

13.1.3 IDA Policy No. 4 - Minimum Standards for Institutional Account Opening, Operation and Supervision

INVESTMENT DEALERS ASSOCIATION OF CANADA – POLICY NO. 4 - MINIMUM STANDARDS FOR INSTITUTIONAL ACCOUNT OPENING, OPERATION AND SUPERVISION

I OVERVIEW

A Current Rules

In 1993, Minimum Standards for Retail Account Supervision came into force in order to not only ensure that registered representatives comply with the rules of the relevant self-regulatory organizations, but that supervisory personnel have guidance in exercising their responsibilities for compliance with the relevant by-laws, regulations and policies. In 1996, proposed Minimum Standards for Institutional Account Opening, Operation and Supervision were designed to do the same with respect to institutional accounts.

The Board of Directors first approved the Policy on June 18, 1996 and it was published for comment in the Ontario Securities Commission Bulletin on August 30, 1996 (the "1996 Policy"). No public comments were received, although the OSC did have some minor drafting comments at the time. In the interim, discount brokers began seeking an application for relief from general suitability obligations. It was determined that until the issue of suitability was resolved in the retail business, further development of the Policy should be delayed and then reconsidered in the context of changes to the suitability regime in Canada. Once those matters were resolved, the Compliance and Legal Section's Institutional Sub-Committee began to review and redraft the Policy.

On April 25, 2003 the Ontario Securities Commission published for comment proposed Policy No. 4, which sets out the Minimum Standards for Institutional Accounts. One comment letter was received on the proposals in addition to comments from staff of the Canadian Securities Administrators (CSA). In November 2004, at the request of the OSC, the Association withdrew the proposed Policy and informed the OSC that we intended to resubmit a revised version of the Policy, which would address the comments received on the version published on April 25, 2003. This revised version ("revised Policy No. 4") now also reflects discussion with OSC staff with respect to the issue of suitability for Institutional Accounts.

B The Issue

Current IDA rules do not provide procedures for opening institutional accounts, account suitability review and supervision of these accounts. As a consequence, the Policy was developed several years ago and modified more recently.

C Objective

Customers of Members fall into two major categories – retail and institutional. Most Members have separate departments to deal with the different types of customers. Some firms specialize in dealing with only one of these two major types of customers. Policy No.2 - Minimum Standards for Retail Account Supervision provides guidance for opening retail accounts; however, rules for institutional accounts have been informal.

D Effect of Proposed Policy

The Policy will ensure that Members apply institutional standards in a consistent and equitable manner.

II DETAILED ANALYSIS

A Present Rules, Relevant History and Proposed Policy

Overview

The present IDA rules set out the general requirements for know-your-customer and suitability in Regulation 1300. By-law 29.27 generally requires firms to establish supervisory systems and written policies and procedures regarding the conduct for the types of business in which a Member engages. Additional guidance on know-your-customer, suitability and general supervision requirements is found in Policy No. 2 - Minimum Standards for Retail Account Supervision. These standards provide guidance on items such as:

1. establishing and maintaining procedures, delegation and education;
2. opening new accounts;
3. branch and head office account supervision.

Further guidance is needed on the same matters for institutional accounts. Consequently, Policy No. 4 provides guidance on:

1. the definition of an institutional account;
2. customer suitability;
3. opening new accounts;
4. establishing and maintaining procedures, delegation and education;
5. account supervision.

The approach contained in the Policy is flexible and will depend upon the nature of the firm, its procedures and its customers. The implementation of the Policy will require that each Member review its business activities and determine the manner in which the Policy is to be applied.

Definition of Institutional Customer

The CLS Institutional Sub-Committee reviewed current definitions in the IDA Rules, in addition to definitions of “accredited investor” under OSC Rule 45-501 Exempt Distributions and “retail customer” under National Instrument 33-102 Regulation of Certain Registrant Activities. An institutional customer is an acceptable counterparty, acceptable institution, regulated entity, registrant or non-individual with total securities under administration or management exceeding \$10 million.

Suitability Obligation

The Policy defines institutional account and enumerates factors, which will be considered in determining whether the Member’s suitability obligation owed to an institutional customer has been fulfilled.

Revised Policy No. 4 was modified to address suitability. Suitability must be determined for an institutional customer. The trade will be suitable if the Member concludes that the customer is capable of making an independent investment decision and independently evaluating the investment risk for a particular transaction. If no reasonable grounds exist for making these conclusions then the Member must take steps to ensure that the institutional customer fully understands the investment product, including the potential risks. The Policy provides a list of factors to consider when deciding whether the customer is capable of independently evaluating investment risk and is exercising independent judgment.

These factors are based upon NASD Interpretation IM 2310-3 discussed below.

Suitability Exemption

Revised Policy No. 4 exempts from the suitability requirement trades executed on the instructions of another Member, a portfolio manager, investment counsel, limited market dealer, bank, trust company or insurer. This exemption parallels those found in various securities legislation, which do not require a suitability determination to be made by a dealer who executes a trade on the instructions of another dealer, investment counsel, portfolio manager or financial institution.

B Issues and Alternatives Considered

There were no other alternatives considered.

C Comparison with Similar Provisions

The suitability provisions in the Policy were based, in part, on NASD Interpretation IM-2310-3 entitled Suitability Obligations to Institutional Customers. Under the NASD interpretation, once a member has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk (based on enumerated factors), then a member’s obligation to determine that a recommendation is suitable for a particular customer is fulfilled.

Both revised Policy No. 4 and the NASD Rule recognize that these factors are guidelines only and a determination must be made on a case-by-case basis taking into consideration the factors and circumstances of a particular Member-customer relationship.

In the United Kingdom, The Financial Services Authority has suitability requirements only for private customers. The private customers definition parallels the definition of retail customers in Canada. When the customer is an intermediate or market counterparty, similar to an institutional customer in Canada, then the adviser is specifically exempt from suitability requirements.

D Systems Impact of Policy

It is not anticipated that the Policy will have a significant impact on Members' systems as most firms that have institutional customers already have systems in place to monitor and supervise these accounts.

E Best Interests of the Capital Markets

The Board has determined that the public interest Policy is not detrimental to the best interests of the capital markets.

F Public Interest Objective

The Policy addresses the need for completing the guidance available to Members in satisfying know-your-customer and suitability rules in the context of institutional accounts. In addition, the Policy provides guidance and procedures, which will standardize industry practices and ensure increased customer protection.

The proposal does not permit unfair discrimination among customers, issuers, brokers, dealers, Members or others. It does not impose any burden on competition that is not necessary or appropriate in furtherance of the above purposes.

III COMMENTARY

A Filing in Other Jurisdictions

These proposed amendments will be filed for approval in Alberta, British Columbia, Ontario and Quebec and will be filed for information in Manitoba, Nova Scotia and Saskatchewan.

B Effectiveness

The Policy is an effective means of providing guidance and consistent standards for Members who operate institutional accounts.

C Process

The Policy was developed by the Compliance and Legal Section's Institutional Sub-Committee and has been recommended for approval by the Compliance and Legal Section.

IV SOURCES

References:

- IDA By-law 29.27
- IDA Regulation 1300
- IDA Policy No. 2 Minimum Standards for Retail Account Supervision
- IDA Form 1 Joint Regulatory Financial Questionnaire and Report, definition section
- OSC Rule 45-501 Exempt Distributions, definition of "accredited investor"
- National Instrument 33-102 Regulation of Certain Registrant Activities, definition of "retail customer"
- Policy 7.1 of UMIR entitled "Policy on Trading Supervision Obligations"
- NASD Interpretation IM-2310-3 Suitability Obligations to Institutional Customers
- NASD Rule 3310(c)4
- Financial Services Authority Handbook, Principles for Businesses, Chapter 1.2 Introduction: Customers and the Principles and Conduct of Business, Chapter 4.1 Accepting Customers: Customer Classification, Chapter 5.2 Know your customer, Chapter 5.3 Suitability, SIFA Section 9.9 Suitability
- Alberta Securities Commission Rules ss. 30(7)

- British Columbia Securities Commission Rules ss. 49(3) [prior to the enactment of the new Securities Act]
- Nova Scotia Securities Commission Regulations ss. 31(5)
- Saskatchewan Securities Commission Regulations ss. 26(5)

V OSC REQUIREMENT TO PUBLISH FOR COMMENT

The IDA is required to publish for comment the accompanying Policy.

The Association has determined that the entry into force of the proposed Policy would be in the public interest. Comments are sought on the proposed Policy. Comments should be made in writing. One copy of each comment letter should be delivered within 30 days of the publication of this notice, addressed to the attention of Michelle Alexander, Investment Dealers Association of Canada, Suite 1600, 121 King Street West, Toronto, Ontario, M5H 3T9 and one copy addressed to the attention of the Manager of Market Regulation, Ontario Securities Commission, 20 Queen Street West, 19th Floor, Box 55, Toronto, Ontario, M5H 3S8.

Questions may be referred to:

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INVESTMENT DEALERS ASSOCIATION OF CANADA
POLICY NO. 4 – MINIMUM STANDARDS FOR INSTITUTIONAL ACCOUNT OPENING, OPERATION AND SUPERVISION

THE BOARD OF DIRECTORS of the Investment Dealers Association of Canada hereby makes the following amendments to the By-laws, Regulations, Forms and Policies of the Association:

1. By adding new Policy No. 4 as follows:

“POLICY NO. 4
MINIMUM STANDARDS FOR INSTITUTIONAL ACCOUNT OPENING,
OPERATION AND SUPERVISION

INTRODUCTION

This Policy covers the opening, operation and supervision of institutional accounts, which are accounts for investors that are not individuals who meet the requirements of the definition herein.

This document sets out minimum standards governing the opening, operation and supervision of institutional accounts.

Pursuant to IDA By-laws 29.27 and 38, the Member must provide adequate resources and qualified supervisors to achieve compliance with these standards.

Adherence to the minimum standards requires that a Member have in place procedures to properly open and operate institutional accounts and monitor their activity. Following these minimum standards, however, does not:

- (a) relieve a Member from complying with specific SRO by-laws, rules, regulations and policies and securities or other legislation applicable to particular trades or accounts; (e.g. best execution obligation, restrictions on short selling, order designations and identifiers, exposure of customer orders, trade disclosures);
- (b) relieve a Member from the obligation to impose higher standards where circumstances clearly dictate the necessity to do so to ensure proper supervision; or
- (c) preclude a Member from establishing higher standards.

Any account which is not an institutional account governed by these standards will be governed by the Minimum Standards for Retail Account Supervision (Policy No. 2).

A Member may, with the written approval of the Association, establish policies and procedures that differ from this Policy, provided that, in the opinion of the Association, the Member's policies and procedures are appropriate to supervise trading of its institutional customers.

I. ACCOUNT OPENING

A. Definition of an Institutional Customer

For the purposes of this Policy, the following are defined as institutional customers:

1. Acceptable Counterparties (as defined in Form 1);
2. Acceptable Institutions (as defined in Form 1);
3. Regulated entities (as defined in Form 1);
4. Registrants (other than individual registrants) under securities legislation;
5. A non-individual with total securities under administration or management exceeding \$10 million.

B. Customer Suitability

1. When dealing with an institutional customer, a Member must make a determination whether the customer is sufficiently sophisticated and capable of making its own investment decisions in order to determine the level of suitability owed to that institutional customer. Where a Member has reasonable grounds for concluding that the institutional customer is capable of making an independent investment decision and independently

evaluating the investment risk, then a Member's suitability obligation is fulfilled for that transaction. If no such reasonable grounds exist, then the Member must take steps to ensure that the institutional customer fully understands the investment product, including the potential risks.

2. In making a determination whether a customer is capable of independently evaluating investment risk and is exercising independent judgment, relevant considerations could include:
 - i any written or oral understanding that exists between a Member and its customer regarding the customer's reliance on the Member;
 - ii the presence or absence of a pattern of acceptance of the Member's recommendations;
 - iii the use by a customer of ideas, suggestions, market views and information obtained from other Members, market professionals or issuers particularly those relating to the same type of securities;
 - iv the use of one or more investment dealers, portfolio managers, investment counsel or other third party advisors;
 - v the general level of experience of the customer in financial markets;
 - vi the specific experience of the customer with the type of instrument(s) under consideration, including the customer's ability to independently evaluate how market developments would affect the security and ancillary risks such as currency rate risk; and
 - vii the complexity of the securities involved.
3. No suitability obligation shall exist pursuant to Section B(1) nor is a determination required under Section B(2) where a Member executes a trade on the instructions of another Member, a portfolio manager, investment counsel, limited market dealer, bank, trust company or insurer.

C. New Account Documentation and Approval

The following documentation is required for each institutional account opening:

1. New customer account form; and
2. All documentation as required by the self-regulatory organization governing the Member.

The Member may establish a 'master' new account documentation file, containing full documentation and, when opening sub-accounts, it should refer to the principal or 'master' account with which it is associated.

Each new account must be approved by the Department Head or his/her designate who is a partner, director or officer, prior to the initial trade or promptly thereafter. Such approval must be documented in writing or auditable electronic form.

The Member must exercise due diligence to ensure that the new customer account form is updated whenever the Member becomes aware that there is a material change in customer information.

**II. ESTABLISHING AND MAINTAINING PROCEDURES,
DELEGATION AND EDUCATION**

Introduction

Effective self-regulation begins with the Member establishing and maintaining a supervisory environment which fosters both the business objectives of the Member and maintains the self-regulatory process. To that end, a Member must establish and maintain procedures which are supervised by qualified individuals.

A. Establishing Procedures

1. Members must appoint a designated supervisor, who is a partner, director or officer and has the necessary knowledge of industry regulations and Member policy to properly establish procedures reasonably designed to ensure adherence to regulatory requirements and to supervise Institutional Accounts.
2. Written policies must be established to document and communicate supervisory requirements.

3. All supervisory alternates must be advised of and adequately trained for their supervisory roles.
4. All policies established or amended should have senior management approval.

B. Maintaining Procedures

1. Evidence of supervisory reviews must be maintained for seven years and on-site for one year.
2. A periodic review of supervisory policies and procedures should be carried out by the Member to ensure they continue to be effective and reflect any material changes to the businesses involved.

C. Delegation of Procedures

1. Tasks and procedures may be delegated but not responsibility.
2. The supervisor delegating the task must take steps designed to ensure that these tasks are being performed adequately and that exceptions are brought to his/her attention.
3. Those to whom tasks are delegated must have the qualifications to perform them and should be advised in writing what is expected.

D. Education

A major aspect of self-regulation is the ongoing education of staff. The Member is responsible for appropriate training of institutional sales and trading staff, as well as ensuring that Continuing Education requirements are being met.

E. Compliance Monitoring Procedures

Members must establish compliance procedures for monitoring and reporting adherence to rules, regulations, requirements, policies and procedures. A compliance monitoring system should be reasonably designed to prevent and detect violations. The compliance monitoring system will ordinarily include a procedure for reporting results of its monitoring efforts to management and, where appropriate, the Board of Directors or its equivalent.

III. SUPERVISION OF ACCOUNTS

A. Policies and Procedures

1. Members must implement policies and procedures for the supervision and review of activity in the accounts of institutional customers. Such procedures may include periodic reviews of account activity, exception reports or other means of analysis.
2. The policies and procedures may vary depending on factors including, but not limited to, the type of product, type of customer, type of activity or level of activity.
3. The policies and procedures should outline the action to be taken to deal with problems or issues identified from supervisory reviews.

B. Account Activity Detection

The supervisory procedures and the compliance monitoring procedures should be reasonably designed to detect account activity that is or may be a violation of applicable securities legislation, requirements of any self-regulatory organization applicable to the account activity and the rules and policies of any marketplace on which the account activity takes place, and would include the following:

1. Manipulative or deceptive methods of trading;
2. Establishing artificial prices;
3. Trading in restricted list securities;
4. Employee or proprietary account frontrunning;
5. Sales from control blocks;

SRO Notices and Disciplinary Proceedings

6. Exceeding position or exercise limits on derivative products; and
7. Transactions raising a suspicion of money laundering or terrorist financing activity.”

PASSED AND ENACTED BY THE Board of Directors this 19th day of January 2005, to be effective on a date to be determined by Association staff.