers of IIROC dealer members.**

2.4. FAIR Canada recommends that the retail clients of the firms be made aware of the level of protections they are afforded under the existing system, and that the FINRA regulated firms be required to provide a Warning Notice to their retail clients, in plain language, which advises them of the limitations of the protections afforded to them under such an arrangement, including any inability:

- To access Canadian compensation fund coverage in the event of insolvency (unlike an IIROC dealer member);
- To access OBSI in the event of an unresolved customer complaint; and
- To enforce their legal rights through the Canadian courts (or uncertainty in access) in the event of wrongdoing given the lack of any physical presence by these EMDs and Restricted Dealers in any Canadian jurisdiction, the fact they are not incorporated in any jurisdiction in Canada and the lack of any attornment to the Canadian courts.

3. Brokerage Activities Conducted with Accredited Investors Should be Done through Full Dealer Members

3.1. As explained in the IIROC Concept Proposal, the drafting of NI 31-103 combined with certain exemptive relief granted by CSA members (which includes relief from

prohibitions on lending money, extending credit or providing margin) has allowed FINRA members (of which there are approximately twenty-two) to conduct a broad range of brokerage activities that were only intended for IIROC dealer members. Some of these firms have been able, and continue at present, to carry out brokerage activities for accredited investors.

3.2. FAIR Canada has indicated in an earlier submission to the CSA regarding the accredited investor exemption that the presumptions underlying the accredited investor exemption are flawed and that we consider them to be particularly unsuited to the demands and challenges of an increasingly complex and sophisticated securities market. **Given the low threshold and the review of the appropriateness of the accredited investor category, it is not prudent to allow the FINRA firms to conduct brokerage activities under a new category of membership which has less investor protections in respect of retail clients who are "accredited investors".**

3.3. While an accredited investor is undoubtedly valuable to target as a client, the criteria for qualifying as an "accredited investor" are not proxies for investor sophistication or ability to weather a financial loss.

3.4. While FAIR Canada may agree with the statement in the IIROC Concept Proposal that "…truly sophisticated and wealthy Retail Customers are capable of assessing the risks of doing business with a US entity, subject to similar regulatory requirements", the issue is that many accredited investors are not truly sophisticated nor are they necessarily objectively 'wealthy'.

3.5. If these firms wish to do business with Canadian clients who are accredited investors, they should be required to transition to full IIROC Dealer Member status so that all Canadian retail clients have the same level of investor protection.

4. New Restricted Dealer Member Category That Deals with Permitted Clients or Institutional Clients

4.1. **FAIR Canada is of the view that if the FINRA firms are required to migrate to a new "Restricted Dealer Member" category, they should only be allowed to deal with institutional investors and retail investors who qualify as Permitted Clients as defined in NI 31-103.** In addition, the following disclosure requirements should be imposed (beyond those contained in the Concept Proposal):

A. Provide written and oral disclosure to each client confirming the extent of the coverage provided to Canadian clients by SIPC and an explanation of how such coverage differs from what they would receive from the CIPF;

B. Provide a statement in plain language setting out what are a client's potential options for redress, including litigation rights in the US and Canada; and

C. Advise of the ability to access OBSI (or not).

4.2. FAIR Canada notes that the issue of what is the appropriate retail customer for this new category should be determined on a basis that is not inconsistent with the CSA's current review of the accredited investor exemption.

5. FAIR Canada's Comments on Certain Consultation Questions and Other Miscellaneous Comments

Proficiency Requirements Needed

5.1. FAIR Canada believes that IIROC's minimum proficiency requirements should be required for all individuals unless it can be demonstrated that FINRA's existing proficiency requirements are equivalent, with the exception of all client-facing persons who should have a one year transition period after implementation of the restricted dealer member category to complete the required Canadian proficiencies.

Portfolio Margining

5.2. The Investment Industry Association of Canada ("IIAC") notes in their comments on the Concept Proposal that FINRA financial operations rules allow firms to use portfolio margining, which results in clients being entitled to more leverage than if they were using a Canadian IIROC dealer.

5.3. FAIR Canada is concerned about the prevalence of unsuitable borrowing to invest recommendations and strongly recommends that IIROC require, as part of the Concept Proposal, that the FINRA firms who migrate to the Restricted Dealer category comply with IIROC's margin rules until such time as IIROC may amend its rules for all IIROC members as a result of its recent concept paper on the feasibility of portfolio margining.[1] This will allow for consideration of whether FINRA's portfolio margining rules provide adequate safeguards for Canadian investors and will address concerns about lack of a level playing field.

Do Not Create a Race to the Bottom

5.4. Rules exist for the purpose of investor protection and fair and efficient capital markets. FAIR Canada is concerned that if FINRA-regulated firms are not required to comply with Canadian rules which are not simply "regulatory overlap" (that is, the same or almost identical Canadian rule as exists under FINRA's rules), but that are separate Canadian rules, then IIROC Dealer Members may also question the legitimacy of such rules. FAIR

[1] See IIROC Notice 12-0275 dated September 17, 2012, available online at http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=8742D41E7ACB45BAAC838FFFADE18427&Language=en.

Canada does not believe that rules have been imposed on market participants "without consideration of whether these additional compliance requirements are necessary for investor protection purposes." By allowing the FINRA firms to not comply with existing Canadian requirements, IIROC may be unwittingly calling into question the efficacy of existing rules. Such pushback on existing rules is not likely to be in the interests of Canadian investors or the efficiency of Canada's capital markets.

We would be pleased to discuss this letter and our recommendations with you at your earliest convenience. Please contact Ermanno Pascutto at 416-214-3443 (ermanno.pascutto@faircanada.ca) or Marian Passmore at 416-214-3441 (marian.passmore@faircanada.ca).

Sincerely

Canadian Foundation for Advancement of Investor Rights

Cc: Bill Rice, Chair, Canadian Securities Administrators
Cc: Howard Wetston, Chair, Ontario Securities Commission