



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

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Dear Sirs/Madam:

Re: Re-evaluation of Exempt Market Dealer Category

We write in response to the issues raised in CSA Staff Notice 31-327 *Broker Dealer Registration in the Exempt Market Dealer Category* (the "Notice"). The IIAC has been working with our members, as well as IIROC and OSC staff, to better understand the scope of the problem, and provide recommendations on how to address the issues while retaining the capital raising objectives for which the EMD category was created.

As it currently exists, the EMD registration category encompasses a wide variety of dealers undertaking a number of different activities for a diverse client base. Given that the business models, transactions and clients are so varied, it is essential to identify the types of activities that EMDs are permitted to undertake, and then ascertain what level of oversight and regulation should apply to those activities.

The analysis should take into account investor protection considerations, level playing field issues in relation to regulatory requirements and oversight, enforcement concerns, as well as domestic and foreign competition and reciprocity issues.

Problems with current EMD category

One of the issues that resulted from the creation of the EMD category is that a wide variety of transactions are now subject to a two-tiered system of investor protection. As articulated in the Notice, the original intent in creating the EMD category was to facilitate limited capital raising activities for issuers, using existing prospectus exemptions. Unfortunately, the drafting in NI 31-103 created opportunities for EMDs to undertake many other activities outside of the intended realm, many of which could be categorized as "brokerage activities" for which IIROC registration would generally be required.



Under NI 31-103, EMDs can:

- (i) act as a dealer by trading a security that is distributed under an exemption from the prospectus requirement, whether or not a prospectus was filed in respect of the distribution,*
- (ii) act as a dealer by trading a security that, if the trade were a distribution, would be exempt from the prospectus requirement,*
- (iii) receive an order from a client to sell a security that was acquired by the client in a circumstance described in subparagraph (i) or (ii), and may act or solicit in furtherance of receiving such an order, and*
- (iv) act as an underwriter in respect of a distribution of securities that is made under an exemption from the prospectus requirement.*

While EMDs are subject to the regulation imposed under NI 31-103, the scope and application of the regulation is considerably less than for IIROC registrants. The result is that certain investors that are most likely to participate in securities transactions involving significant funds could be vulnerable to service providers that are subject to lower professional standards, and fragmented and inconsistent regulatory oversight. Given the wide variety of capital markets activities transactions that can be conducted under this provision (including securities issuance and secondary market trading), it is foreseeable that dealers serving institutional investors and high net worth (“HNW”) clients may opt out of the rigorous regulatory standards imposed by IIROC and undertake this type of business through an EMD.

We have been advised that, consistent with the regulation, certain US based EMD firms are offering trading services, sophisticated electronic services, DMA, and other prime brokerage services to clients. They also are offering private equity products to HNW clients. Given the predominance of secondary market trading over primary distributions, the expansion of permissible activities from limited capital raising distributions to secondary market trading represents a very significant increase in the ability of EMDs to participate in capital markets activities, magnifying the investor protection and level playing field concerns.

Not only does this expansion of scope pose an investor protection problem, it places the firms and individuals that have undertaken the steps required to meet the rigorous IIROC regulatory and educational standards at a disadvantage to the more lightly regulated and less qualified EMDs. These firms may be able to offer similar services without incurring the costs of creating and maintaining robust compliance and oversight systems and processes.

Ultimately the investing public bears the costs that result from inconsistent regulation. In addition to confusion about the regulatory and professional standards applicable to their advisors, fragmented oversight can lead to significant gaps in surveillance and enforcement of investor protection regulation.

Lack of clarity regarding investment dealer activities

We understand that the current EMD problem arose as a result of broad drafting that expanded the scope of allowable activities that EMDs are able to undertake under NI 31-103. We note however, that the problem was compounded by the absence in the regulation of a more detailed description of activities that only investment dealers can undertake.

Section 7.1(2) of NI 31-103 states that, “A person or company registered in the category of (a) investment dealer may act as a dealer or underwriter in respect of any security.” Section 9.1 states that, “An investment dealer must not act as a dealer unless the investment dealer is a “Dealer Member” as defined under the rules of IIROC.”



The generality of the drafting provides investment dealers with wide scope, in terms of the activities and transactions that they can undertake. However, it does not articulate what transactions or activities can only be undertaken by a registered investment dealer. The Staff Notice collectively refers to such activities as "brokerage activities." The term "brokerage activities" is not defined in the Staff Notice or any regulatory instrument, which adds to the confusion. This lack of clarity relating to what transactions require registration as an investment dealer have resulted in a regulatory gap that has been exploited in the manner described in the Notice.

In order to prevent this from reoccurring, it is important that the transactions and activities that warrant registration as an investment dealer be clearly defined. If exemptions are required in particular circumstances, for sound policy reasons, the circumstances and limitations of the exemptions must also be explicitly defined.

Inconsistency in Regulatory Standards

IIROC dealers are held to rigorous regulatory compliance standards relating to all aspects of their business, from KYC obligations, suitability, reporting, conflict management, educational requirements, and client priority, to a myriad of financial and other obligations. These regulations help ensure the client is well protected and the integrity of the capital markets is maintained. They also represent significant cost to firms operating within this structure.

As noted above, under NI 31-103, EMDs can offer a variety of services (trading in Canadian securities, electronic trading, DMA, prime brokerage services) to certain Canadian retail and institutional clients, without being a member of IIROC.

We understand from our discussions with CSA and IIROC staff that the problem appears to be confined to US firms registered with FINRA that have been granted EMD status. Audits of IIROC carrying brokers have not shown that Canadian EMDs are also undertaking these activities.

In addition to the FINRA EMD issue, we remain concerned about the general regulatory inconsistency in respect of the capital raising activities for which the EMD category was created. IIROC dealers that provide the same capital raising services as EMDs are subject to all of the standards, rules, surveillance and enforcement and audit activities that are part of IIROC registration in respect of those activities while EMDs are only subject to the more general and less stringent regulation and oversight pursuant to NI 31-103. The differences between the regulation in NI 31-103 and IIROC Rules and practices create an inconsistency that operates in favour of US and Canadian EMDs, and against IIROC registrants, particularly since IIROC practice does not permit its members to register a separate EMD to conduct this business outside of IIROC oversight.

This inconsistency encourages regulatory arbitrage for those seeking out those services, and those wishing to provide them. The resources devoted to firm compliance which ultimately serves the investor protection mandate, are less applicable to EMDs, which means that they can operate a lower cost, at greater risk to the client.

We understand and agree that for certain transactions with clients with a particular profile, there may be a justifiable public policy reason to apply a lower regulatory standard. Such transactions may include certain capital raising activities for issuers with clients that are truly knowledgeable and sophisticated enough to not require the protection afforded by dealing with IIROC registrants.



It is important that these transactions are clearly identified and a cost-benefit analysis be conducted that not only applies to the potential investors, but to the market in general. Exemptions from high regulatory standards must only be permitted when it is clear that the intended outcomes of the transactions cannot be achieved without such exemptions. It must also be clearly established that investors are not put at risk, and market integrity and confidence in the market will not be compromised by the use of these exemptions.

Investor Protection Concerns

From an investor protection standpoint, individual retail investors using an EMD to purchase securities raise concerns. There is a general impression, as expressed in the Notice, and confirmed in the Alberta Securities Commission Review of Exempt Market Dealers (released January 12, 2012) that certain EMDs are not properly ascertaining if retail clients actually qualify under the accredited investor exemption criteria. There are also concerns that the accredited investor exemption is not a proxy for sophistication and, may result in investors purchasing securities that are not appropriate in respect of their circumstances or their risk profile. The CSA has explicitly acknowledged this concern and requested input in CSA Staff Consultation Note 45-401 *Review of Minimum Amount and Accredited Investor Exemptions*. This is more likely to occur where the dealer facilitating the transaction is not subject to rigorous oversight regarding suitability and KYC requirements, as noted in the ASC Review. In addition, non-accredited investors using other exemptions such as the offering memorandum exemption, or the minimum investment exemption could be quite vulnerable. We have expressed these concerns in our recent submission to the CSA on Staff Consultation Note 45-401.

It should be noted that there is no corresponding reduction in investor protection when accredited investors are dealing with IIROC firms, which are held to high regulatory standards regardless of the exemption under which their clients purchase securities.

Oversight and Regulation of EMDs

As noted above, we are concerned about fragmentation and inconsistency in the regulation and oversight of EMDs, as they fall under provincial oversight rather than being subject to a national SRO. This is as much of a resourcing issue as it is one of expertise. IIROC has a long history of actively regulating and providing oversight for the precise types of activities undertaken by the EMDs. Regulation has, and continues to evolve based on the ongoing needs and experiences of investors, as well as the firms undertaking such activities. The skills, experience and resources required to develop, monitor and enforce regulatory requirements are significant. IIROC's long history as the industry SRO has allowed it to develop the expertise and structure to provide such oversight. At this point, it is not clear that the CSA is appropriately resourced and has the internal infrastructure to consistently regulate and oversee "brokerage activities" (eg: sales compliance, trading oversight etc) that are, and can be undertaken by firms in the EMD category.

In addition to the differences in resourcing, priorities and expertise in respect of EMDs, we are also concerned that when firms undertake similar activities which are regulated by different entities with different oversight standards across different provincial jurisdictions, it is more difficult to identify systemic problems, and regulatory arbitrage will most certainly arise as EMDs identify the areas with the least resources devoted to oversight. The result is that the depth and robustness of oversight brought to bear on EMDs will be compromised, leading to inconsistent investor protection.

It is important to minimize the areas of overlap in respect of activities that can be characterized as "brokerage activities" which can be undertaken by both IIROC dealers and EMDs.



MFDA Dealer Implications

In respect of mutual fund dealers, we are concerned that it is possible that an MFDA firm obtaining an EMD registration could result in such dealers being able to undertake transactions not regulated or overseen by the MFDA. We believe that it is important for the CSA to examine the possible unintended consequences of the EMD regulation in respect of such firms.

Specific Concerns with FINRA EMDs

Surveillance and Oversight

In respect of FINRA registered firms applying to have a Canadian EMD, our concerns about the inconsistency in regulation and oversight are compounded.

Although we acknowledge that FINRA registrants are subject to US regulatory standards, it is important to understand that FINRA regulations and oversight are designed to monitor US clients on US exchanges and not to protect Canadian investors or ensure compliance with regulations designed to protect such investors.

IIROC's UMIRs are designed to protect Canadian market integrity, through a comprehensive framework of rules and disclosure requirements relating to matters such as proprietary and client trading, conflict of interest and trading on undisclosed market information.

FINRA is not in a position to enforce Canadian regulation in respect of its Canadian clients and transactions, potentially leaving such clients trading through a FINRA EMD exposed.

For example, the FINRA regulatory regime does not impose similar and integrated reporting and audit trail requirements that would ensure Canadian regulators are aware of, and can properly conduct surveillance, monitoring and transaction audits of transactions occurring with Canadian clients in Canada through a US EMD. The UMIRs ensure that transactions carry specific markings and are disclosed and trackable through specific audit trails. If a US based EMD, which is not an IIROC registrant undertakes such a transaction, it is not subject to these rules, or marking requirements.

The trades may be conducted through an omnibus account, so specific information about the parties involved and the characteristics of the trade are not available to regulator to establish an audit trail. The use of such accounts may impede the regulator's ability to look at trading quickly and effectively, as the audit trail is more difficult to follow due to aggregation.

In addition, key provisions of UMIR are based on whether trades are taken on behalf of clients or principals. When a FINRA EMD is involved, the client priority disappears, as the EMD is not characterized as a principal, so they are on equal footing with the client. This is contrary to the basis of Canadian investor protection regulation.

The ability to conduct compliance monitoring and enforcement is critical in protecting Canadian investors and the integrity of the Canadian marketplace. Inconsistency in regulatory and reporting requirements as well as fragmentation of surveillance and enforcement can result in problems in identifying and tracking transactions of concern, such as insider and pro trading. This presents a serious problem in respect of market integrity.



Lack of Reciprocity

Although the CSA has put restrictions on the most recent EMD applicants to ensure they are not able to undertake “brokerage activities”, the current EMD structure creates a non-level playing field that puts Canadian dealers at a disadvantage to US firms. If a Canadian firm wished to undertake similar activities in the US, it would have to be fully registered with FINRA. As noted above, our concern is that effectively, this allows US EMDs to pursue certain Canadian retail and institutional clients without the oversight and costs applicable to Canadian dealers, undermining Canadian competitiveness in its own market.

Submission by Securities Industry and Financial Markets Association

We are aware that the US based Securities Industry and Financial Markets Association (“SIFMA”) has made a submission to the CSA objecting to the current restrictions being placed on new EMD applicants. The submission notes that FINRA dealers are highly regulated and subject to rigorous investor protection regulations. Although we acknowledge that FINRA dealers are indeed governed by high regulatory standards, as noted above, these regulatory standards are designed to protect US investors and the integrity of the US marketplace.

The SIFMA letter articulated an objection to CSA the process of dealing with new EMD applicants, citing that it is unfair to those registrants whose applications had not been processed and those who had not had the opportunity to establish an EMD under the existing rules without any conditions. Although we acknowledge that the process in relation to this issue has been unusual, it is appropriate that Canadian regulators, upon discovering a problem in existing regulation that may compromise Canadian investors and the Canadian capital market as a whole, take action to mitigate any damage and ensure that the underlying conditions that created the situation is dealt with in on a timely basis,

Although this may create a less than ideal situation for future US applicants looking to take advantage of this acknowledged “gap” in Canadian regulation, it is not the role of the Canadian regulators to ensure that US firms are all provided equal opportunity to take advantage of problems with Canadian regulation. The manner in which the CSA has dealt with this issue is abundantly fair, in that no existing US EMDs are subject to retroactive restrictions on their activities. The conditions imposed on new applicants have been publicly disclosed and are designed to protect the Canadian marketplace until new rules are in place. We understand that these EMDs will be subject to any new restrictions imposed on EMDs as a result of the review of the registration category, anticipated to be completed by March 2013, when the restrictions applicable to EMDs expire.

We support the CSA efforts to restrict EMD registration as articulated in the Notice until an appropriate policy solution is implemented to address the investor and market integrity concerns.

Recommendations

Scope of EMD Registration

It is our understanding that the regulatory intention was to permit EMDs to assist in capital raising, and not trade in the secondary market except in relation to those securities sold pursuant to the specific capital raising transaction in which the client participated. Consequently, EMDs should be restricted in providing access to the secondary market only to those clients and in relation to the securities sold in respect of the specific financing which were subject to the capital raising exemption in the first instance. The unrestricted secondary market trading access for prospectus exempt securities including DMA and other electronic trading services) should not be permitted except through an IIROC firm.



Client Base for EMDs

In terms of the type of investor that EMDs should be permitted to serve, restricting the clientele to institutional clients would address some of the issues in respect of investor protection and non-level playing field. Our concerns about suitability and KYC procedures are outlined above. In addition, unlike IIROC rules, NI 31-103, allows suitability requirements to be waived for Permitted Clients. Retail clients are afforded a higher standard of protection by IIROC registered firms, who can only waive the suitability requirement for Institutional clients who are Permitted Clients. Given the additional investor protection concerns when firms deal with retail clients, EMDs should not be permitted to deal with retail clients, whether or not they are Permitted Clients. This position is consistent with our response to the CSA's request for comments on the Minimum Amount and Accredited Investor exemptions.

Conclusion

The IIAC appreciates the efforts of the CSA to address this issue, and its assistance in providing information to our working group in respect of its concerns and findings. We would be pleased to meet with you at your convenience to provide further input to come to a workable regulatory solution.

Yours sincerely,

c.c: Sandra Blake - Ontario Securities Commission
Susan Wolburgh-Jenah - IIROC