



**CIRCULAR**  
May 8, 2003

**EARLY WARNING – ESTABLISHING AND  
MAINTAINING ADEQUATE INTERNAL CONTROLS  
AMENDMENTS TO ARTICLE 7010 AND TO POLICY C-4**

The Special Committee – Regulatory Division of Bourse de Montréal Inc. (the “Bourse”) has approved amendments to article 7010 of the Rules and to Policy C-4 of the Bourse relating to the Early Warning System. These amendments become effective immediately.

Considering that the objective of the Early Warning System, as an instrument of advance warning, is to identify approved participants heading toward financial or operational difficulties, Policy C-4 of the Bourse has been amended to require approved participants to make, at least once a week, the calculation of the liquidity and capital tests of level 1 and/or level 2 of the Early Warning System and, at least once a month, the calculation of the profitability tests. Furthermore, any situation or circumstances that could place an approved participant in level 1 or level 2 of the Early Warning System after applying these tests shall be declared promptly to the Bourse by this approved participant.

Furthermore, in order to allow the Bourse to react more promptly when an approved participant triggers the Early Warning System, paragraphs 2) e) and 3) h) of article 7010 have been amended in order that the discretionary power to place an approved participant in level 1 or level 2 of the Early Warning System be in the hands of the Vice-President of the Regulatory Division instead of those of the Examination Sub-committee. However, any decision taken pursuant to this discretionary power shall be, even though it is effective immediately, ratified by the Examination Sub-committee within the next five (5) business days.

Furthermore, an additional amendment has been made to article 7010 in order to obligate approved participants to transmit to their external auditor and to the Canadian Investor Protection Fund copies of the notices they are required to send to the Bourse when there is a triggering of the Early Warning System. Also, in the case of a triggering of level 2 of the Early Warning a new provision has been added obligating approved participants to submit a business plan if required to do so by the Bourse.

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Finally, a new paragraph 5) has been added to article 7010 in order to make clearer what is the period of time during which an approved participant remains in the Early Warning System and at which point in time he is presumed to no longer be in it.

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Encl.

**7010 Early Warning System**

(01.09.89, 01.07.91, 01.10.92, 01.04.93, 11.03.98, 08.05.03)

- 1) No transaction, of the type of those described in subparagraph 2 e) iv) of the present article and the undertaking of which would place the approved participant into the Early Warning System, must be done without prior notice to the Vice-President of the Regulatory Division of the Bourse and prior written authorization from him to complete such transaction.
- 2) LEVEL 1        An approved participant is deemed to be in the early warning category Level 1 when one of the following situations occurs:
  - a) the risk adjusted capital of the approved participant is less than 5% of the aggregate of the total margin required for the approved participant;
  - b) the quotient based upon dividing the risk adjusted capital by the average (when the average is a loss) of the preceding six months net profit or loss (before interest on internal subordinated debt, bonuses, income taxes and extraordinary items) is:
    - i) for two consecutive months, greater or equal to 3, but less than 6;
    - ii) for the current month, greater or equal to 3, but less than 6 and for the preceding month, less than 3;
  - c) the risk adjusted capital of the approved participant is less than 6 times the net loss (before interest on internal subordinated debt, bonuses, income taxes and extraordinary items) of the approved participant for the current month;
  - d) the Early Warning Reserve is negative; or
  - e) the condition of the approved participant, at the discretion of the Vice-President of the Regulatory Division of the Bourse, is not satisfactory for any reason including, without limitation, financial or operating difficulties, problems arising from record keeping conversion or significant changes in clearing methods, the fact that the approved participant is a new approved participant or that he has been late in any required filing or reporting;

then, the following provisions apply:

- i) when in the normal course of its capital surveillance activities, the approved participant realizes that he has crossed the threshold that activates the Early Warning System Level 1, then he must promptly notify in writing the Vice-President of the Regulatory Division of the Bourse. The notice must be provided by letter signed by the Chief Executive Officer and the Chief Financial Officer, which letter must contain the following:
  - [1] which circumstances in paragraphs a), b), c) or d) are applicable;
  - [2] an outline of the problems associated with the circumstances that triggered the Early Warning;
  - [3] an outline of the proposal of the approved participant to rectify the problems identified; and

- [4] an acknowledgment that the approved participant is in an Early Warning category and that the restrictions contained in sub-paragraph iv) apply;

A copy of said notice must be provided to the approved participant's external auditor and to the Canadian Investor Protection Fund.

- ii) the Vice-President of the Regulatory Division of the Bourse must immediately designate the approved participant as being in Level 1 of the Early Warning System and must deliver to each of the Chief Executive Officer and Chief Financial Officer a letter containing the following:
  - [1] advice that the approved participant is designated as being in an Early Warning category;
  - [2] a request that the approved participant files its next monthly financial report no later than 10 business days thereafter or, in the discretion of the Vice-President of the Regulatory Division of the Bourse if he considers it to be necessary, at such earlier time following the end of the relevant month;
  - [3] a request that the approved participant provides the notice required under sub-paragraph e) i), if this has not already been done and any additional information as required in sub-paragraph e) iii) and a statement that the notices received pursuant to sub-paragraphs e) i) and e) iii), will be forwarded to the Canadian Investor Protection Fund and may be forwarded to any securities commission having jurisdiction over the approved participant ;
  - [4] advice that the restrictions referred to in subparagraph e) iv) of this article apply to the approved participant; and
  - [5] such other information as the Vice-President of the Regulatory Division of the Bourse considers relevant.
- iii) the Chief Executive Officer and the Chief Financial Officer of the approved participant must respond to the Vice-President of the Regulatory Division of the Bourse by letter signed by them both within five business days of receipt of the letter referred to in subparagraph e) ii), with a copy to be sent to the auditor of the approved participant, containing the information and acknowledgment required pursuant to sub-paragraph e) i) 2), 3) and 4), to the extent not previously provided, or an update of such information if any material circumstances or facts have changed;
- iv) if and so long as the approved participant remains designated as being in this Early Warning category, it must not, without the prior written consent of the Vice-President of the Regulatory Division of the Bourse:
  - [1] reduce its capital in any manner including the redemption, re-purchase or cancellation of any of its shares;
  - [2] reduce or repay any indebtedness which has been subordinated with the approval of the Bourse;
  - [3] directly or indirectly make any payments by way of loan, advance, bonus, dividend, repayment of capital or other distribution of assets to any director, officer, partner, shareholder, related company or affiliate; or

- [4] increase its non allowable assets unless a prior binding commitment to do so exists or enter into any new commitments which would have the effect of materially increasing to non allowable assets of the approved participant;
- v) if and so long as the approved participant remains designated as being in this Early Warning category, it must continue to file its monthly financial reports within the time specified pursuant to subparagraph e) ii) 2);
- vi) as soon as practicable after the approved participant is designated as being in this Early Warning category, the Vice-President of the Regulatory Division of the Bourse must conduct an on-site review of the approved participant's procedures for monitoring capital on a daily basis and prepare a report as to the results of the review;
- vii) the Vice-President of the Regulatory Division of the Bourse must also advise the Examination Sub-committee of the fact that an approved participant has been designated as being in an Early Warning Category Level 1 without naming the approved participant.

Any decision taken by the Vice-President of the Regulatory Division of the Bourse under subparagraph e) of the present article is effective immediately. However, it must be ratified by the Examination Sub-committee of the Bourse within the next five (5) business days.

- 3) LEVEL 2      An approved participant is deemed to be in Early Warning category Level 2 when one of the following situations occurs:
  - a) risk adjusted capital of the approved participant is less than 2% of the aggregate of the total margin required for the approved participant;
  - b) the quotient based upon dividing the risk adjusted capital of the approved participant by the average (where the average is a loss) of the preceding six months net profit or loss (before interest on internal subordinated debt, bonuses, income taxes and extraordinary items) is:
    - i) less than 3, for two successive months;
    - ii) greater or equal to 3, but less than 6 for the current month and less than 3 for the preceding month;
  - c) the sum (where the sum is a loss) of the preceding three months net profit or loss (before interest on internal subordinated debt, bonuses, income taxes and extraordinary items) exceeds the risk adjusted capital at the end of the third month;
  - d) the risk adjusted capital of the approved participant is less than three times the net loss (before interest on internal subordinated debt, bonuses, income taxes and extraordinary items) of the approved participant for the immediately preceding completed month;
  - e) the Early Warning Excess is negative;
  - f) the approved participant has been on Early Warning 3 times in the last 6 month period;
  - g) one or the other of the two profitability tests triggers Level 1 in conjunction with capital or liquidity tests of Level 1;

- h) the condition of the approved participant, at the discretion of the Vice-President of the Regulatory Division of the Bourse, is not satisfactory for any reason including, without limitation, financial or operating difficulties, problems arising from record keeping conversion or significant changes in clearing methods, the fact that the approved participant is a new approved participant or that he has been late in any required filing or reporting;

then, the following provisions must apply in addition to the provisions of Level 1 which must continue to apply, except to the extent inconsistent with paragraph 3:

- i) when in the normal course of its capital surveillance activities, the approved participant realizes that he has crossed the threshold that activates the Early Warning System Level 2, then he must promptly notify in writing the Vice-President of the Regulatory Division of the Bourse. The notice must be provided by letter signed by the approved participant's Chief Executive Officer and Chief Financial Officer;
- ii) the approved participant must file a weekly financial report containing the same information required in a monthly financial report no later than 5 business days or, if the Vice-President of the Regulatory Division of the Bourse considers it to be necessary, at such earlier time;
- iii) the Chief Executive Officer and the Chief Financial Officer of the approved participant must attend at the offices of the Bourse to outline the proposals of the approved participant for rectifying the problems which account for the approved participant being designated as being in Early Warning Category Level 2;
- iv) the approved participant must report weekly in a format satisfactory to the Vice-President of the Regulatory Division of the Bourse aged segregation deficiencies and indicate their resolution;
- v) the approved participant must pay the costs associated with any special examination or monitoring deemed necessary by the Vice-President of the Regulatory Division of the Bourse ;
- vi) the approved participant may be subject, at the discretion of the Vice-President of the Regulatory Division of the Bourse, to a reduced allowable free credit ratio;
- vii) the Vice-President of the Regulatory Division of the Bourse may require from the approved participant and the latter must then elaborate and provide, in such time and for such period as the Vice-President of the Regulatory Division of the Bourse deems expedient, a business plan relating to its business in order to answer his questions;
- viii) the Vice-President of the Regulatory Division of the Bourse may request from the approved participant and the latter must then provide in such time as the Vice-President of the Regulatory Division of the Bourse deems expedient, such reports or information, on a daily or a less frequent basis, as may be necessary or desirable in the opinion of the Vice-President of the Regulatory Division of the Bourse to assess and monitor the financial condition or operations of the approved participant;
- ix) the Vice-President of the Regulatory Division of the Bourse, as soon as practicable after he has designated an approved participant as being in Level 2 of the Early Warning System, must prepare and submit a report to the Examination Sub-committee outlining the financial and operational conditions of the approved participant and must, at its request, identify the approved participant to the Examination Sub-committee;

- x) the Examination Sub-committee may in its discretion, without according the approved participant a hearing, prohibit or restrict an approved participant from opening any new branch offices, hiring any new registered representatives, opening any new customer accounts or changing in any material respect its inventory positions;
- xi) the Vice-President of the Regulatory Division of the Bourse must promptly advise any other participating institution of the Canadian Investor Protection Fund of which the approved participant is also a member, of the fact that the approved participant has been designated as being in Level 2 of the Early Warning System, the reasons for such designation and any sanctions or restrictions that have been imposed upon the approved participant pursuant to paragraph 3 of this article.

Any decision taken by the Vice-President of the Regulatory Division of the Bourse under subparagraph h) of the present article is effective immediately. However, it must be ratified by the Examination Sub-committee of the Bourse within the next five (5) business days.

- 4) Requirements imposed in this article must continue to apply until the approved participant is no longer designated as being in Level 1 or Level 2 of the Early Warning System as demonstrated by the latest filed monthly financial report of the approved participant.
- 5) An approved participant shall remain designated as being in level 1 or level 2 of the Early Warning System, as the case may be, and pursuant to the present article, until the latest filed Monthly Financial Report of the approved participant demonstrates, in the opinion of the Vice-President of the Regulatory Division of the Bourse, that the approved participant is no longer required to be designated as being in one of the levels of the Early Warning System and that he has otherwise complied with the present article.

## **POLICY C-4**

### **ESTABLISHING AND MAINTAINING ADEQUATE INTERNAL CONTROLS** (26.01.96, 08.05.03)

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#### **I. CAPITAL ADEQUACY**

This section focuses on the monitoring of an approved participant's capital position, principally through its system of management reporting. The effectiveness of such monitoring depends in large measure on the timeliness, completeness and accuracy of the accounting books and records from which those management reports are drawn. Establishing and maintaining policies and procedures to ensure such timeliness, completeness and accuracy is part of an approved participant's responsibility for internal control. However, these matters are outside the scope of the present section.

##### **A) Control objective**

To monitor and act upon information produced by the management reporting system so that Risk Adjusted Capital is maintained at all times in an amount at least equal to the minimum required by regulation.

##### **B) Minimum required approved participant policies and procedures**

1. The Chief Financial Officer is responsible for continuous monitoring of the capital position of the approved participant to ensure that at all times Risk Adjusted Capital is maintained as prescribed by the Bourse regulation.
2. The approved participant's planning process recognizes the projected capital requirements resulting from current and planned business activities.
3. Activity limits for the major functional areas of the approved participant (such as capital markets, principal trading, borrowing/ lending, etc.) are designed to ensure that the combined operations of the approved participant maintain at least the minimum required amount of Risk Adjusted Capital.
4. Such activity limits are approved by senior management and communicated to the executives responsible for the various major functional areas. Actual performance is compared to such limits by the Chief Financial Officer or designated person assigned the task of monitoring the capital position, and breaches are reported promptly to senior management.
5. At least weekly, but more frequently if required (e.g. the approved participant is operating close to early warning levels or volatile market conditions exist), the Chief Financial Officer or designated person assigned the task for monitoring the capital position documents that he/she has:
  - a) received management reports produced by the accounting system showing information relevant to estimation of the capital position;
  - b) obtained other information concerning items that, while they may not yet be recorded in the accounting system, are likely to significantly affect the capital position (e.g. bad and doubtful



- debts, unreconciled positions, underwriting and inventory commitments and margin requirements);
- c) estimated the capital position, compared it to planned capital limits and the prior period, and reported adverse trends or variances to senior management; and
  - d) proceeded to the calculation of the liquidity and capital tests of level 1 and/or level 2 of the early warning in accordance with the provisions of article 7010. In addition, at least once a month, proceed to the calculation of the profitability tests of level 1 and/or level 2 of the early warning in accordance with the provisions of article 7010.
- 6. Senior management takes prompt action to avert or remedy any projected or actual capital deficiency and reports any deficiencies, when required, immediately to the appropriate regulators. In addition, senior management promptly reports to the Bourse any situations or circumstances that may have as a consequence to include the approved participant in level 1 or level 2 of the early warning following the application of the liquidity, capital or profitability tests of article 7010.
  - 7. The month-end estimate of required and Risk Adjusted Capital is reconciled to the Monthly Financial Report submitted for regulatory filing. Material discrepancies are investigated and steps taken to preclude re-occurrence.
  - 8. At least annually, there is a documented supervisory review of the approved participant's management reporting system related to capital, to identify and implement changes required to reflect developments in the business or in regulatory requirements.

**C) Indications that internal control is not adequate**

- 1. The accounting system produces information that is late or requires correction.
- 2. Staff responsible for preparing Risk Adjusted Capital reports lack an understanding of the regulatory requirements.
- 3. The Chief Financial Officer or the person designated with the supervisory task of monitoring the capital position of the approved participant lacks an understanding of the business and of the different functional areas of the firm and cannot properly evaluate their activities level and capital/risk implications for the firm.
- 4. No steps are taken to establish the reliability of management reports utilized to monitor the capital position.
- 5. Planning procedures fail to take into account the impact of planned activities on required capital.
- 6. The approved participant is operating unexpectedly near its early warning levels.
- 7. The approved participant experiences significant unexpected changes in its capital position.

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