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Consolidated Compliance Report:

Examination Findings in the 2009/2010 Examination Cycle and the Focus for the Current Examination Cycle

IIROC is pleased to present the Annual Consolidated Compliance Report to assist member firms in their compliance efforts and in meeting regulatory expectations. This report presents some general and specific examination deficiencies found by the IIROC compliance teams including Financial and Operations Compliance, Business Conduct Compliance and Trading Conduct Compliance. This report also highlights the examination focus of the current year examination program.

Prior to discussing the examination findings there are some specific concerns that require member firm attention.



Many firms continue to review their current business models and look for ways to effectively reduce costs or enter new business lines. As always it remains important for all firms to maintain effective compliance and risk control programs within their businesses. Firms have a regulatory obligation to maintain an effective compliance regime when planning for and undertaking new business. IIROC Notice 09-0100 released April 3, 2009 outlines the importance of maintaining an effective compliance regime. IIROC Notice 10-0060 “Reporting of changes to business models” released in March 2010 established the requirement to provide advance notification of material changes in the firm’s business model. This allows IIROC the ability to discuss any additional compliance changes which may be required to address new business functions.

Recent trends indicate that many firms are considering outsourcing aspects of their current activities. Firms should take note of regulatory obligations under National Instrument (NI)31-103 and in particular Part 11 – Internal controls and systems of the Companion Policy, that has established the need to document firm due diligence in the selection of service providers. This includes the need to carefully manage all risks when deciding to outsource functions, activities or processes to third party service providers, especially those that are critical to the firm meeting its regulatory obligations and to the protection of customers. It is important that all such arrangements include a detailed written contract that establishes all necessary obligations including the privacy and confidentiality of customer information and the ability for regulators and auditors to directly access records of the firm and inspect the operations of the service provider. No contract can subrogate the regulatory responsibilities of the firm. IIROC is developing guidance around the core regulatory issues to be considered when outsourcing firm activities.

In addition, many firms continue to introduce new securities products to their clients. It is important that firms proactively review new products and have adequate review processes and supervisory policies and procedures in place to both oversee the sale of these products and to ensure that when they are sold to clients they are suitable for the clients to whom they are sold. All new product features and risks must be clearly understood by the firm and the Registered Representative (“RR”) who is selling these products, to ensure that their customers receive timely, accurate and clear disclosure of the features and risks of these new products. As the market continues to evolve and create new product structures, firms must ensure they are aware of the product risks and that their RRs understand the products they are selling. For guidance in this area please consult IIROC Notice 09-0087 released on March 23, 2009 “Best Practices for product due diligence”. IIROC issued this guidance notice to assist member firms in their efforts to ensure that they have adequate new product due diligence and oversight of the sale of these products. IIROC compliance teams continue to find deficiencies in this area and will again be testing these activities in the current examination cycle.

Suitability is a fundamental obligation of RRs to their clients. All products sold to clients must be assessed as suitable for the client taking into consideration the client’s risk tolerance



investment objectives and all other know your client (KYC) information. All firms are required to have adequate internal controls, effective tools to monitor and the proper supervision in place to ensure that client interests are protected. It is important for firms to maintain vigilance in their internal reviews and supervision of client accounts for suitability. IIROC tests for compliance with suitability obligations during all examinations and will continue to do so during the current year. Many firms are now beginning to automate their suitability testing to ensure that larger samples are tested or in some cases that most transactions are tested. Given the volume of transactions in some firms, automated testing is strongly encouraged.

IIROC field examination and review findings

During the past fiscal year, April 2009 to March 2010, IIROC examined more than 200 member firms through the Financial and Operations Compliance, Business Conduct Compliance and Trading Conduct Compliance programs. Each team selects the firms to examine each year based on a risk assessment of the firm and the elapsed time since the previous exam. Examinations are scheduled and undertaken independently by each functional compliance area and the final report findings or deficiencies are sent to the firms on the completion of the examination.

IIROC issued a total of 303 reports during the year. It is mandatory that each firm address all of the issues highlighted within these reports and that both adequate and timely action is taken by the firm to correct any deficiencies.

IIROC found that the majority of member firms continue to work hard to be compliant with both IIROC Rules and securities legislation requirements. Firms are generally very responsive to deficiencies indicated by IIROC examination staff and the majority of firms correct all deficiencies promptly.

IIROC staff continues to find that some business and compliance activities require further attention by members to ensure compliance with IIROC Rules. Each compliance examination team has compiled a list of the most common and some general examination deficiencies encountered by all three compliance teams.

It is important to note that the deficiencies noted below are a compilation of deficiencies encountered across the membership. These deficiencies have not been found at all firms reviewed and no single firm has received a report containing all or even most of these deficiencies.

IIROC staff have seen an improvement in the compliance focus on several of the reported deficiencies in the past year's examination cycle. Noted below are the areas in which improvement is needed.



General compliance deficiencies:

Three specific common deficiencies have been identified across all 3 compliance examination programs. They are:

- Inadequate supervisory testing
- Inaccurate or incomplete books and records
- Compliance programs not updated to reflect new rules or obligations

Inadequate supervisory testing:

In the previous year inadequate supervision was identified as a general deficiency. IIROC is pleased to report that during the past year this was no longer a common deficiency. However, IIROC continues to find less than adequate supervisory testing in some areas of firm activities. Supervision of all activity within the firm is fundamental to ensure compliance. It is also necessary that firms can demonstrate that they maintain adequate evidence of their supervision and supervisory testing and follow up on any deficiencies they encounter.

The key to compliance at any firm is adequate and comprehensive supervision. Firm management and the Board are responsible for ensuring that the firm has effective supervision in place for all of its business activities. The Ultimate Designated Person and Chief Compliance Officer must ensure that there is adequate supervision and testing and that there is meaningful and timely follow-up on any compliance issues identified within the firm. It is also important that compliance issues and the effectiveness of a firm's compliance system are reported at least yearly to the Board.

It is important to note that many firms are now automating their testing specifically in areas of high volume activity. Firm mind and management should assess whether manual testing remains feasible for parts of their business model.

Inaccurate or incomplete books and records:

This continues to be a general finding as it was in the previous report. A key part of adequate supervision is ensuring that a firm's books and records accurately reflect all of the activity in the business. Compliance examination teams continue to see incomplete or inaccurate books and records in some firms. Failure to adequately record all transactions on book, to have missing or inaccessible supporting documentation, to not maintain evidence of reconciliation records and to allow poor documentation practices are all matters that require attention by all firms. All firm business must be properly recorded. In addition, in some cases these issues are compounded by a series of patchwork systems or a combination of manual and legacy systems. Maintaining accurate audit trails of all securities-related transactions is a fundamental obligation for all firms. This is necessary to ensure that the firm's own internal



controls, testing regimes and supervisory activities can be effective and is fundamental to good risk management practices.

Compliance programs not updated to reflect new rules or obligations:

A key part of firm compliance is ensuring that the supervisory and compliance programs keep pace with any changes in rules or obligations introduced. IIROC continues to find firms that have not incorporated procedures to supervise or test for new rules or obligations. In some cases IIROC finds that programs have not been reviewed and updated for several years. It is important that all firms review their compliance and supervisory programs on a regular basis to ensure that they have been updated to incorporate all current obligations and cover any changes in the firm's business or supervisory structure. In addition to new rules, compliance programs need to keep pace with all firm business and should be established as part of any new activity. Doing business in new markets, with new products or with new tools all require attention by compliance. Firm business leaders must include compliance staff in the planning for any new business activity.

Firms should note that IIROC compliance staff will focus on testing for each of these common deficiencies in the current examination cycle.

Specific compliance deficiencies:

In addition to general deficiencies listed above, IIROC wishes to highlight some specific deficiencies encountered by each of the compliance teams that require additional attention by some firms. Each firm should review these deficiencies and ensure that they have adequate controls and tests in place to avoid these issues.

Financial and Operations Compliance:

Inaccurate or inappropriate margin provisions:

IIROC continues to find situations where inaccurate margin rates have been provided. These include deficiencies where the wrong margin rates are used and where the inventory margin is understated due to the inappropriate use or interpretation of margin offsets. Two deficiencies are of particular concern. The first is the practice of not providing margin on customer trade orders processed through accumulation or average price inventory accounts by Type 2 carrying firms. The second is the extension of leverage through the use of margin accounts as opposed to operating the account as a cash account by institutional customers that qualify as acceptable counterparties such as hedge funds.

Firms are required to apply the appropriate prescribed minimum margin rules to accurately quantify their position risk exposure and effectively monitor their capital adequacy.



Books and records issues:

Accurate and complete books and records of a member firm is an important function of the designated Chief Financial Officer of the firm. IIROC continues to see some failures in this area including:

- the failure to record off-book transactions in the firm records
- not recording give-up transactions in the client account
- the use of a sub-system of records that does not capture all trading activity that reconciles with the counterparty
- reliance on counterparties to provide trading details
- issues around record differences in system conversions
- comingling of books and records with the parent company
- no clear agreements or controls between members and their affiliates and related companies

Firms must maintain accurate books and records at all times. Where business or services are undertaken in related companies or affiliates it is important the member firms accurately record these transactions.

Business Conduct Compliance:

Inadequate policies and procedures:

IIROC continues to see instances where policies and procedures have not been appropriately customized to the firm's business and risks. It is important that these written policies and procedures include detailed procedures covering the internal controls, supervision and testing within the firm. In addition, these procedures should be accessible and understood by the firm's compliance and supervisory staff and there should be adequate training around these procedures.

Conflicts of interests and outside business activities:

IIROC continues to see some firms that are not adequately focusing on identifying the conflicts of interest within the firms or at the RR level. Conflicts of interest around products and outside business activities of RRs must be identified and carefully considered to ensure that clients are protected and sold suitable products.

Firms must clearly identify conflicts of interest in their business and ensure that there are adequate controls in these areas and that these conflicts are either mitigated or avoided. In particular it is important to consider the conflicts and the necessary disclosure around the sale of products of related or connected issuers or the proprietary products of related entities such



as limited partnerships, mutual fund dealers, exempt market dealers and portfolio managers. It is also important to consider conflicts that are associated with registrants employed by multiple related entities and ensure that these conflicts are weighed and addressed.

In addition, firms must ensure that they know and approve of outside business activities of their registrants to ensure that no conflict of interest is present. Member firms must report all outside business activities (OBA) to the National Registration Database and must carefully consider if any conflicts of interest exist before approving any OBAs.

Inadequate controls around the sale of private placements:

IIROC continues to see a lack of adequate controls around the sale of private placements. Controls over the sale of private placements must include verifying the accredited investor status, maintenance of documentation verifying client priority has been achieved, the maintenance of records establishing that adequate due diligence was undertaken and that expressions of interest and pro-involvement in the sale has been recorded. In addition, some firms have permitted private placements to occur off book and in some cases were not aware of the distribution of private placements.

All securities transactions in which a member acts must be recorded on the member's books and in the client's account. This includes:

- making a recommendation to the client, whether the transaction is the RR's recommendation or the client's;
- bringing the client's attention to a possible transaction and arranging the transaction in any way; and
- receiving compensation in any form (all compensation must be paid directly to the member and not the individual RR).

See Member Regulation Notice MR0481, July 13, 2007.

All firms must have adequate controls and records of all private placements undertaken within the firm.

Inadequate controls around non-client accounts:

The controls and supervision of the activity within non-client accounts within a firm are important for the firm to understand whether conflicts of interest are being managed and if information barriers are effective. Supervision of non-client activity needs to be comprehensive and include all transactions within the account. Controls over the use of external accounts needs to be vigilant and all accounts need to be reviewed against the grey and restricted lists.



Trading Conduct Compliance:

Inadequate internal testing:

IIROC staff continues to find inadequate or missing records of internal trade testing within the firms. Internal testing is required under Universal Market Integrity Rules (“UMIR”), however, some firms do not undertake adequate testing and in some cases are not maintaining adequate records of this testing. Internal testing is necessary for firms to understand their own compliance with UMIR and to ensure that their trading desks are marking all orders appropriately and protecting clients in the market.

Missing trade confirmation disclosures:

With the continued launch of new equity market trading venues in Canada, firms must continue to disclose to the client the market on which their order has been traded. This is an obligation under securities law, NI 31-103 and IIROC rule 200.1 (h). IIROC provided guidance to firms on this issue in RS Notice 2006-020 released October 30, 2006. IIROC does understand the operational difficulties some firms do have in making this identification, however, firms must update their internal manual or automated processes to make this disclosure. IIROC staff have also encountered poor compliance with the requirement to include marketplace disclosures to clients in cases when trades are confirmed at an average price.

Firms are obligated to ensure that their clients receive accurate disclosure on all of their trading confirmations.

Inadequate controls over primary distribution of debt:

A review of debt market primary distributions at member firms has indicated that some firms do not have adequate controls over these activities. All firms must maintain complete records of their debt market transactions with evidence of their client, non-client and inventory participation. All firms must have formal written allocation procedures for debt offerings and retain records of their efforts of offerings to clients.

Firms have several obligations that apply to the primary distribution of debt. IIROC Business Conduct Rule 29.3 states that firms must make bona fide efforts to offer these distributions to public investors and Rule 2800 3.2 requires fair allocation of these offerings. In addition Rule 29.3A states the firms must give client orders priority when allocating debt offerings. IIROC Rule 200.1 (g) states that firms must keep an audit trail records of all such orders and transactions and IIROC Rule 2800 2.1-2.3 outlines the requirement to supervise these activities.



Market Regulation:

Inadequate supervision of automated trading, including Direct Market Access, Algorithmic and Order execution account trading:

IIROC continues to see a growing percentage of automated trading accessing the market through firm systems. This “direct” trading is undertaken by direct market access clients (DMA), algorithmic trading programs run by either firms or clients (Algo) and finally by order execution accounts (Order Ex). DMA and Algo trading is generally reviewed and supervised by the firm after these orders are submitted to the marketplace, however the firm is responsible for ensuring that these clients understand their trading obligations, understand UMIR and that these connections can be severed in the case of technical problems. Order Ex accounts should have pre-trade controls within the firm.

It is imperative that firms undertake effective post-trade reviews of this trading. It is a firm’s responsibility to effectively oversee this trading to ensure it is compliant with UMIR and that it is reviewed for any indications of insider trading and market manipulation. Recently, IIROC encountered several instances of poorly written or malfunctioning Algorithmic trading programs which caused market integrity concerns. These issues have occurred due to both firm and client Algo. Firms are obligated to be aware of and monitor all such programs connected to their systems to detect problems as they occur and ensure that they can disconnect such access when required. Trading through DMA and Order Ex access is also important to monitor and firms need to ensure that their clients understand how to trade in compliance with UMIR and statutory obligations. In some cases IIROC detected instances of clients appearing to manipulate by entering a number of bids or offers into the book with the intent to alter the perception of supply and demand. These cases have been referred to the appropriate CSA member for further review. Firms should test for all kinds of manipulative activity by their clients including layering and spoofing. For further information firms are directed to Algorithmic Trading Notices 09-0081, issued March 20, 2009, and 2008-003, issued January 18, 2008, and DMA and Order Execution Notices 2007-011 and 2007-010 dated April 20, 2007.

Inadequate procedures to ensure that better priced orders in the visible market are not traded-through:

IIROC continues to monitor for firms that trade through better priced visible orders in Canada. The overall rate of such violations has dramatically declined in the past year. The majority of firms have either ensured that they have procedures in place to avoid trading through better priced orders by either directly connecting to all visible markets, by using effective order routers to access visible orders or through other arrangements. Trade-throughs continue to be detected. However, the majority occur at market opening and in periods of fast markets or at times of high latencies in market data. Firms that have not implemented adequate



procedures to avoid trading through better priced orders are referred to IIROC's Enforcement division.

Summary:

Improvement in IIROC firm compliance activities is evident on many fronts. IIROC has identified several examination deficiencies that will be the focus of the current year regulatory examination program, including:

- inadequate supervisory testing;
- inaccurate or incomplete books and records;
- compliance programs not updated to reflect new rules or obligations;
- inaccurate or inappropriate margin provisions;
- inadequate policies and procedures;
- inadequate controls associated with conflicts of interests and outside business activities;
- inadequate controls around the sale of private placements;
- inadequate controls around non-client accounts;
- inadequate internal trade testing;
- missing trade confirmation disclosures;
- inadequate controls over primary distribution of debt;
- inadequate supervision of automated trading, including Direct Market Access, Algorithmic and Order execution account trading; and
- inadequate procedures to ensure that better priced orders in the market are not traded-through.

These deficiencies require attention by member firms and all firms should review and test these activities to ensure compliance with IIROC rules. Firms are reminded that when preparing for examinations by IIROC they should consider all of the deficiencies discussed in this Notice and not only the previous deficiencies identified within the firm. In addition, IIROC will be undertaking focused regulatory reviews on an ongoing basis to test for compliance in specific areas. These reviews may include any of the areas of focus outlined in this Notice.

We hope that by sharing these general and specific deficiencies member firms will be better able to focus and assess the effectiveness of their compliance programs, supervisory oversight and internal controls.

IIROC will continue to provide assistance to firms through the designated responsible manager in each program area and through the provision of regulatory guidance. Firms are encouraged to contact their designated manager if there are any questions about this report.