Chapter 13

SROs, Marketplaces and Clearing Agencies

13.1 SROs

13.1.1 OSC Staff Notice of Commission Approval – MFDA Amendments to MFDA Rule 2.2.1 and Policy No. 2

OSC STAFF NOTICE OF COMMISSION APPROVAL

MUTUAL FUND DEALERS ASSOCIATION OF CANADA (MFDA)

MFDA AMENDMENTS TO MFDA RULE 2.2.1 (KNOW-YOUR-CLIENT) AND POLICY NO. 2 MINIMUM STANDARDS FOR ACCOUNT SUPERVISION

The Ontario Securities Commission approved the MFDA's amendments to MFDA Rule 2.2.1 and amendments to Policy No. 2 regarding suitability obligations including criteria for the purpose of assessing the suitability of borrowing to invest ("leverage").

The British Columbia Securities Commission has approved the amendments. The Alberta Securities Commission, the Saskatchewan Financial Services Commission, the Manitoba Securities Commission, the New Brunswick Securities Commission and the Nova Scotia Securities Commission did not object to the MFDA's amendments.

Summary of Material Rule

The amendments to the rule and policy set out general obligations for members and approved persons to establish policies and procedures to assess the suitability of the use of leverage as part of a member's overall obligation to assess investment suitability in relation to client accounts and client transactions.

The MFDA made the following changes to the current Rule 2.2.1 and Policy No. 2:

- clarified that the suitability of leverage must be assessed having regard to the client's investment knowledge, risk tolerance, age, time horizon, net worth, income, and investment objectives;
- codified minimum criteria standards for members and approved persons in assessing the suitability of client leveraging;
- provided guidance on the type of documents the MFDA's members will be required to review and maintain to facilitate proper supervision of a leveraging strategy;
- clarified the respective obligations of the registered salesperson and branch and head office supervisory staff in assessing the suitability of investments and leveraging strategies; and
- clarified that the obligation to review leveraged trades and leverage recommendations at the branch and head office applies to accounts, other than registered retirement savings plans and registered education savings plans.

Summary of Public Comments

The OSC published the amendments for comment on July 8, 2011 at (2011) 34 OSCB 7716 for a 90-day comment period. The MFDA received eight comment letters. The MFDA summarized the comments it received on the proposal and provided responses. We attach the MFDA's summary of public comments received and responses as Attachment A. We also attach a blacklined copy of Policy No. 2 showing changes to the version published for comment as Attachment B.

Attachment A

Summary of Public Comments Respecting Proposed Amendments to MFDA Rule 2.2.1 ("Know-Your-Client") and Policy No. 2 *Minimum Standards for Account Supervision* and Responses of the MFDA

On July 8, 2011, the British Columbia Securities Commission published proposed amendments to MFDA Rule 2.2.1 ("Know-Your-Client") and Policy No. 2 *Minimum Standards for Account Supervision* (the "**Proposed Amendments**") for a 90-day public comment period.

The public comment period expired on October 6, 2011.

Eight submissions were received during the public comment period:

1. Kenmar Associates ("Kenmar")
2. J.C. Hood Investment Counsel Inc. ("J.C. Hood")
3. Royal Mutual Funds Inc. ("RMFI")/Phillips, Hager & North Investment Funds Ltd. ("PH&N")
4. The Investment Funds Institute of Canada ("IFIC")
5. BMO Investments Inc. ("BMOII")
6. Desjardins Group ("Desjardins")
7. Canadian Foundation for Advancement of Investor Rights ("FAIR")
8. Joe Killoran

A copy of the comment submission may be viewed on the MFDA website at: http://www.mfda.ca/regulation/comments.html#221.

The following is a summary of the comments received, together with the MFDA's responses.

General Comments

Kenmar, FAIR and Desjardins expressed general support for the intent of the Proposed Amendments. A number of commenters cited examples of unsuitable leverage practices generally or unsuitable advice/practices encountered as a result of calls received from investors.

Several commenters agreed that MFDA Policies are an effective means of ensuring consistent and objective minimum industry standards, but expressed the view that certain aspects of Policy No. 2 are overly prescriptive and would be better suited as guidance to Members. BMOII suggested that such prescriptive elements be included in the Leverage Supervision Guide as suggested practices. RMFI/PH&N and BMOII noted that Policies should be principles-based to allow Members the flexibility to implement policies and procedures that correspond to their business models and risks.

IFIC and BMOII noted that dealers have implemented robust compliance systems to supervise the use of leverage and, as a result, the Proposed Amendments should regulate the use of leverage without creating duplicative or burdensome requirements. IFIC and BMOII expressed support for the use of a risk-based approach when ensuring compliance for the use of leverage, as dealers should focus their resources on resolving higher risk issues as opposed to complying with prescriptive rules.

FAIR recommended that there should be a presumption that leverage is unsuitable for retail investors, with the onus on salespeople to prove that leverage is suitable and that clients understand the risks. FAIR was of the view that some Approved Persons and firms suggest the idea of leverage to consumers and persuade consumers to borrow money to invest by presenting a misleading picture of the risks and benefits of leverage. FAIR suggested that advisors and firms are incented to do so because of a misalignment between the interests of the financial intermediary and those of the consumer.

MFDA Response

Staff acknowledges support for the Proposed Amendments and comments citing examples of unsuitable leverage advice/practices. The Proposed Amendments, in conjunction with the revised leverage risk disclosure in MR-0074 *Leverage Risk Disclosure*, guidance in MR-0069 *Suitability Guidelines* and the Leverage Supervision Guide, have been developed to address such issues and staff is satisfied that they meet their regulatory objectives. We note that, as a result of guidance issued

by the MFDA and the efforts of Members to date, compliance systems to supervise leverage generally have been implemented at Member firms.

Policy No. 2 currently sets out a general obligation for Members to have policies and procedures to assess the suitability of leverage, but does not set minimum criteria in this area. The Proposed Amendments to Policy No. 2 are intended to codify the guidance in MR-0069 for the purpose of establishing such minimum criteria. Most Members currently comply with the guidelines in MR-0069 and MFDA staff is of the view that including minimum criteria in the Policy will ensure consistent and objective minimum industry standards for assessing leverage suitability for the benefit of Members and investors. Policy No. 2 currently uses a combination of prescriptive and principles based requirements.

In the view of staff, a general presumption of leverage unsuitability across all retail clients does not take into account the requirement to consider the circumstances of each client, as required under MFDA Rules and securities legislation. As set out under Rule 2.2.1, as revised, the suitability of orders accepted or recommendations made, including leverage recommendations and transactions involving the use of borrowed funds, must be determined having regard to the essential facts relative to the client and any investments in the account.

Rule 2.2.1

Rule 2.2.1(f)(iii) – Requirement for Leverage Suitability Review on Change in Approved Person Responsible for Client Account

IFIC agreed that an Approved Person should be familiar with leveraging strategies used in accounts under their name, but questioned whether a full suitability review of the leveraged account is required in such circumstances. IFIC noted that the leveraging strategy would have been reviewed previously within the dealer and approved in accordance with the dealer's policies and procedures. The change of Approved Person would not cause a leveraging strategy that was previously reviewed and found to be suitable and compliant to become non-compliant. IFIC recommended that this requirement be removed from Rule 2.2.1 and section III (Registered Salespersons) of Policy No. 2.

BMOII supported IFIC's comments and noted that its accounts are not assigned to specific Approved Persons and clients can be served by any appropriately registered Approved Person at the Member. BMOII sought confirmation that, in such circumstances, the Proposed Amendments are not intended to require any Approved Person who handles the account to re-assess the suitability of a leverage strategy.

MFDA Response

Under current Policy No. 2, Approved Persons are already required to review the client's KYC information where they have been assigned responsibility for a client's account. This requirement follows from the obligation under Rule 2.2.1(e)(iii) for the suitability of investments within each client's account to be assessed by the new Approved Person when there has been a change in the Approved Person responsible for the client's account at the Member. Proposed Rule 2.2.1(f)(iii) will clarify that the requirement to assess suitability in such circumstances also applies to the use of leverage. If accounts are not assigned to individual Approved Persons, the requirement in proposed Rule 2.2.1(f)(iii) would not apply.

Policy No. 2

Part III – Assessing Suitability of Investments and Borrowing to Invest ("Leveraging") Strategies

Proposed Leverage Suitability Criteria too Low

FAIR expressed the view that several of the minimum criteria for leverage suitability outlined in the Proposed Amendments are too low to adequately protect investors. FAIR recommended additional protections relating to investment knowledge, risk tolerance, net worth, gross income, employment status and ability to withstand loss. FAIR also questioned the applicability of using net worth in evaluating leverage suitability, since many people have high net worth due to the value of their homes.

MFDA Response

The proposed "red flags" under subsections 1(a)-(f) are not indicators that the use of leverage, in any given situation, is suitable. Rather, they are minimum criteria that are intended to trigger further supervisory review and investigation to determine if the use of leverage in any given situation is suitable. The triggering of one or more red flags is intended to give rise to a requirement for further investigation into leverage suitability, having regard to the client's circumstances as a whole, and does not stop or conclude such investigation. The red flags are intended to ensure that Members have an appropriate minimum supervisory structure and controls for assessing the suitability of leverage. These criteria have been developed based on issues with the assessment of leverage suitability that staff has become aware of as a result of its experience to date. Members may elect to use more stringent minimum criteria.

As noted above, staff is of the view that a general presumption or restriction respecting leverage across all retail clients does not take into account the obligation to consider the circumstances of each client, as required under MFDA Rules and securities legislation. As set out under Rule 2.2.1, as revised, the suitability of orders accepted or recommendations made, including leverage recommendations and transactions involving the use of borrowed funds, must be determined having regard to the essential facts relative to the client and any investments in the account.

Reference to Risk Tolerances/Inconsistencies between MR-0069 and IFIC Risk Classification Guidelines

Kenmar recommended that the MFDA clarify the meaning of "MEDIUM" as applied to risk in the Proposed Amendments. In addition, Kenmar noted that MR-0069 currently states that the risk ranking of a mutual fund should be determined with reference to the mutual fund's prospectus. However, risk categories assigned and disclosed in the prospectus by some fund companies are based on the IFIC Risk Classification Guidelines, which determine the risk volatility of a fund based on standard deviation and are not intended for use in determining suitability (i.e. the appropriateness of any given mutual fund having regard to the risk tolerance of individual investors). Kenmar noted that the Canadian Securities Administrators have permitted the IFIC risk classifications to be used in the Fund Facts, a point of sale document that is, presumably, intended to reflect individual investor risk (i.e. suitability) and not risk volatility based on standard deviation. Kenmar recommended that the MFDA act quickly to resolve this conflict.

MFDA Response

Rule 2.2.5 (Relationship Disclosure) requires that, on account opening, Members provide all clients with core information about the nature of their relationship with the Member and its Approved Persons. Subsection 2.2.5(e) requires disclosure defining the various terms with respect to the KYC information collected by the Member and describing how this information will be used in assessing investments in the account.

Appendix 1 to MR-0069 (Example of KYC Information) sets out and provides explanations in respect of the various risk tolerance ranges. Where the Member is using the concept of volatility, the client should be provided with a clear explanation as to what types of investments would be suitable for their portfolio.

Investment Knowledge

FAIR recommended that, in order to use leverage to invest, retail investors should be required to meet a minimum level of investment knowledge regarding financial markets and the risks associated with leverage. FAIR suggested that this knowledge could be independently certified, or certified by dealers that are Members of the MFDA, and, therefore, are backed by a compensation fund and subject to a strict liability standard.

MFDA Response

In accordance with the requirements of Rule 2.2.1, it is the Member and Approved Person that are responsible for ensuring that each order accepted or recommendation made, including recommendations to borrow to invest, are suitable for the client. Staff is concerned that the suggestion for a minimum level of investment knowledge could, in certain circumstances, operate to shift responsibility away from the Member and Approved Person to the investor in a manner that takes away from existing levels of investor protection. Staff is of the view that the potential for such a shift in responsibility is inconsistent with the regulatory objectives of the Proposed Amendments and the current obligations of Members and Approved Persons under Rule 2.2.1, MFDA Rules generally and securities legislation.

Total and Liquid Net Worth

Subsection 1(e) requires further supervisory review and investigation where the total leverage amount exceeds 30% of the client's total net worth. Desjardins noted that MR-0069 references this requirement, adding that the investment loan should not exceed 50% of a client's *liquid net worth*. Desjardins sought clarification as to whether the MFDA still intends to use the concept of "liquid net worth" in assessing leverage suitability and, if not, this reference should be removed from MR-0069.

MFDA Response

Staff intends to make appropriate amendments to MR-0069 to ensure that it is consistent with Policy No. 2, as revised, once the Proposed Amendments have been approved.

Policy No. 2 currently requires the Member to obtain for non-registered leveraged accounts, details of the net worth calculation, specifying liquid assets plus any other additional assets less total liabilities. Staff notes that the guidance set out in MR-0069 indicating that the investment loan should not exceed 50% of a client's liquid net worth has not been included in Policy No. 2. With respect to how liquid net worth should be used, MR-0069 will be amended to provide guidance that where the net worth red

flag in subsection 1(e) is triggered or close to being triggered, a leverage suitability assessment should take into consideration the percentage of total net worth that is liquid and the amount that a loan represents as a percentage of liquid net worth.

Ability to Withstand Loss

Kenmar and FAIR recommended that the list of factors requiring further supervisory review and investigation, as currently set out in proposed subsections 1(a)-(f), be amended to include client loss capacity/loss tolerance.

MFDA Response

The concept of client loss capacity/loss tolerance is already addressed under the discussion of "risk tolerance" in MR-0069. In clarifying how this term should be understood and determined, MR-0069 notes that Members and Approved Persons should consider risk tolerance to be the *lower of the investor's willingness to accept risk and the investor's ability to withstand declines in the value of his or her portfolio* (i.e. risk tolerance should be determined as the lesser of both criteria). As there are instances where Members and Approved Persons may be determining client risk tolerance as a result of a combination of other KYC criteria, MR-0069 clarifies that while other KYC criteria, such as income, net worth and time horizon, should be considered and discussed with clients when assisting them in understanding risk tolerance and how they factor into risk and return, *these criteria should not override the client's ultimate assessment of their actual willingness and ability to accept risk.*

Gross Income – Inconsistency between Proposed Amendments and MR-0069

Under subsection 1(f), further supervisory review and investigation is required when total debt and lease payments exceed 35% of the client's gross income. RMFI/PH&N noted that the addition of *total lease payments* is in contrast with Part 4.C(f) of MR-0069, which currently only references *debt payments*, and expressed the view that subsection 1(f) should remain consistent with the general guideline in MR-0069. If both debt and lease payments must be considered for the purposes of this subsection, RMFI/PH&N suggested that the debt to income ratio be increased, to account for the more comprehensive calculation. RMFI/PH&N also noted that clarification as to what total debt and total lease payments include should be removed from this subsection, so as to allow Members the flexibility to set their own standards based on their business models and risks.

MFDA Response

The inclusion of "lease payments" along with debt was intended to clarify that the calculation should include any ongoing, material financial obligation (e.g. mortgage, rental or lease payments), as all such payments would impact a client's borrowing ability (i.e. the ability of the client to service the loan) and the availability of income for investment purposes.

In addition, staff notes that Members have the flexibility to use a more comprehensive cash flow analysis and adopt a higher threshold, provided that it is consistent with the regulatory objectives of this section and Policy No. 2 generally.

Leverage Suitability – Objective of Supervisory Review (Section 2)

Section 2 notes that the objective of the supervisory review is to *assess* the suitability of the leveraging strategy. IFIC and BMOII noted that a requirement to "assess" confuses the roles of the Approved Person and branch/head office supervisory staff. It was suggested that the role of the Approved Person should be to perform the suitability assessment, while the role of branch/head office supervisors should be to review and confirm the suitability assessment performed by Approved Persons. IFIC recommended that the word "assess", as used in this section and Part IV (Branch Office Supervision), "Other Reviews", be changed to "confirm" to indicate the correct role for the supervisory review. IFIC also recommended that the second sentence of section 2 be removed, as conflicts of interest should be handled through the dealer's conflict of interest policies and MFDA Rule 2.1.4.

BMOII expressed the view that Members must be given flexibility to determine when a rationale is required to be documented, with reference to the "red flags" set out in section 1. BMOII suggested that Members should be permitted to determine which red flags would warrant further inquiry into the rationale of the strategy and then should be required to document their rationale for approval only if the Member approves the strategy despite the presence of red flags selected by the Member.

MFDA Response

For the purpose of greater clarity, staff will amend this section by adopting "review" in place of "assess".

The second sentence of section 2 specifies how the supervisory review and investigation of leverage suitability must be conducted by restating general obligations under Rules 2.1.4 and 2.1.1. Such information would not be inconsistent with anything in a dealer's conflict of interest policies and staff is of the view that its inclusion in this section is necessary and appropriate in clarifying minimum regulatory standards.

The red flag criteria set out under this section represent minimum standards for further supervisory review and investigation in respect of leverage suitability that have been adopted based on staff's review of Member practices and compliance experience to date. In each case where any of the red flag criteria are triggered and a leverage strategy is approved, the analysis and rationale must be documented. The level of analysis/assessment and documentation required in any given situation will depend upon different variables, including the number of red flag criteria triggered and the extent of variance from the specified triggering red flag(s).

Leverage Suitability – Requirement for Member to Review and Maintain Documents to Facilitate Proper Supervision (Section 4)

Desjardins noted that subsection 4(a) does not specify the frequency at which outstanding loan value information needs to be updated in the Member's books and records. Desjardins noted that such information is not available through FundServ and therefore cannot be updated on an ongoing basis.

RMFI/PH&N noted that the level of detail proposed under 4(b), which requires supervisory staff to compare the client's KYC information with all other information received in respect of the loan and follow up on any material inconsistencies, is appropriate where the Member or registered salesperson assists the client in completing the loan application, but is not suitable in all cases.

With respect to the proposed requirements of 4(c), which requires Members to review and maintain details in support of income and net worth calculations, RMFI/PH&N, BMOII and Desjardins noted that the obligation for Members to maintain client information relating to all of their existing debt/investment loan payments is too onerous to be a requirement in all instances. RMFI/PH&N and BMOII recommended that these subsections be excluded from Policy No. 2 and incorporated into the Leverage Supervision Guide as best practices. Desjardins noted that there are individuals that for privacy reasons do not wish to provide evidential information regarding income or assets held external to the dealer.

MFDA Response

Staff would expect Members and Approved Persons to make specific inquiries of clients when they become aware of any investment loan(s) or when they make a leverage recommendation to the client.

Apart from these specific situations, Members and Approved Persons should make reasonable inquiries ***of clients*** to obtain information/updates in respect of outstanding loan values whenever updates to a client's KYC information are made. There is no requirement that Members obtain this information from third parties. We understand that, as a best practice, many Members currently have arrangements with financial institutions to obtain such information.

The requirements of proposed subsection 4(b) are intended to apply to information that should already be on hand and available to the Member and Approved Person. Thus, for example, if the Approved Person did not help the client to complete loan documentation, staff would not expect the Approved Person to obtain documentation in respect of such information. However, staff would expect the Approved Person to make reasonable inquiries of the client and compare information received from such inquiries to the client's KYC information for the purpose of assessing leverage suitability. The intent of proposed subsection 4(c) is not to require documentary evidence supporting income, net worth or investment loan payments (e.g. loan documentation, T4s, etc). Rather, the subsection is intended to require the individual data components that make up the income and net worth calculations specified under subsections 1(e) and 1(f) (e.g. value of loan payments and total net worth). The individual figures making up income and net worth must be shown separately so that it is clear how each of the income and net worth calculations was arrived at. We have amended the language of subsection 4(c) to clarify this intent.

Registered Salespersons – Suitability Triggering Events (Section 2)

Under section 2, where there is a transfer of assets into an account at the Member, a suitability assessment must be performed *no later than the time of the next trade*. IFIC noted that this requirement should include the exclusion for automatic transactions, such as PACs and SWPs and that this exclusion should be added to section 3 and Part V (Head Office Supervision), section 1 (Daily Reviews).

MFDA Response

The purpose of the suitability triggers is to ensure that the suitability of investments in each client account is assessed on the occurrence of key triggering events. With respect to the suggestion that an allowance be made for automated transactions to continue without a suitability assessment being made, there is no exception from suitability obligations under current MFDA Rules or securities legislation with respect to trades made under automatic payment plans.

In addition, staff notes that the use of leverage generally magnifies investment risk. Thus, where a transfer of assets into an account at the Member involves automated transactions using borrowed funds, all such transfers, from the perspective of a risk-based approach, should be subject to the prescribed suitability assessment.

Part IV (Branch Office Supervision) and Part V (Head Office Supervision)

Daily Reviews/Other Reviews

RMFI/PH&N, BMOII and Desjardins noted that proposed amendments to Part IV (Branch Office Supervision), Daily Reviews, (section 2) and Part V (Head Office Supervision), Daily Reviews (section 1), Other Reviews (section 1) apply to accounts *other than registered retirement savings plans or registered education savings plans* and sought clarification as to whether the intent of these amendments is to also exclude registered retirement income funds and registered disability savings plans and include tax-free savings accounts. If so, RMFI/PH&N suggested certain drafting revisions.

FAIR recommended that branch or head office review be required for leveraged trades and leverage recommendations relating to RRSPs and RESPs.

MFDA Response

The review requirements of this section apply to leveraged trades/leverage recommendations for all accounts, with specific exclusions for RRSPs and RESPs as, in the experience of MFDA staff, borrowing to invest in these registered products is not subject to the same risks or abuse.

Borrowing to invest in RRSPs or RESPs is, as a general matter, a limited, short-term strategy. People do not keep borrowing to invest in such plans, as their investment is capped at their contribution limit. In addition, in the case of RRSPs, risk is further mitigated by the availability of a tax refund to pay down the investment loan. Conversely, borrowing to invest in an open account is, as a general matter, a less limited and longer-term strategy. Interest on borrowed funds is deductible, an investor may continue to borrow so long as they make their interest payments and the ability to continue to invest is not capped by contribution limits. Where staff has observed leverage strategies involving RRIFs, such strategies have been used for the purpose of investment in an open account and we note that this is already addressed under the Policy.

In circumstances where a client is using a small investment loan (to top up a tax-free savings account for example), a Member would consider the client's KYC information on file. Based on this review, if the minimum criteria set out in Policy 2 for supervisory review of leverage is unlikely to be triggered, a full assessment of the leverage strategy may not be necessary.

Other Recommendations/Suggestions

FAIR indicated that marketing materials should not be permitted to play down the associated risks of leverage and recommended a requirement for full disclosure to the client of commissions and other remuneration that would be paid to the Approved Person as a result of the use of leverage by the client.

FAIR also recommended the adoption of a Clients First Model that would require that all client recommendations be in the best interests of the investor, rather than requiring only suitability.

FAIR proposed that MR-0074 (long form leverage risk disclosure) be amended (with corresponding amendments to MFDA Rule 2.6) to include a certification (and client acknowledgement) requirement that would oblige Approved Persons to certify, at the time of a leverage recommendation, that they have explained the risks associated with leverage to the client and their belief that the client understands the associated risks.

MFDA Response

MFDA Rule 2.7.2 (Advertising and Sales Communications – General Restrictions), notes, in addition to other restrictions, that Members may not issue to the public, participate in or knowingly allow their name to be used in respect of any advertisement or sales communication in connection with their business that: contains any untrue statement, or omission of a material fact, or is otherwise false or misleading; fails to fairly present the potential risks to the client; or does not comply with any applicable legislation or the guidelines, policies or directives of any regulatory authority having jurisdiction over the Member. We note that there are similar requirements under securities legislation. In addition, guidance in respect of this issue has been provided under MR-0070 *Misleading Communications Regarding Leverage*, issued in 2008, and the Leverage Supervision Guide, issued in 2010.

The recommendation regarding adoption of a Clients First Model is beyond the scope of the Proposed Amendments. We note that an initiative addressing this matter is currently under consideration by the securities regulatory authorities.

With respect to recommended amendments to MR-0074, as noted above, it is the Member and Approved Person that are responsible for ensuring that each order accepted or recommendation made, including recommendations to borrow to invest, are suitable for the client. Staff is concerned that the suggestion for a certification and client acknowledgement requirement could, in certain circumstances, operate to shift responsibility away from the Member and Approved Person to the investor in a

manner that takes away from existing levels of investor protection. Staff is of the view that the potential for such a shift in responsibility is inconsistent with the regulatory objectives of the Proposed Amendments and the current obligations of Members and Approved Persons under Rule 2.2.1, MFDA Rules generally and securities legislation.

Attachment B

MUTUAL FUND DEALERS ASSOCIATION OF CANADA

MFDA POLICY NO. 2

MINIMUM STANDARDS FOR ACCOUNT SUPERVISION

Version Showing Amendments from the Version Published for Comment on July 8, 2011

Introduction

This Policy establishes minimum industry standards for account supervision. These standards represent the minimum requirements necessary to ensure that a Member has procedures in place to properly supervise account activity. This Policy does not:

(a) relieve Members from complying with specific MFDA By-laws, Rules and Policies and securities legislation applicable to particular trades or accounts; or

(b) preclude Members from establishing a higher standard of supervision, and in certain situations a higher standard may be necessary to ensure proper supervision.

To ensure that a Member has met all applicable standards, Members are required to know and comply with MFDA By-laws, Rules and Policies as well as applicable securities legislation which may apply in any given circumstance. The following principles have been used to develop these minimum standards:

(a) The term "review" in this Policy has been used to mean a preliminary screening designed to detect items for further investigation or an examination of unusual trading activity or both. It does not mean that every trade must be reviewed. The reviewer must use reasonable judgement in selecting the items for further investigation.

(b) It has been assumed that Members have or will provide the necessary resources and qualified supervisors to meet these standards.

(c) The initial compliance with the know-your-client (“KYC”) rule and suitability of investment requirements is primarily the responsibility of the registered salesperson. The supervisory standards in this Policy relating to KYC and suitability are intended to provide supervisors with a checklist against which to monitor the handling of these responsibilities by the registered salesperson.

Members that seek to adopt policies and procedures relating to branch and head office supervision or the allocation of supervisory activities that differ from those contained in this Policy must demonstrate that all of the principles and objectives of the minimum standards set out in this Policy have been properly satisfied. Further, any such alternative policies and procedures must adequately address the risk management issues of the Member and must be pre-approved by MFDA staff before implementation.

Supervisory staff has a duty to ensure compliance with Member policies and procedures and MFDA regulatory requirements, which includes the general duty to effectively supervise and to ensure that appropriate action is taken when a concern is identified. Such action would depend on the circumstances of each case and may include following up with the registered salesperson and/or the client. Supervisory staff must also maintain records of the issues identified, action taken and resolution achieved.

I. ESTABLISHING AND MAINTAINING PROCEDURES

Effective self-regulation begins with the Member establishing and maintaining a supervisory environment which both fosters 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 major aspect of self-regulation is the ongoing education of staff in all areas of sales compliance.

Establishing Procedures

1. Members must appoint designated individuals who have the necessary knowledge of industry regulations and Member policies to properly perform the duties.

2. Written policies must be established to document supervision requirements.

3. Written instructions must be supplied to all supervisors and alternates to advise them on what is expected of them.

4. All policies established or amended should have senior management approval.

Maintaining Procedures

1. Evidence of supervisory reviews must be maintained. Evidence of the review, such as inquiries made, replies received, date of completion etc. must be maintained for seven years and on-site for one year.

2. An on-going review of sales compliance procedures and practices must be undertaken both at head office and at branch offices.

Delegation of Procedures

1. Tasks and procedures may be delegated to a knowledgeable and qualified individual but not responsibility.

2. The Member must advise supervisors of those specific functions which cannot be delegated, such as approval of new accounts.

3. The supervisor delegating the task must ensure that these tasks are being performed adequately and that exceptions are brought to his/her attention.

4. Those who are delegated tasks must have the qualifications and required proficiency to perform the tasks and should be advised in writing of their duties. The general expectation is that tasks be delegated only to individuals with the same proficiency as the delegating supervisor. In certain limited circumstances, it may be acceptable to delegate specialized tasks to an individual that has not satisfied the proficiency requirements provided that the individual has equivalent training, education or experience related to the function being performed. The Member must consider the responsibilities and functions to be performed in relation to the delegated tasks and make a determination as to appropriate equivalent qualifications and proficiency. The Member must be able to demonstrate to MFDA staff that the equivalency standard has been met. Tasks related to trade supervision can only be delegated to individuals that possess the proficiency of a branch manager or compliance officer.

Education

1. The Member's current policies and procedures manual must be made available to all sales and supervisory staff.

2. Introductory training and continuing education should be provided for all registered salespersons. For training and enhanced supervisory requirements for newly registered salespersons, please refer to the MFDA Policy No. 1 entitled “New Registrant Training and Supervision Policy.”

3. Relevant information contained in compliance-related MFDA Member Regulation Notices and Bulletins and compliance-related notices from other applicable regulatory bodies must be communicated to registered salespersons and employees. Procedures relating to the method and timing of distribution of compliance-related information must be clearly detailed in the Member's written procedures. Members should ensure that they maintain evidence of compliance with such procedures.

II. OPENING NEW ACCOUNTS

To comply with the KYC and suitability requirements set out in MFDA Rule 2, each Member must establish procedures to maintain accurate and complete information on each client. The first step towards compliance with this rule is completing proper documentation when opening new accounts. Accurate completion of the documentation when opening a new account allows both the registered salesperson and the supervisory staff to conduct the necessary reviews to ensure that recommendations made for any account are appropriate for the client and in keeping with investment objectives. Maintaining accurate and current documentation will allow the registered salesperson and the supervisory staff to ensure that all recommendations made for any account are and continue to be appropriate for a client's investment objectives.

Documentation of Client Account Information

1. A New Account Application Form ("NAAF") must be completed for each new account.

2. A complete set of documentation relating to each client's account must be maintained by the Member. Registered salespersons must have access to information and documentation relating to the client's account as required to service the account. In the case of a Level 1 Introducing Dealer and corresponding Carrying Dealer, both Members must maintain a copy of each client's NAAF.

3. For each account of a client that is a natural person, the Member must obtain information sufficient to allow for the operation of the account and sufficient to determine the essential facts relative to each client, which would include, at a minimum, the following information:

   (a) name;

   (b) type of account;

   (c) residential address and contact information;

   (d) date of birth;

   (e) employment information;

   (f) number of dependants;

   (g) other persons with trading authorization on the account;

   (h) other persons with a financial interest in the account;

   (i) investment knowledge;

   (j) risk tolerance;

   (k) investment objectives;

   (l) time horizon;

   (m) income;

   (n) net worth;

   (o) for non-registered leveraged accounts, details of the net worth calculation, specifying liquid assets plus any other additional assets less total liabilities;

   (p) information required by other laws and regulations applicable to the Member's business as amended from time to time including information required for relevant tax reporting; information required for compliance with the *Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations* and any authorization necessary to provide information to the MFDA under applicable privacy legislation.

   The preceding provides a list of minimum requirements. The Member may require clients to provide any additional information that it considers relevant. In the case of accounts jointly owned by two or more persons, information required under subparagraphs (a), (c), (d), (e), (f) and (i) must be collected with respect to each owner. Income and net worth may be collected for each owner or on a combined basis as long as it is clear which method has been used.

4. For each account of a client that is a corporation, trust or other type of legal entity, the Member must obtain information sufficient to allow for the operation of the account and sufficient to determine the essential facts relative to the client, which would include, at a minimum, the following information:

   (a) legal name;

   (b) head office address and contact information;

   (c) type of legal entity (i.e. corporation, trust, etc.);

(d) form and details regarding the organization of the legal entity (i.e. articles of incorporation, trust deed, or other constating documents);

(e) nature of business;

(f) persons authorized to provide instructions on the account and details of any restrictions on their authority;

(g) investment knowledge of the persons to provide instructions on the account;

(h) risk tolerance;

(i) investment objectives;

(j) time horizon;

(k) income;

(l) net worth;

(m) information required by other laws and regulations applicable to the Member's business as amended from time to time including information required for relevant tax reporting; information required for compliance with the *Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations* and any authorization necessary to provide information to the MFDA under applicable privacy legislation.

The preceding provides a list of minimum requirements. The Member may require clients to provide any additional information that it considers relevant.

5. For supervisory purposes, registered accounts, leveraged accounts and accounts of any registered salesperson's family member operating under a limited trading authorization or operating under a power of attorney in favour of the registered salesperson must be readily identifiable.

6. If the NAAF does not include KYC information, this must be documented on a separate KYC form(s). Such form(s) must be signed by the client and dated. A copy of the completed NAAF and KYC form, if separate from the NAAF, must be provided to the client.

7. The Member must have internal controls and policies and procedures in place with respect to the entry of KYC information on their back office systems. Such controls should provide an effective means to detect and prevent inconsistencies between the KYC information used for account supervision with that provided by the client.

8. Except as noted in the following paragraph, NAAFs must be prepared and completed for all new clients prior to the opening of new client accounts. The new account or KYC information must be approved by the individual designated as responsible for the opening of new accounts under Rule 2.2.3 no later than one business day after the initial transaction date. Records of all such approvals must be maintained in accordance with Rule 5.

9. Notwithstanding the preceding paragraph, NAAFs for clients of a registered salesperson transferring to the Member must be prepared and completed within a reasonable time (but in any event no later than the time of the first trade). The new accounts or KYC information for clients of the transferring salesperson must be approved by the individual designated as responsible for the opening of new accounts under Rule 2.2.3 no later than one business day after the date that the NAAF is completed. Records of all such approvals must be maintained in accordance with Rule 5.

10. In the event that a NAAF is not completed prior to or within a reasonable time after opening an account, as required by this Policy, the Member must have policies and procedures to restrict transactions on such accounts to liquidating trades until a fully completed NAAF is received.

Changes to KYC Information

1. The registered salesperson or Member must update the KYC information whenever they become aware of a material change in client information as defined in Rule 2.2.4(a).

2. On account opening, the Member should advise the client to promptly notify the Member of any material changes in the client information, as defined in Rule 2.2.4(a), previously provided to the Member and provide examples of the types of information that should be regularly updated.

3. In accordance with Rule 2.2.4(e), Members must also, on an annual basis, request in writing that clients notify them if there has been any material change in client information, as defined in Rule 2.2.4(a), previously provided, or if the client's circumstances have materially changed.

4. Access to amend KYC information must be controlled and instructions to make any such amendments must be properly documented.

5. A client signature, which may include an electronic signature, or other internal controls sufficient to authenticate the client's identity and verify the client's authorization must be used to evidence any change in client name, client address or client banking information.

6. Material changes to client information, as defined in Rule 2.2.4(a), may be evidenced by a client signature, which may include an electronic signature or, alternatively, such changes may be evidenced by maintaining notes in the client file detailing the client's instructions to change the information and verified by providing written confirmation to the client with details of the instructions and providing an opportunity for the client to make corrections to any changes that have been made.

7. All material changes in client information, as defined in Rule 2.2.4(a), must be approved by the individual designated as responsible for the opening of new accounts under Rule 2.2.3 no later than one business day after the date on which notice of the change in information is received from the client. When approving material changes, branch managers should be reviewing the previous KYC information to assess whether the change appears reasonable. Branch managers should be aware of situations where material changes may have been made to justify unsuitable trades or leveraging. For example, branch managers should investigate further material changes that accompany trades in higher risk investments or leveraging or changes made within a short period of time (for example 6 months). Records of all such approvals must be maintained in accordance with Rule 5.

8. Where any material changes have been made to the information contained in the NAAF or KYC form(s), the client must promptly be provided with a document or documents specifying the current risk tolerance, investment objectives, time horizon, income and net worth that applies to the client's account.

9. The last date upon which the KYC information has been updated or confirmed by the client must be indicated in the client's file and on the Member's back office system.

Pending/Supporting Documents

1. Members must have procedures in place to ensure supporting documents are received within a reasonable period of time of opening the account.

2. Supporting documentation that is not received or is incomplete must be noted, filed in a pending documentation file and reviewed on a periodic basis.

3. Failure to obtain required documentation within 25 days of the opening of the account must result in positive actions being taken.

Client Communications

1. All hold mail must be authorized by the client in writing and be controlled, reviewed on a regular basis and maintained by the responsible supervisor. Hold mail should never be permitted to occur over a prolonged period of time (i.e. in excess of 6 months).

2. Returned mail is to be promptly investigated and controlled.

III. ASSESSING SUITABILITY OF INVESTMENTS AND BORROWING TO INVEST ("LEVERAGING") STRATEGIES

General

1. Members must establish and maintain policies and procedures with respect to their suitability obligations. The policies and procedures must include guidance and criteria for registered salespersons to ensure that recommendations made and orders accepted (with the exception of unsolicited orders accepted pursuant to Rule 2.2.1(d)) are suitable for the client. The policies and procedures must also include criteria for supervisory staff at the branch and head office to review the suitability of the investments in each client's account and the client's use of borrowing to invest ("leverage").

2. The criteria for selecting trades and leverage strategies for review, the inquiry and resolution process, supervisory documentation requirements and the escalation and disciplinary process must be documented and clearly communicated to all registered salespersons and all relevant employees. Registered salespersons must be advised of the criteria used in assessing suitability, actions the Member will take when a trade or leverage strategy has been flagged for review and appropriate options for resolution.

Leverage Suitability

1. ~~The suitability of leverage must be assessed having regard to the client's investment knowledge, risk tolerance, age, time horizon, income, net worth and investment objectives.~~ The minimum criteria listed below are intended to prompt a supervisory review and investigation by the Member of a leverage strategy. While Members must consider all the criteria in assessing the suitability of the leverage strategy, the triggering of one or more of the criteria may not necessarily mean that the leverage strategy is unsuitable.

   The review and investigation of leverage suitability must be conducted in a fair and objective manner having regard only to the best interest of the client in accordance with Rule 2.1.4 and the general standard of conduct required by Rule 2.1.1. Where the leverage strategy is approved, the analysis and rationale must be documented.

   Minimum criteria that require ~~further~~ supervisory review and investigation include the following:

   (a) investment knowledge of low or poor (or similar categories);

   (b) risk tolerance of less than medium (or similar categories);

   (c) age of 60 and above;

   (d) time horizon of less than 5 years;

   (e) total leverage amount that exceeds 30% of the client's total net worth; and

   (f) total debt and lease payments that exceed 35% of the client's gross income, not including income generated from leveraged investments. Total debt payments would include all loans of any kind whether or not obtained for purpose of investment. Total lease payments would include all significant ongoing lease and rental payments such as automobile leases and rental payments on residential property.

~~2. The objective of the supervisory review is to assess the suitability of the leveraging strategy. The supervisory review and investigation of leverage suitability must be conducted in a fair and objective manner having regard only to the best interest of the client in accordance with Rule 2.1.4 and the general standard of conduct required by Rule 2.1.1. Where the leverage strategy is approved, the analysis and rationale must be documented.~~

~~3~~2. With respect to a recommendation for a client to use a leveraging strategy, Members and registered salespersons may not obtain a waiver from the client to exempt the Member and the registered salesperson from their obligations to ensure the suitability of such a recommendation.

~~4~~3. The Member must review and maintain documents to facilitate proper supervision. This would include:

   (a) Lending documents and details of lending arrangements – The Member or registered salesperson must either maintain copies of the lending documents or make sufficient inquiries to obtain details of the loan, including interest rate, terms for repayment, and the outstanding loan value. Where the Member or registered salesperson assists the client in completing the loan application, the Member must maintain copies of lending documents in the file, including copies of the loan application.

   Where the client arranges their own financing, it may be difficult in some cases for the Member or registered salesperson to obtain details of the lending arrangement from the client. Where a client is unwilling to provide details of the lending arrangement, the Member and registered salesperson ~~should~~must advise the client that they cannot assess the suitability of the leverage strategy without additional information and maintain evidence of such advice.

   (b) NAAF and updates to KYC information – Supervisory staff must compare the client's KYC information with all other information received in respect of the loan and follow up on any material inconsistencies, which may require obtaining additional supporting documentation from the client.

   (c) Numerical ~~D~~details in support of income and net worth calculations required by sections 1(e) and 1(f) ~~– This would include information on all existing debt payments, as well as the investment loan payments~~.

(d) Trade documents, notes supporting client instructions or authorizations and notes supporting the rationale for recommending a leverage strategy to the client.

Registered Salespersons

1. All recommendations made and orders accepted by registered salespersons (with the exception of unsolicited orders accepted pursuant to Rule 2.2.1(d)) must be suitable in accordance with Rule 2.2.1(c). Where the registered salesperson recommends a leverage strategy to a client or where the registered salesperson is aware that a transaction ~~proposed by the client~~ involves the use of borrowed funds, the registered salesperson must ensure that the client's account is identified as "leveraged" on the Member's system in accordance with the Member's policies and procedures.

2. Registered salespersons must assess the suitability of investments in each client account whenever:

   – the client transfers to the Member or transfers assets into an account at the Member;

   – the Member or registered salesperson becomes aware of a material change in the client's KYC information; or

   – the client account has been re-assigned to the registered salesperson from another registrant at the Member.

   Where there is a transfer of assets into an account at the Member or where the client account is re-assigned to the registered salesperson from another registrant at the Member, the suitability assessment must be performed within a reasonable time, but in any event no later than the time of the next trade. The determination of "reasonable time" in a particular instance will depend on the circumstances surrounding the event that gives rise to the requirement to perform the suitability assessment. For example, with respect to client transfers, the volume of accounts to be reviewed may be a relevant factor in determining reasonable time.

   Where the Member or registered salesperson becomes aware of a material change in the client's KYC information, the suitability assessment must be performed no later than one business day after the date on which the notice of change in information is received from the client.

3. Registered salespersons must also assess the suitability of a leverage strategy <u>having regard to the client's investment knowledge, risk tolerance, age, time horizon, income, net worth and investment objectives</u> whenever:

   – the client transfers assets purchased using borrowed funds into an account at the Member;

   – the Member or registered salesperson becomes aware of a material change in the client's KYC information; or

   – the client account has been re-assigned to the registered salesperson from another registrant at the Member.

   Where there is a transfer of assets purchased using borrowed funds into an account at the Member or where the client account is re-assigned to the registered salesperson from another registrant at the Member, the suitability assessment must be performed in a timely manner as soon as possible after the transfer in accordance with~~in~~ the circumstances, but in any event no later than the time of the next trade.

   Where the Member or registered salesperson becomes aware of a material change in the client's KYC information, the suitability assessment must be performed no later than one business day after the date on which the notice of change in information is received from the client.

4. Should a registered salesperson identify unsuitable investments in a client's account or an unsuitable leverage strategy, the registered salesperson must advise the client and take appropriate steps to determine if there has been any change to client circumstances that would warrant altering the KYC information. Where there has not been a change in client circumstances, it is inappropriate to alter the KYC information in order to match the investments in the client's account or the leverage strategy. If there is no change to the KYC information, or if investments in the account or the leverage strategy continue to be unsuitable after the KYC information has been amended, the registered salesperson should discuss any inconsistencies with the client and provide recommendations as to rebalancing investments in the account. Transactions in the account must only be made in accordance with client instructions and any recommendations made with respect to the rebalancing of the account must be properly recorded.

Where an existing leverage strategy is determined to be unsuitable, the client must be advised of his/her options.

5. Registered salespersons must maintain evidence of completion of all suitability assessments performed and any follow up action taken with respect to such assessments.

IV. BRANCH OFFICE SUPERVISION

Each branch manager must undertake certain activities within the branch for purposes of assessing compliance with the Member's policies and procedures and regulatory requirements. These activities should be designed to identify failures to adhere to required policies and procedures and provide a means of revealing and addressing undesirable account activity.

Daily Reviews

1. All new account applications and updates to client information must be reviewed and approved in accordance with this Policy.

2. The branch manager (or alternate) must review the previous day's trading for unsuitable trades, leveraging and any other unusual trading activity using any convenient means. This review must include, at a minimum, all:

   – initial trades;

   – trades in exempt securities (excluding guaranteed investment certificates);

   – ~~leveraged trades/leverage recommendations~~leveraging for accounts other than registered retirement savings plans or registered education savings plans;

   – trades in accounts of family members of registered salespersons operating under a power of attorney in favour of the registered salesperson;

   – redemptions over $10,000;

   – trades over $2,500 in moderate-high or high risk investments;

   – trades over $5,000 in moderate or medium risk investments; and

   – trades over $10,000 in all other investments.

   For the purposes of this section, “trades” does not include redemptions except where specifically referenced.

3. When reviewing redemptions, branch managers should seek to identify and assess:

   – the suitability of the redemption with regard to the composition of the remaining portfolio;

   – the impact and appropriateness of any redemption charges;

   – possible outside business activity where money may be leaving the Member for reinvestment into other potentially inappropriate or unauthorized investments; and

   – potential churning, including situations where redemption proceeds are being held on a temporary basis pending reinvestment.

4. The branch manager (or alternate) is responsible for following up on unusual trades identified by head office.

Other Reviews

1. The branch manager must review ~~assess~~ the suitability of investments in each client account and the suitability of the client’s use of leverage, if any, where the Member becomes aware of a material change in the client’s KYC information that results in a significant decrease in the client’s risk tolerance, time horizon, income or net worth or more conservative investment objectives. The suitability assessment must be performed no later than one business day after the date on which notice of the change in information is received from the client.

2. In addition to transactional activity, branch managers must also keep themselves informed as to other client-related compliance matters such as complaints.

V. HEAD OFFICE SUPERVISION

A two-tier structure is required to adequately supervise client account activity. While the head office or regional area level of supervision by its nature cannot be in the same depth as branch level supervision, it should cover the same elements. Head office review should be focused on unusual activity or reviews that cannot be carried out at the branch level. Head office reviews must include procedures to effectively detect unsuitable investments and excessive trading in client accounts.

Daily Reviews

1. In addition to the trading review criteria for branch managers, head office must conduct daily reviews of account activity which must include, at a minimum, all:

   – redemptions over $50,000;

   – trades over $5,000 in exempt securities (excluding guaranteed investment certificates), moderate-high or high risk investments, or ~~leveraged trades/recommendations~~leveraging for accounts other than registered retirement savings plans or registered education savings plans;

   – trades over $10,000 in moderate or medium risk mutual funds; and

   – trades over $50,000 in all other investments (excluding money market funds).

   For the purposes of this section, "trades" does not include redemptions except where specifically referenced.

2. There must be closer supervision of trading by registered salespersons who have had a history of questionable conduct. Questionable conduct may include trading activity that frequently raises questions in account reviews, frequent or serious complaints, regulatory investigations or failure to take remedial action on account problems identified.

3. Daily reviews should be completed within one business day unless precluded by unusual circumstances.

4. Daily reviews should be conducted of client accounts of producing branch managers.

Other Reviews

1. On a sample basis, the Member must review the suitability of investments in accounts where clients have transferred assets into an account in accordance with Rule 2.2.1(e)(i). The Member must have policies and procedures regarding sample size and selection, which should be based on the risk level associated with the account, focusing on accounts that hold higher risk investments, exempt securities or products not sold by the Member, accounts that are operated under a power of attorney in favour of a registered salesperson and accounts employing a leverage strategy other than registered retirement savings plans and registered education savings plans. The Member's reviews must be completed within a reasonable time, but in any event no later than the time of the next trade.

2. Members must also review the suitability of the use of leverage in all cases where the client transfers assets purchased using borrowed funds into an account at the Member. Given the high risk nature of leveraging strategies, the Member's reviews must be completed in a timely manner as soon as possible after the transfer in accordance with the circumstances, but in any event no later than the time of the next trade.

VI. IDENTIFICATION OF TRENDS IN TRADING ACTIVITY

1. Members must establish policies and procedures to identify trends or patterns that may be of concern including:

   – excessive trading or switching between funds indicating possible unauthorized trading, lack of suitability or possible issues of churning (for example, redemptions made within 3 months of a purchase, DSC purchases made within 3 months of a DSC redemption or accounts where there are more than 5 trades per month);

   – excessive switches between no load funds and deferred sales charge or front load funds;

   – excessive switches between deferred sales charge funds and front load funds; and

   – excessive switches where a switch fee is charged.

2. Head office supervisory review procedures must include, at a minimum, the following criteria:

   – a review of all accounts generating commissions greater than $1,500 within the month;

   – a quarterly review of reports on assets under administration ("AUA") comparing current AUA to AUA at the same time the prior year;

   – a quarterly review of commission reports for the previous 12 month period comparing commissions received in the current year to commissions received for the same period in the prior year.

   Significant increases in commissions or AUA beyond those caused by market fluctuations may indicate issues with churning or leveraging strategies. Significant decreases may indicate potential inappropriate outside business activity.

3. Reviews should be completed within 30 days of the last day of the period being reviewed unless precluded by unusual circumstance