13.1.5 IDA Response to Comment Received on Proposed Amendments to IDA By-laws 1.1 and 29 – Conflicts of Interest and Client Priority

INVESTMENT DEALERS ASSOCIATION OF CANADA (IDA)
RESPONSE TO COMMENT RECEIVED ON PROPOSED AMENDMENTS TO
IDA BY-LAWS 1.1 AND 29 – CONFLICTS OF INTEREST AND CLIENT PRIORITY

On July 2, 2004 the Investment Dealers Association of Canada (IDA) republished for comment proposed amendments to IDA By-laws 1.1 and 29 concerning conflicts of interest and client priority (the "proposed Rules").

One comment was received from the Canadian Bankers Association (the "CBA").

SUMMARY OF WRITTEN COMMENTS RECEIVED ON THE PROPOSED RULES

Overview

In reviewing the comments made by the CBA and the Association's specific responses, the IDA thought it would be useful to review the overriding objectives of the proposed Rules.

The Joint Securities Industry Committee on Conflicts of Interest was convened in 1996 to examine the potential conflicts of interest that occur when salespersons and Member firms participate in emerging company financings. The result was the Hagg Report, which outlined a number of recommendations for changes to the rules of self-regulatory organizations. The Association has drafted the proposed Rules in response to the recommendations stated in the Hagg Report.

The proposed Rules address potential conflicts of interest in situations where the Members, its employees, affiliates and certain associates thereof hold equity and certain debt securities of an issuer and the Member also provides services to the same issuer in connection with a private placement or public offering.

Conflicts may arise as a result of the pro group holding a significant investment in an emerging company and then engaging in underwriting and trading for clients in the shares of these companies. The objectivity of the pro group when dealing with clients can be compromised when the pro group has a material interest in the company.

The effect of the proposed Rules is to make clients aware of the pro group's ownership in an issuer in situations in which conflicts of interest would have the most serious impact. This gives clients new and important information, which they can use to assess the potential for conflicts of interest when receiving advice or recommendations relating to securities in which the pro group has a significant interest. The information would allow them to ask whatever questions of their broker they consider appropriate, and to weigh the objectivity of the broker and the advice being given.

Another objective is to make clients aware of suitable private placements in situations where the Member firm influences the issuer's financing strategy. The results will be increased client participation in private placement financings, a more level playing field between clients and brokers, and the elimination of transactions that are engineered by and for the primary benefit of the pro group.

No U.S. Equivalent and No Cost Benefit Analysis

Comment

The CBA questioned why Members should be subject to more onerous disclosure requirements and additional compliance costs. (Also raised in bullet point 3 on page 2)

Response

The Association based the proposed Rules on the analysis of the industry by the Joint Securities Industry Committee on Conflicts of Interest that produced the Hagg Report. The Committee undertook a detailed review of SRO rules, securities regulations and met extensively with representatives of members firms, regulators, issuers and investors. The Hagg Report identified significant conflict of interest issues that the Association believes need to be addressed. These types of conflicts exist in the United States. Consequently, the issue should be why the United States does not have similar conflict of interest rules.

Conflict issues do arise and when detected they are dealt with. This can be seen, for example, in recent actions by U.S. regulators concerning research analyst conflicts, IPO allocations and late trading and market timing abuses by mutual fund companies.

With respect to a cost-benefit analysis, the IDA did not perform an extensive analysis because the Joint Securities Industry Committee on Conflicts of Interest and the Securities Industry Committee on Analyst Standards both identified the need to address conflicts issues. While it was recognized that the costs would be significant to Members, the Association found that the benefits to investors outweighed the costs.

Material Conflicts

Comment

In numerous locations in the CBA comment letter (specifically bullet points 1, 2 and 4), the CBA submits that only material, direct and clear cut conflicts should be disclosed.

Response

The Association has limited the scope of the proposed Rules from numerous earlier drafts and even from the scope recommended by the Hagg Report. The scope, rather than including all securities that the pro group may

hold, has been reduced to those securities for which the Member is providing services related to a private placement or public offering.

The conflicts that may arise in these circumstances are substantial and material. The scope of the rule identifies the pro group's ownership in an issuer in circumstances where conflicts of interest would have the most serious impact, be it where no established market for the security exists or the market can be easily manipulated or is not a reliable indicator of price.

Percentage Holdings

Comment

The CBA believes that it would be more meaningful for a client to disclose a material conflict than to disclose detailed lists of percentage holdings.

Response

The Association had to balance disclosure that was material and disclosure that was understandable. We felt that this balance was achieved by a percentage amount. The other methods we considered were too complex to be meaningful.

Investor Abilities

Comment

The totality of disclosure and ability of investors to assimilate such information should be considered.

Response

The Association believes investors have the ability to understand the proposed conflicts of interest disclosure.

National Instrument 33-105

Comment

The CBA states that many of the goals of the proposed Rules are currently found in existing regulatory requirements, such as those of National Instrument 33-105. It uses as an example the definition of "related issuer".

Response

National Instrument 33-105 *Underwriting Conflicts* does not address all the goals of the proposed Rules. For example, conflicts of interest involving client priority or conflicts of interest involving the resale of securities where hold periods are in place but may be abridged, are not covered in National Instrument 33-105. Neither does the National Instrument contain a basket clause to address disclosure of conflicts not specifically set out in the Instrument or the proposed Rules.

In addition, with respect to National Instrument 33-105, the CBA argues elsewhere in its comment letter that the conflicts that the IDA proposes to address via the proposed Rules are too complex and not material.

We have argued that the scope of the proposed Rules have been limited to focus on those conflicts that are material to an investor when determining whether to purchase securities that are the subject of a placement or offering and we have attempted to draft it as simply as possible. Clearly, though, the issues are complex as is evident by the charts accompanying the National Instrument in order to assist in determining its application.

Lastly, by including a bright line test of 10% the Association is avoiding the differences of interpretation caused by some of the requirements of the National Instrument. For example, it is a matter of interpretation as to what parties fall under the relationship of "connected issuer" and there are difficulties and complexities involved in the determination of who falls under the definition of "influential securityholder".

Are these relationships found under the National Instrument any less broad or more material than the "pro group" relationships? In fact, the "connected issuer" is broader than the "pro group" definition and captures more individuals.

Firm Practices

Comment

The CBA states that many firms have added measures to their normal practices to deal with conflicts, which has not been taken into account in assessing the need for new IDA measures.

Response

The CBA refers to "many firms", but as the Association has over 200 Members we need clear and consistent standards that are applicable to all our Members and protect investors regardless of which Member firm they choose to deal with. It is not unusual for IDA Member firms to anticipate IDA rule making by implementing best practices before being mandated to do so.

Pro Group Holdings

Detailed Database

Comment

The CBA is concerned that the proposed Rules will require firms to develop a detailed database, which will result in enormous development and maintenance costs.

Response

While there will be increased costs in order to satisfy reporting and disclosure requirements, they are not unduly large when considering the ultimate goals that will be achieved: increased investor protection; the leveling of the

playing field and increased participation in the capital raising process.

As stated in the discussion paper that accompanied the proposed Rules when published for comment, there are various means available to Members to retrieve outstanding share data. For listed issuers, a Member can find outstanding share data from the market or from a reliable third-party data vendor. The means available to Members include, for example, National Instrument 51-102 where reporting issuers are required to disclose in financial statements each class and series of voting or equity securities of the reporting issuer that are outstanding. In addition, The Toronto Stock Exchange requires issuers to report within ten days of month end their issued and outstanding securities. In addition, the website for TSX shows the number of shares outstanding for issuers listed on the TSX and TSX Venture Exchange. This information should be current as the issuer is to advise the exchange of share issuances. Timely Disclosure requirements, such as section 2.5 of TSX Venture Exchange Policy 3.3 obligates issuers to immediately notify the exchange of any issuance of securities or any change in capital structure. In addition, under section 4.2 of TSX Venture Exchange Policy 3.2 the registrar and transfer agent are obligated to send the exchange a copy of any treasury order that the issuer has sent to them and the treasury order must contain the number of issued and outstanding shares following the new issuance.

Member firms are also presently required to track the holdings of their employees for the purposes of the current requirements for priority rules and in connection with their daily and monthly review of pro (i.e. employee) trading.

For unlisted securities, the Member should be able to get outstanding share data from the issuer itself. This is also the case for outstanding subordinated debt. In both these situations the Member has a relationship with the issuer and therefore it should not be difficult to receive this information from the issuer.

Furthermore, because the disclosure is now only triggered in relationships where the Member is providing services related to a private placement or public offering, the calculation of pro group holdings is limited to securities that are the subject of those relationships.

In summary, as a result of the ability of Members to obtain outstanding share data and the reduced scope of the proposed Rules, the Association believes the creation of a centralized system is not justified. Because Members will only be required to make the calculation where the Member is providing services to the issuer in connection with a private placement or public offering, and the Member itself has access to outstanding share data, the Members have the information and capability to produce their own calculations. A centralized database will not provide any added benefit. Furthermore, as a result of these factors, the costs to Members in making the calculation themselves will not be prohibitive.

Employee and Associate Compliance

Comment

The CBA states that the tracking of personal securities holdings and trading activities of employees and associates is extremely invasive and gives rise to employment law and privacy concerns. There may also be compliance difficulties if an associate objects to providing trading information.

Response

The Association does not believe the reporting required is contrary or inconsistent with any provincial or federal laws. Currently, privacy and employment issues do not arise in the industry where Member firms must track employee trading for compliance with National Instrument 33-105, priority rules and for the purposes of their daily/monthly pro trading reviews.

With respect to associates objecting, registrants of the Member will have a relationship with the associate and will therefore already be aware of the information or be able to easily obtain it. In addition, since the provisions of the proposed Rules are only triggered when the Member is involved in an issuer's private placement or public offering, it is likely to be relatively easy to ascertain whether an associate has purchased these securities. In addition, secondary market trading of securities by associates would not be captured, except where these securities are in the same class as the securities in the new issue.

Managed Accounts

Comment

The CBA is concerned about the tracking of accounts that are fully managed by third parties.

Response

The definition of "pro group holdings" specifically excludes under clause (a)(ii) securities in a managed account.

Exclusions for Affiliates and Associates – Distinct Business or Activity

Comment

The CBA believes that the exemption is not extensive enough and catches more than is intended. Further, the CBA submits that there could be situations of hundreds of affiliates and it is not clear what engaged in a "distinct business or investment activity" would entail.

Response

The Association believes it achieved as clear an exemption as possible without being overly inclusive.

It is up to Member firms to use their best judgment in the determination whether an affiliate would/should fall under

the definition of "pro group". Members, when making this determination should consider the principles and goals of the proposed Rules: would the holdings of an affiliate cause an investor to question whether the recommendations given to an investor were wholly independent, whether the price of the securities is fair and the process by which that price was determined was not impacted in any way as a result of certain relationships with the issuer?

Where it is unclear whether disclosure of affiliates holdings should be made the Member may apply for an exemption.

Higher Burden than National Instrument 33-105

Comment

The CBA believes that the proposed Rules are inconsistent and more onerous than National Instrument 33-105, requiring disclosure of pro group holdings where a Member is neither "related" to the issuer nor an "influential securityholder".

Response

As set out above, the Association agrees that the proposed Rules may be more onerous than National Instrument 33-105 in some respects. But as outlined in the Hagg Report, specific conflicts concerns were identified that required redress.

Furthermore, National Instrument 33-105 is only slightly less onerous in respect of the definition of "influential securityholder". For example, under that definition professional groups would be required to disclose in a manner similar to the proposed Rules (i.e. direct or beneficial ownership of voting securities entitling the group to cast more than 10% of votes for the election/removal of directors, equity securities entitling the group to receive more than 10% of the dividends or distributions, etc). What makes National Instrument 33-105 a little less onerous is the additional provision that the pro group must also be entitled to nominate at least 20% of the directors of the issuer or has partners, directors or officers constituting 20% of the directors of the issuer).

However, in other respects, National Instrument 33-105 is more onerous. For example, it requires disclosure of "connected issuers". That definition uses a broad test of whether the relationship between the issuer and a registrant may lead a reasonable prospective purchaser of the securities to question the independence of such parties for purposes of the distribution. This would cover such scenarios as when a significant shareholder of the registrant is the chair of the board of directors of the issuer.

No Similar Requirements in Other Professions, Jurisdictions

Comment

The CBA states that other securities regulators in other jurisdictions and other professions do not require such information to be monitored or disclosed.

Response

Regardless of what other securities regulators or professions require, the need for such requirements, via the Hagg Report, was identified. To simply wait for other regulators/professions to act is not an effective means of regulation. But in fact, other jurisdictions and other regulators do address conflicts of interests. For example, one of the core principles of the Fair Dealing Model proposal is that any conflicts of interest must be managed to avoid self-serving outcomes on the part of the adviser. The principle of transparency in the Fair Dealing Model proposal would also require the disclosure of all conflicts, for example, in relation to compensation received by advisers.

Under the revised BC Securities Act, a Code of Conduct has been drafted. Principle 6 of this Code addresses conflicts of interest. It requires that all conflicts of interest be resolved in favour of the client. It also requires that when acting as an underwriter, registrants must act in the best interest of the investors and they must disclose any relationships with the issuer that would lead a reasonable investor to question whether the registrants and issuer are in fact independent from each other.

Finally, the Conduct and Practices Handbook Course that all registrants must read, contains a Code of Ethics and Standards of Conduct, which requires the priority of client's interests and that registrants must disclose all real and potential conflicts of interest in order to ensure fair, objective dealings with clients. The CPH also requires the priority of client orders over non-client orders.

Definition of Debt

Comment

The CBA asks that guidance be provided regarding what types of debt securities are intended to be captured by subsection 29.28(2). The CBA also questions the relevance of a pro group holding subordinated debt.

Response

Subordinated debt holdings can give rise to the same conflicts as equity securities. In situations where the pros hold 10% or more of subordinated debt and the client is considering purchasing common shares, the debt holdings give rise to a relationship between the issuer and the Member and its registrants that lends to the perception that they are not independent of one another and the prices of common securities may be affected by this conflict.

As in the proposed Rules, the NASD identifies certain debt holdings as relevant in regards to conflicts of interest. NASD Rule 2720(b)(7)(a) states that a conflict of interest is presumed to exist where the member and/or associated persons, parent or affiliates beneficially own 10% or more of the subordinated debt of a company.

Preferred Shares

Comment

The CBA questions why preferred shares of an issuer are included under the reporting and disclosure requirements and does not see this as giving rise to a conflict of interest.

Response

The inclusion of preferred shares was also included in the Hagg Report. There should be no distinction between common and preferred shares. Conflicts of interest occur regardless of whether the shares held are common or preferred. The NASD shares the view that conflicts of interest may exist where 10% or more of preferred shares are beneficially owned by a member and/or its associated persons, parent or affiliates (NASD Rule 2720(b)(7)(C)).

Furthermore, the CBA later on makes reference to the disclosure of conflict provisions found under sections 225 and 228 of the Regulations under the *Securities Act* (Ontario). Those provisions require disclosure prior to trading or recommending securities of the registrant. These requirements apply to all securities be they common equity, preferred equity or debt.

No Room on Trade Confirmation

Comment

The CBA states that there is no room on a trade confirmation for all of the required disclosure. They further submit that the required disclosure is neither relevant nor gives rise to a conflict of interest be it with respect to common shares, preferred shares or debt securities of an issuer.

Response

With respect to relevance, the Association is of the view that we have addressed this comment elsewhere in this response to comments. However, we reiterate that the ownership that pros have in a company is meaningful to investors as it makes transparent the financing of these companies. The participation by the pro group in the issuer is of relevance to a potential investor.

The industry has proven itself able through technological innovation to physically provide the disclosure that has been mandated by securities regulation.

General Conflicts

Comment

The CBA believes that the "General Conflicts" provision under section 29.31 is unduly broad and open-ended and should not be a regulatory requirement. The CBA states that it also provides no appreciable benefit to investors and will increase litigation over what a client thinks ought to have been a conflict in their view.

Response

The IDA believes that a general conflicts provision is necessary in order to capture scenarios not strictly covered in the proposed Rules; however, we acknowledge that it may not be feasible to "ensure" disclosure. Consequently, the IDA has removed that language so that a more reasonable efforts expectation is implied. A "reasonable client" test is consistent with tests found in common law and securities legislation (i.e. in the definitions of "material fact" and "material change".) The "reasonable" standard is also found throughout the IDA Rulebook (i.e. By-laws 29.12, 29.27, 38.11, 40.12; Regulations 1300.1, 1500.1 and Policies No. 1 and No. 2). Increases in litigation have not necessarily resulted due to the use of these reasonable person tests.

Although the CBA states that provisions in the proposed Rules are unduly broad, if the IDA attempted to draft provisions setting out every type of conflict of interest, the proposed Rules would be excessively detailed and complicated. Further, the industry has often stated that they do not desire overly prescriptive rules that do not adequately address the variances in business models and clients. The provision was also included in anticipation of the introduction of the new BC Code of Conduct, which contains numerous provisions dealing with conflicts of interest.

Specifically, section 16 of the Code requires procedures to be developed to resolve conflicts of interest and disclose them to the client. Furthermore, section 17 of the Code requires the prompt disclosure to the client of any information that a reasonable client would consider important for assessing the Member's ability to provide objective service or advice. As a result, we believe it is necessary for the IDA to include a general conflicts of interest disclosure provision.

The IDA expects its Members to use their expertise and business judgment to make determinations as to what may constitute a general conflict of interest (as they must do for determining material facts or changes).

Furthermore, as stated in the discussion paper, a Member Regulation Notice will provide guidance as to what types of situations will likely be caught by the general provision.

Exclusions From the Definition of "Pro Group Holdings"

Comment

Prior drafts of the proposed Rules allowed Members to deem an affiliate or associate not to be a member of the pro group where effective Chinese walls are in place. The current version of the proposed Rules now requires the prior approval of the Association. The CBA would like the previous version to stand.

Response

The IDA agrees. The proposed Rules have been amended.

Restrict Pro Group to the Deal Team

Comment

The CBA states that a more appropriate starting point for defining "pro group" is in the NASD Rules which treats as the pro group the deal team that participated in the public offering and not the entire firm. The CBA comments that there is no conflict of interest where an employee is wholly unconnected to the deal and purchases the securities in the secondary market.

Response

While NASD Rule 2710 does require those participating in a public offering (and their immediate family) to file a statement with the NASD disclosing if they hold 5% or more of any class of the issuer's securities, the Rule does not require this information to be disclosed to investors, nor does the Rule address private placements.

The IDA believes that the group should be broader than the "deal team" in any event, as ownership of the securities by others at the firm may still give rise to conflicts of interest. That view seems to be shared by the NASD as set out in NASD Rule 2720. This Rule requires disclosure to investors of conflicts of interest and is not simply restricted to the "deal team" of the member involved in the public offering. The ultimate result is that investors are provided with information that they can use when contemplating recommendations on securities in which the pro group has a significant investment.

The IDA agrees in part with the CBA statement that purchases in the secondary market do not give rise to conflicts of interest. As previously discussed, the scope of the proposed Rules has been reduced to only include those securities for which the Member is providing services related to a private placement or other offering. Thus it will not generally include trading in the secondary market. The goal is to focus on private placements, and public offerings where full information with respect to prices is difficult to find or the risk of market manipulation is higher.

Simplify the Required Disclosure

Simplify the Disclosure Requirements

Comment

The CBA states that the disclosure should be clear, uncomplicated and direct.

Response

The IDA has previously dealt with these comments.

Only Private Placements and No Debt

Comment

The CBA argues that the only conflicts of particular concern regard private placements and the by-law should exclude debt, which would be consistent with the exclusion of debt under National Instrument 33-105.

Response

To reiterate, we have addressed the comments as to what is of "particular concern" with respect to the situations that give rise to a conflict of interest.

Disclose "Material Amount" not Percentages

Comment

The CBA submits detailed information about ownership percentages would likely confuse investors and a better approach would be for a dealer to exercise its judgment concerning whether a "material amount" is held. The CBA suggests that a dealer could be required to simply disclose "we have a significant ownership stake".

Response

The IDA has addressed this comment earlier.

Alternative Approach

Comment

The CBA suggests an approach where an ownership limit of 20% is set beyond which an independent underwriter would be required. The CBA states that this would simplify compliance and disclosure and avoid costly databases for dealers.

Response

This approach is currently contained in National Instrument 33-105. Furthermore, is the CBA suggesting that conflicts of interest would be satisfied merely by requiring an independent underwriter without the need for disclosure to investors? This would not satisfy the underlying objectives of the conflicts of interest rules.

Form and Time Prescribed by the IDA

Comment

The CBA believes that subsection 29.28(1) that provides for disclosure of pro group holdings in a form and at the time prescribed by the IDA should be disclosed at this time so that the full impact of the proposal is clear and transparent.

Response

The IDA fully supports clear and transparent rules with input from the industry. We will ensure that Members have an opportunity for input to ensure proper compliance with this provision.

While the Association anticipates calculation of pro group holdings on a monthly basis and at the outset of an underwriting commitment until the position is extinguished, the use of the provision as currently worded allows the IDA to retain some flexibility to change the reporting requirement at a later time if determined necessary. In addition, the technical details regarding disclosure are more appropriately set out in a Notice rather than in the By-law. In this way requirements can be periodically updated in a more efficient way as issues arise. Maximum flexibility can be best achieved in this manner.

Entering into an "Understanding" with an Issuer

Comment

The CBA submits that triggering public disclosure based on an understanding under subsections 29.28(2) and 29.29(2) could constitute tipping. The CBA has issues with disseminating information prior to a public announcement by an issuer.

Response

The goal of these provisions is to make clients aware of circumstances in which a Member firm has an influence over the price or the market in some fashion with respect to certain securities and to ensure that investors have access to private placement opportunities that are suitable investments. These are important goals. Further, while these provisions do not constitute tipping, even if they could be misconstrued as such, securities legislation would take precedence over the proposed Rules.

No Formal Engagement

Comment

The CBA is unsure as to whether subsection 29.28(2) applies for a firm or registrant which receives a commission from an issuer because of the participation of clients where the firm does not have a formal engagement to act as an adviser, agent or underwriter.

Response

We are unclear as to what role the firm or registered representative is playing in the above scenario. How are the clients made aware of the issuer's private placement?

This may be an example where requiring disclosure based on an "understanding" would come into play. In the alternative, if an argument was to be made that such a situation would not fall under subsection 29.28(2), this type of scenario is precisely the type that we envision would be covered via the basket clause provision under section 29.31.

Duplication of Regulatory Requirements

Comment

The CBA believes that the proposed Rules are duplicative in certain respects and inconsistent in other respects with National Instrument 33-105 and sections 225 and 228 of the Regulation under the Securities Act (Ontario). The CBA takes note that the definition in National Instrument 33-105 and the proposed Rules differ and suggest that the definitions be revised for consistency.

Response

As discussed above, National Instrument 33-105 does not fully address all conflicts of interest deemed serious enough to warrant additional disclosure requirements, nor does it address other aspects of the proposed Rules regarding client priority and hold periods.

With respect to varying definitions, an explanation for the differences in definitions such as "associated party" and "associate" or "professional group" and "pro group" are clearly set out in the discussion paper.

Client Priority

Limited Benefit

Comment

The CBA is of the view that the client priority regime for private placements is onerous, complex and costly and will not benefit the majority of the investing public.

Response

First, the client priority rule was implemented in 1998 through Bulletin No. 2508 (September 11, 1998). Members

have been expected since then to be in compliance with the client priority rule and we have not been made aware of any issues with respect to costs and complexity.

Second, the benefits far outweigh the costs when the goal is to achieve fairness for the client.

Role of Registered Representative and Keeping Records

Comment

The CBA questions the intent of the rule in respect of situations where a registered representative does not ordinarily recommend a particular industry to clients because he or she does not follow that industry or has no expertise but the client may nevertheless be eligible to participate. The CBA states that the registered representative will have to keep records of every private placement and why he or she did or did not bring it to the attention of eligible clients.

Response

In the first instance, we question how Members currently address this situation if the client priority has already been implemented.

Nevertheless, the registered representative does not have to keep records of every private placement. First, records are only required under clause 29.28(5)(c) to demonstrate an effort to inform eligible clients of private placements. Second, registered representatives need not keep abreast of every private placement, simply the ones where the Member firm has entered into an agreement, commitment or understanding with the issuer and where the pro group holdings are more than 20% of the outstanding securities of a class of voting or equity securities of that issuer.

When attempting to analyze and subsequently follow the proposed Rules, it is important to focus on the intent. In this case, the rule is intended to make clients aware of suitable private placement offerings in circumstances where the firm has an influence over the private placement.

Contacting the Client and Record Keeping

Comment

The CBA queried if a registered representative could not contact a client, would it be sufficient that a message be left regarding an opportunity to participate in a private placement? Further, the CBA states that the requirement to keep records noting that the required disclosure has been made to a client would be a source for litigation if the investment fails.

Response

Clearly, the IDA simply expects firms to use reasonable efforts and measures to contact clients. Where a client cannot be reached, a message would be sufficient.

Proper record keeping will result in *protection* from litigation and causes for litigation would only arise if the recommendation was determined to be unsuitable for the client.

Eligible Clients

Comment

The CBA is concerned that the obligation to advise all "eligible" clients of the private placement may be misconstrued by some clients to be a recommendation. Alternatively, the CBA queries whether the Member will be exposed to regulatory and civil liability if the client is not advised of the private placement because the registrant did not believe it to be suitable.

Response

The proposed Rules are not intended nor should they be interpreted as taking priority over existing client suitability rules found in the IDA Rulebook and under securities legislation. The know-your-client requirement is one of the fundamental principles of securities law and any provisions in the IDA Rulebook must take into account the KYC rule.

Suitable Time Period and Reasonable Efforts

Comment

The CBA requests guidance regarding what a "suitable time period" is and what constitutes "reasonable efforts" to inform eligible clients. They also request that the Association considers distinguishing private placements of debt and equity securities as the proposed Rules may not make sense in application to private placements of debt.

Response

The Association expects firms to use their judgment and expertise in these matters. Whether a time period is suitable or reasonable efforts have been made depends on the relevant facts and circumstances of a particular case.

We have provided explanations above as to why the proposed Rules should be applied equally to both equity and debt (i.e. clients should be made aware of investments, particularly private placements which are not publicized and where a Member has an influence over the private placement).

May Conflict with SEC Regulation D and Rule 144A

Comment

The CBA notes that the client priority rule may conflict with other private placement rules prohibiting wide solicitation of private placements or conditioning the market. The CBA refers to SEC Regulation D and Rule 144A.

Response

As we discussed previously, Canadian securities legislation has priority over IDA Rules in the event of a conflict.

With respect to SEC requirements, the IDA is of the view that different markets require different responses. With a smaller market in Canada containing more illiquid securities and more uncertainties regarding issues surrounding pricing the proposed Rules respond appropriately to conflict of interest issues.

However, the IDA is of the view that there is no conflict with SEC requirements in these circumstances. The proposed Rules do not allow for the wide solicitation of private placements or for conditioning of the market as the CBA contends. Firstly, private placements may only be offered to eligible clients. In addition, both Canada and the U.S. have KYC requirements, which would have to also be taken into account.

The CBA refers to Rule 144A and Regulation D. Rule 144A allows for the resale of privately placed securities in that a resale during the hold period may be made to qualified institutional investors. Regulation D also provides criteria for exemptions for private placement offerings made to "accredited investors". The Regulation also specifically prohibits offers or sales by general solicitation or general advertising with respect to these offerings. The Association sees no conflict in these requirements to those contained in the proposed Rules or how the proposed Rules conflict with similar requirements found in Canada.

Outside of Members' Control

Comment

The CBA states that Members have little control over the issuance of a press release announcing a private placement or the time period between the announcement and the time in which it becomes available to pro group members.

Response

Often the Member will have input in these decisions due to their special relationship with the issuer. In other situations where there is less ability to control the situation, these would be factors that would be taken into account upon any sales compliance reviews of the Member by the Association.

Pre-Approval and Control of Associates

Comment

The CBA believes that pre-approval requirements for the re-sale by associates of employees may be impractical for a Member to enforce. Further, Members do not have the power to prevent associates of employees from qualifying the re-sale of their private placement securities by prospectus.

Response

While there are no "pre-approval requirements" there are certain factors that must be considered before holdings of the pro group can be qualified for re-sale under section 29.30.

Although the IDA acknowledges some challenges in ensuring certain associates of employees comply with the proposed Rules, by the very nature of an employee relationship with an associate, the employee would obviously be aware of an attempt to re-sell the securities via prospectus (i.e. the employee's wife wants to sell her securities over which the employee has discretionary authority, the partnership that the employee is involved with wants to sell the securities, etc.)

The challenges that may occur in enforcement are outweighed by the benefits achieved. Where hold periods are abridged, this gives rise for the opportunity for pros who hold a major investment to utilize public markets to cash out quickly, sometimes at significant premiums over the price recently paid for the private placement shares. This can result in unfairness in the marketplace.

Replacement of Member Regulation Notices

Comment

The CBA requests clarification as to whether By-law 29 replaces other Member Regulation Notices issued by other regulators dealing with conflict issues.

Response

The IDA can only comment on the Association's own Member Regulation Notices and Bulletins, which do not appear to conflict with the provisions of the proposed Rules. If the CBA is referring to Member Regulation Notices 0279 and 0267 regarding client priority in TSX Venture private placements, where the Member complies with the requirements set out in the notices, they would have made "reasonable efforts' for the purposes of the client priority rule.

Furthermore, any previously issued Bulletins or Notices issued by the SROs on the subject of conflicts of interest would likely no longer be in effect as member regulation functions have been transferred to the Association.

Exception to the Client Priority Rule

Comment

The CBA does not understand the exception to the client priority rule in subsection 29.29(1) which states in part: "if such trade or activity is in compliance with the by-laws, rules or regulations" of any exchange, regulation services provider, etc. The CBA is unclear how this provision is applied since all trades are done in compliance with the rules.

Response

This provision previously existed in the IDA Rulebook and any changes made were strictly housekeeping in nature.

Regulations 1300.17 and 1300.20 were previously deleted in anticipation of the consolidation of the client priority rule under By-law 29.3A. However, these Regulations allowed for an exemption from the client priority rule if the trade was "in compliance with they by-laws, rules or regulations of any recognized stock exchange or clearing corporation applicable thereto."

The reference to "in compliance" refers to the fact that strict client priority may not be required under other SRO rules. The SROs may use other priority rules, for example, the in-house client priority rule under section 5.3 of the Universal Market Integrity Rules.

The only change to Regulations 1300.17 and 1300.20 was to consolidate them all and revise it to include a reference to regulation services providers and quotation and trade reporting systems. This revision came about as a result of the implementation of National Instrument 21-101 Marketplace Operation and National Instrument 23-101 Trading Rules.