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MFDA STAFF NOTICE

KNOW-YOUR-CLIENT (KYC) and SUITABILITY

MFDA Staff Notices are intended to assist Members and their Approved Persons in the interpretation, application of and compliance with requirements under MFDA By-laws and Rules. Notices make reference to these requirements and set out MFDA staff's interpretation of how to comply with these requirements. Notices may also include best practices or guidance.

This Notice provides guidance to Members on how to establish a suitability framework to comply with their ~~obligation to ensure each order accepted or recommendation made is in keeping with clients' know-your-client ("KYC") information. It provides further guidance on assessing suitability where borrowed funds have been used to invest and advises of MFDA staff's view when assessing suitability as part of a compliance examination or enforcement case.~~ obligations under Rules 2.2.1 ("Know-Your-Client"), 2.2.4 ("Updating Client Information"), 2.2.5 ("Know-Your-Product"), 2.2.6 ("Suitability Determination"), and Policy No. 2 – *Minimum Standards for Account Supervision*.

~~DOCs 326182v2~~
DM#823567

MUTUAL FUND DEALERS ASSOCIATION OF CANADA
KYC AND SUITABILITY

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~~SUITABILITY~~

1. KNOW YOUR CLIENT ("KYC")

A. Maintaining Accurate and ~~Complete~~Sufficient KYC Information to support Suitability Determinations

In order to meet requirements under MFDA Rule 2.2.1 ("Know-Your-Client~~") requires~~"), Members and ~~their~~ Approved Persons ~~("APs") to use due diligence to ensure that "each order accepted or recommendation made for any account of a client is suitable for the client based on the essential facts relative to the client and any investments within the account". In order to meet this obligation, Members and APs~~ must obtain and maintain complete, timely and accurate Know-Your-Client ("KYC") information. Without this information, a determination cannot be made as to whether a recommendation is suitable for a client~~. Accordingly,~~ and puts the client's interest first (a "suitability determination"). The KYC process is an ongoing one which does not end after the initial KYC analysis is complete. Members are required to obtain complete KYC information when opening an account, and before trading on behalf of clients~~.~~ or taking any other action referred to in Rule 2.2.6(1). KYC obligations cannot be delegated. A Member or Approved Person may not rely on a third party, such as a referral agent, for KYC information.

Members and ~~APs~~Approved Persons are required to take reasonable steps to learn the essential facts relative to each client and to each order or account accepted~~. Such facts include, but may not necessarily~~ and ensure they have sufficient information to make a suitability determination. What is sufficient is to be ~~limited to, the enumerated items set out~~ determined in accordance with Section II of Policy No. 2 *Minimum Standards for Account Supervision*~~.~~ ~~Depending~~, which sets out minimum requirements for the collection of KYC information, and notes that, depending on the circumstances, ~~the~~a Member or ~~AP~~Approved Person may need to collect ~~other~~additional information to fully ~~understand the client's investment needs and objectives.~~ know the client. KYC information must be defined in a clear and concise way to assist clients in understanding what the terms mean and how the criteria relate to specific investments recommended or accepted by the Member. ~~An illustration of how to define KYC information is attached as Appendix 1.~~

A Member's New Account Application Form ("NAAF") or KYC form should be developed considering the Member's business model, the nature of its relationships with the client, the investment products the Member distributes, investment strategies offered to clients, and trade supervision policies and procedures of the Member, in order to adequately capture sufficient information to assess whether recommendations made or orders accepted are suitable~~.~~ and put the client's interest first. Where changes to investment products, investment strategies or internal policies are made, the form should be flexible enough to reflect new information required or a new form should be created. ~~Where a form does not provide enough specific,~~

~~detailed information to assess whether a recommendation or order is suitable, the Member should take the most conservative approach in assessing suitability.~~ KYC information must not be determined in order to correspond or match with an investment product, account or portfolio or otherwise be manipulated to lead to a pre-determined outcome.

The process of collecting and updating a client's KYC information must amount to a meaningful interaction between the client and the Member and Approved Person. Although standardized questionnaires or other tools may be used to facilitate the collection of KYC information and to document that information, the Member and Approved Person remain responsible for the KYC process. The KYC obligation does not vary depending on the medium through which the Member or Approved Person interacts with its client to gather the necessary information.

Members are required to have policies and procedures relating to obtaining, approving and updating KYC information. ~~Policies~~At a minimum, policies and procedures should include a description of the process to:

- Open and approve new accounts, including timeframes for submission of the information and subsequent approval;
- Update KYC information, including ~~recommended~~ timeframes to update the information and a description of the approval process for updates;
- Ensure ~~completeness~~sufficiency of KYC information prior to opening or trading in an account~~; and~~, or otherwise making a suitability determination;
- Detect or prevent inconsistent KYC information in use by ~~APs~~Approved Persons and by supervisors~~.~~;
- Determine how the subjective elements of client information are established, including investment time horizon, investment objectives, and risk profile; and
- Collect sufficient information about the client to allow the Member and Approved Person to determine if the client meets the requirements of a prospectus exemption, where reliance upon one is proposed.

Where an account has been opened without first obtaining ~~complete~~sufficient KYC information, the ~~account~~Member should have a process in place to restrict investment actions that can be ~~restricted from trading, except to allow~~ taken by or on behalf of a client (for ~~redemptions.~~example, by restricting the account to liquidating trades, transfers or disbursement). The Member should also investigate why the account was opened without sufficient KYC information on file.

Members are also required to have internal controls over the entry of KYC information into their back office system when opening a new account or updating KYC for an existing account.

B. ~~Approval of~~ KYC Information

~~Members must have policies and procedures for both branch and head office staff relating to the opening of new accounts and updating of KYC information. The approval process should not be viewed solely as an administrative function. Rather, KYC information submitted for approval should be reviewed for completeness, as well as reasonableness and consistency.~~

~~***Completeness***~~
~~Members must have controls in place to ensure accounts are only opened if complete KYC information is obtained. In cases where a Member has accounts that have already been opened and KYC information is not complete, the accounts should be restricted from trading, except to allow for redemptions.~~

~~***Reasonableness***~~
~~The approval of new accounts and KYC updates should include the objective review of the KYC information submitted. For example, a 70 year-old client with a long term time horizon and high risk tolerance should be flagged for follow-up to assess whether the KYC information is accurate or whether there are other objectives of the client that have not been identified or recorded on the KYC form.~~

~~***Consistency***~~
~~Members should have controls in place to prevent or detect inconsistencies in KYC information. For example, a client with a "speculative" investment objective should not also have a "low" risk tolerance. In some instances, Members have incorporated edit checks into their trading systems that prohibit inconsistent KYC information from being entered or accepted.~~

~~Evidence of inquiries made, responses received and approvals given must be maintained as verification of the Member's supervisory activities. When issuing an inquiry, the reason for the inquiry, as well as timelines to respond and additional information required, should be documented and the progress monitored to ensure a timely resolution.~~

~~When approving new accounts, KYC amendments or performing branch examinations, Member supervisory staff should be alert to situations where APs have a significant number of client accounts with the same or very similar KYC information.~~

~~MFDA staff has found, in examinations and investigations, APs who use the same KYC information for a number of their clients in order to match their trade recommendations or investment strategies. APs are expected to make suitable recommendations based upon specific client KYC information and should not document KYC information solely to support their recommendations.~~

~~C. Material Changes to KYC Information~~

~~Members should have policies and procedures for updating KYC information as a result of material changes that would include:~~

- ~~The requirement to obtain supervisory approval in accordance with Rule 2.2.4(c);~~
- ~~Internal controls to ensure accuracy of client information in use by APs and supervisory staff; and~~
- ~~Compliance with record keeping requirements, including the requirement to maintain evidence of client instructions and authorization regarding material changes.~~

~~Material changes would include any information that results in changes to the stated risk tolerance, time horizon and investment objectives, as well as any situation that would have significant impact on net worth or income of the client (for example, a job loss, long term illness, or new debt financing).~~

~~MFDA Rule 2.2.1(a) requires KYC information to be up-to-date at the time of a trade, and MFDA Rule 2.2.4(e) requires that Members annually ask clients, in writing, if KYC information has changed. As a best practice, some Members have also instituted a policy that requires APs to directly contact clients annually to confirm or update KYC information.~~

~~Some Members are also able to flag stale-dated KYC information within their back office system. Typically, the system flags KYC information that has not been updated in the past twelve months.~~

~~MFDA Rule 2.2.4 (Updating Client Information) and Policy No. 2 require that all material changes to client information be approved by the individual designated as responsible for the opening of new accounts under Rule 2.2.3 (New Account Approval) no later than one business day after the date on which notice of the change of information is received from the client.~~

~~When approving material changes, Branch Managers should review 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).~~

~~When performing branch examinations, MFDA staff frequently finds KYC information in a client file to be different from the KYC information on a Member's back office system. In some cases, this occurs because Members permit APs to make changes to KYC information directly on the back office system without sufficient controls to ensure the changes are accurate and supported by evidence of the client's instructions to change the information. Staff has also found that updated KYC information is generally not subject to an approval process and there are few, if any, controls or procedures to ensure head office records have been amended to~~

~~reflect the new information. In other instances, Members have made changes to their NAAF without a corresponding change to their back office system or have made changes to their back office system without corresponding changes to their NAAF. The result is inaccurate information being used by the Member's head office supervisory staff to assess suitability. It is important for Members to develop policies and controls with respect to the update process. When a Member performs its branch reviews in accordance with MFDA Policy No. 5 *Branch Review Requirements*, the Member should also test to ensure consistency between the information on its system and the information within the client file, including KYC information contained in financial plans or lending documents where available.~~

~~D. New Account Application or KYC Form~~

KYC information must be defined in a clear and concise way to assist clients in understanding what the terms mean and how the criteria will relate to the specific investments recommended or accepted by the Member~~.~~ and Approved Person. Members and Approved Persons must take reasonable steps to confirm the accuracy of the information they collect in order to form a reasonable belief that they know the identity of an individual.

~~An illustration of how to define KYC information is attached in Appendix 1 to provide further information on how to apply the concepts discussed below.~~

~~***KYC Information***~~

~~KYC information includes:~~

- ~~Age~~

While some of the information collected can be readily obtained from the client, other elements may require explanation and further discussion with the client. For example, clients may need assistance in articulating their investment needs and objectives. Clients may also provide instructions that are unclear or give inconsistent responses to KYC questions. In these situations, the Member or Approved Person should make further enquiries of the client. Particular care should be exercised by Members and Approved Persons concerning less sophisticated clients and those who may be vulnerable due to considerations such as age or disability. A Member or Approved Person should not simply assume that the client will understand KYC questions and technical terms used in related discussions or interactions. KYC questions and client communications should be in plain language and supported with explanations of what each question or item relates to and what relevant terms and expressions mean.

Minimum KYC Requirements

Policy No. 2 establishes the minimum client information that must be obtained by Members to meet the KYC requirements to which they are subject (some of these factors are discussed below). As set out under Policy No. 2, a Member may require additional information to comply with its KYC obligations and to make a suitability determination.

a) Personal Circumstances

Personal circumstances include the client's date of birth, employment information (e.g. employment status and occupation), and number of dependants.

~~*a)*~~*b)* ***Investment Knowledge***

- ~~Annual Income~~
- ~~Net worth~~
- ~~Investment Objectives~~
- ~~Time horizon~~
- ~~Risk Tolerance~~

~~***b) Age***~~

~~The client's date of birth must be recorded.~~

~~***c) Investment Knowledge***~~

Investment knowledge should reflect the client's understanding of investing, investment products and their associated risks. This includes the client's understanding of financial markets, the relative risk and limitations of various types of investments, and how the level of risk taken affects potential returns. We expect Members and Approved Persons to inquire about a client's level of awareness and previous experience with investments and financial matters. Members and Approved Persons should make further inquiries if the information provided by a client appears to be inconsistent with their apparent level of investment knowledge. For example, a client may indicate that they have limited investment knowledge and experience, while also indicating a willingness to accept a high level of risk.

c) Financial Circumstances

Determining a client's financial circumstances requires consideration of a number of factors, including information pertaining to a client's income, liquidity needs, financial assets and financial obligations, net worth, and whether the client is using leverage or borrowing to finance the purchase of investment products.

In accordance with Policy No. 2, Members and Approved Persons are required to record, at a minimum, the following:

Annual Income

This should represent annual income from all relevant sources. It should be collected as a number or by using reasonable ranges.

Financial Assets and Net Worth

Members and Approved Persons should take reasonable steps to determine a client's net worth, which includes understanding financial and other assets and liabilities. In certain circumstances, a Member or Approved Person may need to enquire about investments the client holds outside of the Member to have a better understanding of a client's financial circumstances to sufficiently support its suitability determination. This information may be particularly important to the Member and Approved Person's ability to assess whether an investment might lead a client to become over-concentrated in an investment product or sector.

For non-registered, leveraged accounts, details of the net worth calculations must be recorded, specifying liquid assets plus any other additional assets less total liabilities.

Net worth should only include assets of the account holder and his or her spouse. Liquid assets would include those that are not subject to restrictions and that are readily converted into cash without penalties. For example, generally, investments would be considered liquid assets unless they are locked-in or held in a registered plan where there would be taxes owing on withdrawal. For other accounts, it is sufficient to record total net worth. ~~Further guidance on assessing the suitability of leverage is in section 4 of this Notice.~~

Leverage or borrowing to finance the purchase of investment products
Members and Approved Persons are required to identify accounts where a client has borrowed to invest. Members and Approved Persons should gather sufficient details to make a suitability determination where a client has borrowed to invest. For non-registered leveraged accounts, Members and Approved Persons must collect specific additional information pursuant to Policy No. 2 including, total debt and lease obligations and details of the net worth calculation. Further guidance on assessing the suitability of leverage is in section 3 of this Notice.

d) Investment Needs and Objectives

~~Investment~~ A client's investment objectives are the results they want to achieve when investing, such as capital preservation, income generated by invested capital, and capital growth. The discussion between the Approved Person and the client to ascertain the client's investment needs and objectives should include consideration of any liquidity needs the client may have. The discussion should also provide an opportunity for-the client to express their investment needs and objectives in non-technical terms that are meaningful to them, such as saving for retirement to maintain a certain lifestyle, increasing wealth by a certain percentage in a specific number of years, investing for the purchase of a home, or investing for the post-secondary education of their children.

After a thorough assessment, the client's investment needs and objectives should be recorded on the KYC documentation clearly so as to reflect the result desired by the client from investing and ~~should relate to~~to allow for comparison for suitability and supervisory purposes against the type of investments that will be purchased ~~by~~for the client._ To the extent a client has multiple investment needs and objectives, the Member must have a way of identifying the relative importance of each ~~objective~~ within the account. _This can be done by using percentages or descriptions of the investor profile and recommended ~~account holdings, as further described under the model portfolio approach explained in section E that follows.~~ asset allocation.

~~MFDA staff has observed that certain Members use tick boxes and may tick multiple objectives for an account without indicating what percentage of the account should be allocated to each objective. MFDA staff has also observed KYC forms with investment objectives that are too broad or vague to relate to any specific trade or investment, but that relate more to the overall objectives of the account (such as "retirement savings" or "tax planning").~~

~~If a Member wants to also record these types of overall goals, they can be separately documented on the KYC form. However, the investment objectives used for trade supervision and the suitability assessment should clearly relate to the type of investments that will be purchased by the client.~~

~~Definitions of "growth", "income" and "balanced" are provided in Appendix 1. Where Members use the term "balanced", it should be defined in terms of a reasonable allocation between income and growth investments. Staff has observed the use of other terms, including "capital preservation" and "speculative". Where these terms are used, they must be appropriately defined in a manner that allows the client to understand what types of investments they relate to.~~

Where an Approved Person determines that it is appropriate to establish investment goals with a client, they may wish to do so through an investment policy statement or similar document. If an Approved Person and client agree on certain investment goals, these should be set out in terms that are specific and measurable. The Approved Person should consider setting out investment return assumptions that would be required to meet the client's investment needs and objectives. The Approved Person should also periodically update the client on progress towards any goals set for their account or portfolio.

e) Investment Time Horizon

~~Time~~Investment time horizon is the period from now to when the client will need to access a significant portion of the money invested. ~~It~~Members and Approved Persons should ascertain the extent to which a client wishes or needs to access all or a portion of their investments to meet their ongoing and short-term expenses and financial obligations or fund major planned expenditures. Investment time horizon can be defined in absolute terms or in ranges that provide for a sufficient number of categories to assess the suitability of the ~~products sold or investment strategies used~~investment products sold or investment strategies used. When a client identifies their investment time horizon, the Member or Approved Person has a responsibility to assess its feasibility and reasonableness relative to the client's liquidity needs, age, investment needs and objectives, risk profile, and other particular circumstances. When discussing a client's liquidity needs, a Member or Approved Person should consider whether the client has any other means to cover their expenditures, whether the needs are expected or unexpected, and whether, once the need materializes, the money will be withdrawn on a regular basis, such as once a month or once a year.

The length of the client's investment time horizon impacts the types of investments that may be suitable for the client. For example, generally it is considered to be unsuitable for a client to purchase mutual funds on a deferred sales charge basis if the client's time horizon is shorter than the redemption schedule. Investors with a longer investment time horizon may have a greater degree of flexibility when building a portfolio, whereas a short investment time horizon may mean that conservative investments may be the only suitable option.

f) Risk ~~Tolerance~~Profile

~~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. It is not just the client's comfort level or attitude towards risk, but also his or her actual ability to withstand financial losses. Risk tolerance, therefore, should be determined as the lesser of both criteria.~~

~~Incorrectly assessing client risk tolerance is one of the most common allegations made in client complaints to the MFDA. Clients allege that the risk tolerance indicated on the KYC form was higher than what the client asserts was his or her actual risk tolerance.~~

~~In some cases, there is a difference between the risk a client is willing or able to take and the return the client expects, which can result in an AP assessing risk tolerance higher than it should be in an attempt to meet client expectations.~~

~~There are also instances where APs and Members may be determining client risk tolerance as the result of a combination of other KYC criteria. 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 in to risk and return, these criteria should not override the client's ultimate assessment of their actual willingness and ability to accept risk. APs and Members cannot substitute their own judgment for that of the client. For example, a client with a long term time horizon, significant net worth, and income level may be able to withstand fluctuations in the market over the long term, which could lead to the conclusion that the client is high risk or should invest a significant portion of his or her portfolio in high risk investments. However, if the client is not willing to accept that level of risk or is not comfortable with investing in high risk investments, the KYC form should reflect the client's decision and not the AP's view of what the client's risk tolerance should be.~~

Establishing a client's risk profile involves understanding the client's willingness to accept risk, sometimes referred to as risk tolerance, and their ability to endure potential financial loss, sometimes referred to as risk capacity. Risk tolerance and risk capacity are separate considerations that together make up the client's overall risk profile.

Members should have in place a process for assessing a client's risk profile that includes:

- Assessing a client's willingness to accept risk (risk tolerance) and a client's ability to endure potential financial loss (risk capacity);

- Appropriately interpreting client responses to questions and not attributing inappropriate weight to certain answers; and

- Identifying clients that are more suited to placing their money in cash deposits or guaranteed investment products because they are unwilling or unable to accept the risk of loss of capital.

Assessing a client's capacity for loss involves the Member and Approved Person having an understanding of additional factors, particularly the client's financial circumstances, (including liquidity needs, debts, income and assets), and how much of a client's total investments an account or particular investment position represents, and the client's age and life stage. The risk profile for a client should reflect the lower of (a) the client's willingness to accept risk, and (b) the client's ability to endure potential financial loss.

The process for developing a client's risk profile should be supportable and reliable. Tools such as questionnaires can be useful to assess a client's risk profile but should be properly designed. The questions and answers that are used to establish the level of risk a client is willing and able to accept should be documented. The questions should be fair, clear and not misleading. A client's risk profile should not be manipulated to justify recommending higher-risk investment products, for example, by only having a single category for risk tolerance. Clients should not be influenced by an Approved Person as to the way they respond to questions related to their risk tolerance or risk capacity.

Resolving conflicts between a client's expectations and risk profile

Where the client's expectation for returns conflicts with their risk profile, the Approved Person should consider having a detailed discussion with the client on the relationship between risk and return to reconcile such conflicts and establish more realistic expectations.

Approved Persons should not override a client's risk profile or other KYC information to meet a client's expectation for returns. The Approved Person should identify any mismatches between the client's investment needs and objectives, time horizon, risk tolerance and capacity for loss, and revisit them with the client. If a client's goals or return objectives cannot be achieved without taking greater risk than they are able or willing to accept, the Approved Person should clearly explain the available alternatives, such as saving more, spending less or retiring later. Where after discussion with the client, the Approved Person determines that the client does not have the capacity or tolerance to sustain the potential losses and volatility associated with a higher risk portfolio, the Approved Person should explain to the client that their need or expectation for a higher return cannot realistically be met, and as a result, the higher risk portfolio is unsuitable. The interaction with the client and end results should be properly documented.

KYC for Joint Accounts

For joint accounts, certain KYC information, such as age and investment knowledge, should be collected for each individual account holder. Annual income and net worth can be collected for each individual or on a combined basis, as long as it is clear which method has been used. Investment needs and objectives, investment time horizon, and risk ~~tolerance~~profile should relate to the account and should not be collected separately for each individual account holder.

~~E. Methods~~Approval of ~~Recording or Depicting Risk Tolerance~~

~~MFDA staff has observed three methods of depicting risk on KYC forms:~~

~~*a) Tick Boxes*~~

~~This method typically uses three boxes (high, medium and low risk) or a numerical ranking of client risk where the risk rankings are grouped into high, medium and low risk categories (i.e. 1-3 is low risk, 4-6 is medium risk, 7-9 is high risk). Where this method is used, securities with risk higher than the risk tolerance indicated on the form would be unsuitable, as there is no indication that the client has agreed to hold any securities with a risk rating higher than indicated on the form. For example, a "medium" risk client should not invest in a "high" risk mutual fund. If a Member does not want to be limited to accepting securities with a risk tolerance equal to or less than that indicated by the tick box and wants to be able to construct portfolios that include higher risk securities, then the Member must explain to the client the composition of high, medium and low risk investments that will be held in the account and use either the percentage or model portfolio approaches discussed later.~~

~~Staff has observed that some Members use a tick box and disclose that the account may hold a portion of higher risk investments.~~

~~For example, the medium risk tick box would be defined as "a portfolio that holds no more than 20% of high risk investments". Staff would consider any approach that describes the account composition in this manner to be the "model portfolio approach" discussed below.~~

~~Members that want to use the model portfolio approach must be able to demonstrate, using statistical analysis and in consideration of all investments offered for sale, that their~~

~~definitions are appropriate, and that they are able to monitor the portfolio compositions on an ongoing basis.~~

~~*b) Percentages*~~

~~Some Members use a percentage basis to identify the risk composition of the securities to be purchased for the account, which is agreed to by a client (for example 10% high risk, 60% medium risk, 30% low risk). To the extent a trade will result in the risk composition exceeding the stated risk thresholds on the KYC form, it is flagged for a suitability assessment and resolved in the normal course.~~

~~*c) Model Portfolios*~~

~~A few Members have developed a model portfolio approach that categorizes clients based upon their KYC information and matches them to pre-established portfolios. The portfolios are broken down into their various risk levels and by type of investment (i.e. equity or income). Clear disclosure must be given to the client regarding the composition of the portfolios and how the KYC information provided results in the particular portfolio being selected.~~

~~To date, MFDA staff has only seen this approach used in an acceptable form by Members that sell a limited number of products and have access to a portfolio manager, as it requires regular monitoring of the securities within the portfolios to ensure that any account constructed under the model is in fact appropriate for a client with a particular set of KYC information. Any Member using this model has to be able to demonstrate, using valid statistical analysis, that the pre-established portfolios are suitable for clients within each category, considering all the investments the Member sells, and that the Member has the ability to monitor the established portfolio compositions for suitability on an ongoing basis.~~

~~*MFDA Compliance Trade Review Criteria*~~

~~In routine compliance examinations where MFDA staff performs sample testing of trades, staff will inquire about the suitability of any trade that results in the account containing securities in excess of 10% of a client's stated risk tolerance. Staff's threshold to flag trades for inquiry does not in any way detract from a Member's obligation to supervise suitability of trades or handle complaints fairly.~~

~~F.~~C. ~~Use of Questionnaire to Collect~~ KYC Information

~~Questionnaires can be a useful tool in assessing client KYC criteria if used properly. A questionnaire should be designed so that the risk tolerance generated is the lesser of the client's ability to withstand losses or willingness to accept risk. However, MFDA staff has seen instances where the questionnaire does not accomplish this result. In these cases, the questionnaires assign a greater relative weight or score to questions that solicit information regarding the client's ability to withstand losses than questions regarding the client's willingness to accept risk and then averages the scores together. This results in a higher risk tolerance for the client than is appropriate.~~

~~Staff has also seen questions that are too vague to provide reliable information and questions that do not correspond to the Member's KYC criteria. Members that use questionnaires, or allow APs to use their own questionnaires, are expected to review and test them to assess whether they provide appropriate and consistent results.~~

~~G. Additional Concerns with the Quality of KYC Information~~

~~MFDA staff has also identified the following concerns with respect to~~Members must have policies and procedures for both branch and head office staff relating to the opening of new accounts and updating of KYC information. The approval process should not be viewed solely as an administrative function. Rather, KYC information submitted for approval should be reviewed for adequacy as well as reasonableness, consistency, and uniformity.

Adequacy
Members must have controls in place to ensure accounts are only opened if adequate KYC information ~~being collected by Members:~~

- ~~Where ranges are used, at times they are too broad. For example, long term time horizons defined as greater than 3 years and the top category for net worth is greater than $100,000;~~
- ~~The NAAF does not collect~~is obtained. KYC is adequate when it is provides sufficient information to ~~assess~~ allow the Member and Approved Person to make a suitability ~~of particular products or investment strategies of the Member. For example, if selling exempt securities under the accredited investor exemption, the NAAF should include income and net worth~~ determination. In cases where a Member has accounts that have already been opened and KYC information ~~specific enough to demonstrate compliance with the exemption conditions.~~

~~As another example, where a minimum time horizon has been established as a guideline for recommending leveraging, the time horizon on the NAAF~~is not adequate, the accounts should be ~~able to support that this criteria has been met. Staff has also observed that certain Members define long term time horizon as greater than 3 years, which would not be adequate to determine whether the sale of a mutual fund with a deferred sales charge is suitable;~~restricted (for example, by restricting the accounts to liquidating trades, transfers or disbursements).

- ~~KYC choices on the NAAF are ambiguous. For example, time horizon of "none" was interpreted differently by staff at a Member to mean either extremely long term or very short term;~~
- ~~For joint accounts, Members have collected KYC information for each account holder rather than for the account itself. In some cases, the KYC information collected for each account holder conflicts and it is not clear what KYC information relates to the account;~~

~~KYC information that is inconsistent.~~

Reasonableness
The approval of new accounts and KYC updates should include the objective review of the KYC information submitted. For example, a 70 year-old client with a long term investment time horizon and high risk profile should be flagged for follow-up to assess whether the KYC information is accurate or whether there are other objectives of the client that have not been identified or recorded on the KYC form.

Consistency

- Members should have controls in place to prevent or detect inconsistencies in KYC information. For example, a client with a "speculative" investment objective ~~and~~should not also have a "low~~ risk tolerance. A Member should either have controls to prevent such inconsistencies or have detective controls to identify and follow-up where inconsistencies are identified;~~
- ~~Use of calculators or other formula that focus on ability to withstand losses rather than the lesser of the client's willingness and ability to accept risk;~~
- ~~Little or no explanation of terms used on the NAAF, including risk tolerance, investment objectives, and time horizon;~~
- ~~Where the model portfolio approach is used, little or no disclosure to the client regarding the composition of the portfolio, how the portfolio was selected, and no statistical analysis to support its reasonableness;~~
- ~~Where questionnaires are used to assess risk tolerance, the end determination of the client's risk tolerance is greater than what the responses from the questionnaire suggest;~~
- ~~KYC information may either be missing or incomplete;~~
- ~~NAAFs are not reviewed for consistency and reasonableness;~~
- ~~NAAFs are either not approved or not approved in a timely fashion;~~

~~Updates to~~" risk profile. In some instances, Members have incorporated edit checks into their trading systems that prohibit inconsistent KYC information ~~are not reviewed or approved or the Member's back office systems are not updated;~~from being entered or accepted.
~~Supervisors do not question~~

Uniformity
When approving new accounts, KYC amendments or performing branch examinations, Member supervisory staff should be alert to situations where ~~an AP has~~Approved Persons have a significant ~~portion~~number of ~~clients~~client accounts with the same or very similar KYC information. ~~In these cases, it appears the~~Approved Persons are to document KYC information ~~is being determined~~ based ~~upon trading practices used by the AP rather than~~ on ~~clients'~~ actual client circumstances~~;~~, and should not document KYC information solely to fit their investment strategy or recommendations.

- ~~Staff assigned to approve new accounts, or KYC updates, only reviews them for completeness and not consistency or reasonableness; and~~

- ~~Members record risk tolerance either as a number or range of numbers without providing explanation of what the number means or how it was derived. For example, a NAAF may indicate medium risk means a value of "4 to 6" and a client may be given a numerical value of "4". There may be no information or documentation provided to the client as to how the number "4" was derived, no explanation on the NAAF regarding the difference between a medium risk client that rates a "4" versus a "5", and no explanation of what medium risk means in terms of how it will relate to the types of investments that will be purchased.~~

D. Changes to KYC Information

Material Changes

Material changes would include any information that results in changes to the client's risk profile, investment time horizon and investment needs and objectives, as well as any significant changes to the client's personal circumstances (for example, a job loss, long term illness or death of a spouse) or financial circumstances (for example, having a significant impact on net worth or income).

Members should have policies and procedures for updating KYC information as a result of material changes that would include:

- The definition of a "material change";
- The requirement to obtain approval of supervisory staff, in accordance with Rule 2.2.4(c);
- Internal controls to ensure accuracy of client information in use by Approved Persons and supervisory staff; and
- Compliance with record keeping requirements, including the requirement to maintain evidence of client instructions and authorization regarding material changes.

When approving material changes, Branch Managers should review 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 trades or leveraging that are not suitable for the client, and that do not put the client's interest first (hereafter referred to as "unsuitable"). 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).

Updating KYC and Keeping KYC Current

Members and Approved Persons must make reasonable efforts to keep their clients' KYC information current (i.e. such information must be sufficiently up-to-date to support a suitability determination and meet the Member's other regulatory obligations). Members and Approved Persons must collect, review and refresh a client's KYC information after a meaningful and documented interaction with the client. Members and Approved Persons should take the opportunity on the initial KYC collection to explain the client's role in keeping KYC current. Further, MFDA Rule 2.2.4 (e) requires that all Members, at least annually, in writing, request each client to notify the Member if there has been any material change in client information previously provided to the Member or the client's circumstances have materially changed.

Under Rule 2.2.4, the Member and Approved Person must review KYC information within 12 months when transacting in securities requiring registration as an exempt market dealer and in any case no less than once every 36 months.

The periodic update should include a review of all KYC elements with the client. For example, it would not be reasonable to only update a client's income or employment information and not also ask them questions to revisit their risk tolerance and time horizon.

Account vs. Client KYC

A Member should collect KYC Information separately for each account. A client may have different risk ~~tolerance,~~profiles, investment time horizons, and investment needs and objectives for various accounts. However, other factors, such as income, age, and investment knowledge, must remain the same across accounts for the same client.

Where a Member wants to use one set of risk ~~tolerance,~~profile, investment time horizon, and investment needs and objectives for multiple accounts within the firm and assess suitability on a consolidated basis, the Member would have to demonstrate that:

a) The client has agreed that the KYC information relates to all the accounts specifically listed on the KYC form and the combined portfolio in these accounts will be reviewed when ~~assessing~~making suitability determinations;

b) The beneficial owners are the same for all the accounts;

c) The Member's back office system is able to effectively consolidate accounts to allow for a suitability ~~assessment.~~determination. For example, if a Member uses a percentage method for identifying risk ~~tolerance~~profile, the Member would have to demonstrate that its back office system can consolidate assets in all of the client's accounts into their respective risk categories to flag trades that would result in the risk ~~tolerance~~profile of the combined accounts being exceeded; and

d) The Member's back office system is able to separate accounts previously aggregated if one of the account's KYC information changes. For example, if the investment needs and objectives for one of the accounts change, the Member's back office system would have to be able to separately identify that account from the others as part of the trade supervision process.

~~2. KNOW YOUR PRODUCT~~

~~Members and APs must understand the salient facts about the products they offer to their clients in order to fulfill their suitability obligation. MFDA Staff Notice MSN-0048 – *Know-Your-Product* provides further guidance to Members on their due diligence obligations when approving and offering a product for sale.~~

~~A. Assessing Risk of Prospectus Qualified Mutual Funds~~

~~The risk ranking of a mutual fund should be determined with reference to the mutual fund's prospectus. Each mutual fund is assigned a risk ranking in the prospectus, which can change over time.~~

~~Comparing a client's risk tolerance to a mutual fund's risk ranking will not raise significant difficulty when the risk categories used on the KYC information and in the prospectus are the same.~~

~~However, when either the KYC information or the prospectus uses split-risk categories, such as "medium-high", it may be more difficult to match up the risk categories between the KYC information and the prospectus. In these instances, Members and APs should adopt the most conservative approach to assessing risk.~~

~~For example, if a mutual fund uses a risk category of medium-high and the Member uses only high, medium, and low risk tolerances on its KYC form, the fund should be considered high risk for suitability purposes. Additionally, if a Member uses a "tick box" approach and has a number of risk tolerance categories (low, low-medium, medium, medium-high, high), a mutual fund with a risk ranking of high would not be appropriate for a client with a medium-high risk tolerance. Members should also not attempt to divide a split-risk ranked mutual fund into individual risk components (for example, medium-high risk means 50% medium risk and 50% high risk).~~

~~B. Exempt Securities~~

~~A Member may distribute certain exempt securities, such as hedge funds, limited partnerships, or private notes or debentures, for which there is no prospectus. In these circumstances, these securities should be considered to be high risk. It should be noted that these securities are not regulated to the same extent as mutual funds, may have significant liquidity restrictions, and, in the case of hedge funds, may employ riskier strategies than conventional mutual funds, such as leveraging and short selling. These facts alone often justify a high risk ranking.~~

~~Members should also consider the concentration of investments in exempt securities when performing a suitability assessment. An appropriate concentration limit would depend on the exempt security being distributed. Staff has observed Members using a concentration limit range for exempt securities of 10-25% in relation to either the client's total investible assets or the client's total investments with the Member. If a Member assesses concentration limits by considering investments held in external accounts, the Member should have a reasonable process to determine that such information is current and accurate.~~

~~Staff has observed situations where some Members open a new account to trade only in an exempt security. In assessing suitability in these cases, Members should consider whether the KYC information for the new account is reasonable given existing information on file for the client, and also whether the amount invested in the exempt security is suitable given the client's other investments.~~

~~Members should also maintain details of the exemption relied upon and documentation to support reliance on the applicable exemption.~~

~~C. Principal Protected Notes~~

~~Principal Protected Notes ("PPNs") that are guaranteed by a chartered bank or the Government of Canada usually guarantee 100% return of principal. However, they generally require clients to invest their funds for long periods of time and take a risk that their investment may not generate any returns at all during this period.~~

~~PPNs may be subject to liquidity restrictions and may not have a guaranteed secondary market created by the issuer. Even where a buyer is found, the client may be forced to sell the investment in the note at a loss when disposing of it before the maturity date. Furthermore, some PPNs contain early redemption charges over the first 2 or 3 years of the investment, which further penalizes investors who sell the investment in this time period. Accordingly, PPNs are generally not suitable investments for clients with a time horizon shorter than the maturity period of the note.~~

~~Most PPNs do not offer an income stream, but provide a return to clients at the maturity date, provided certain conditions are met. This makes these investments generally unsuitable for clients with an investment objective of "income".~~

~~While they share some common characteristics, PPNs can vary greatly in how their returns are calculated and the term of the investment. When analyzing these products for suitability, Members and APs should always conduct proper due diligence to gain an appropriate understanding of the note in question.~~

~~The MFDA is aware that, in some cases, APs have recommended that clients purchase a PPN with the intent of selling the product before it matures. Where a recommendation is made with the intent of selling these products before maturity, this should be clearly noted in the client~~

~~file, together with a discussion of the risks associated with this strategy. At a minimum, clients should be informed that:~~

- ~~A secondary market may not exist for the PPN, in which case the PPN must be held to maturity;~~
- ~~If a secondary market does exist, the client may not be able to sell the PPN for a profit; and~~
- ~~If the issuer allows early redemptions, the issuer may charge early redemption fees.~~

~~The Member's due diligence and risk ranking should reflect the liquidity restrictions noted above and the fact that the principal is not guaranteed if the product is not held to maturity. A recommendation to purchase a PPN with the intent of selling before maturity is not generally suitable for a low risk investor.~~

~~3.~~2. SUITABILITY PROCESS

A. ~~When is~~ Suitability ~~Assessment Required?~~in General

The obligation to make a suitability determination is a fundamental obligation owed by Members and Approved Persons to their clients and is critical to ensuring investor protection. It is a cornerstone of the registration regime and an extension of the duty to deal fairly, honestly and in good faith which Members and Approved Persons owe to their clients. It cannot be satisfied through the provision of disclosure or by obtaining a client waiver. Meeting the suitability determination criteria does not imply a guarantee of any particular client outcome.

Suitability cannot be determined without having first complied with the KYC and KYP obligations. Members and Approved Persons are required to gather sufficient information through the KYC process to support a suitability determination. Members and Approved Persons must consider each of the KYC elements and suitability factors in Rule 2.2.6(1) (a) and (b) when making a suitability determination. For example, while a client's risk profile is an essential element of the client's KYC information, using the risk rating of an investment product as the only input will not satisfy the requirement to ensure that a recommendation is suitable for the client and puts the client's interest first.

Before a Member or Approved Person opens an account for a client, makes a recommendation for an account of a client, or takes any other investment action for the client the Member or Approved Person must determine that the investment action is suitable for the client, and puts the client's interest first.

The client's interests, as distinguished from the Member's, Approved Person's or anyone else's, are at the core of the obligation. It is not sufficient for a Member to determine that a recommendation or decision is suitable for a client, the Member must also determine that the action puts the client's interests first.

MFDA Rule 2.2.~~1~~6 requires that a suitability ~~review~~determination be performed for each order accepted or recommendation made for any account of a client. This means that the suitability ~~assessment~~determination must be performed for trades that are recommended by the ~~AP~~Approved Person, as well as for orders proposed by the client. For more guidance with respect to suitability obligations for unsolicited orders, please refer to MFDA Staff Notice MSN-0025 – *Suitability Obligations for Unsolicited Orders*.

~~MFDA Rule 2.2.1(e) also requires~~When liquidating investment products for clients, including those transferred in from another Member, Approved Persons must use their professional judgement in a way that puts the client's interest first, being mindful of any tax or other consequences to the client.

If the Member and Approved Person cannot recommend an account, services or investment products to the client that are suitable and put the client's interest first because these are not available at the Member, the Member and Approved Person should decline to open an account or provide investment products or services to the client.

B. When is Suitability Determination Required?

Members and Approved Persons must make a suitability ~~assessment~~determination:

- Before recommending or taking an investment action; and
- When certain triggering events occur as set out below.

Meaning of "investment action"

An "investment action" includes opening an account for a client, purchasing, selling, depositing, exchanging or transferring investment products for a client's account, and taking any other investment action for a client, or making a recommendation or decision to take any such action. An investment action for a client also includes a recommendation or decision to continue to hold investment products, which may be the case, for example, upon a review of a client's account and the investment products in the client's account when reassessing suitability pursuant to a suitability trigger event.

Suitability Trigger Events

A suitability determination of the investments within ~~each~~a client's account ~~i~~ must be performed whenever the following events occur:

a) A client transfers assets to the Member or transfers assets into an existing account at a Member;

b) The Member or Approved Person becomes aware of a change in an investment in the client's account that could result in the investment or account not satisfying the suitability criteria under Rule 2.2.6(1)

c) A Member or ~~AP~~Approved Person becomes aware of a material change in a client's KYC information~~, as defined in~~ that could result in an investment or the client's account not satisfying the suitability criteria under Rule 2.2.6(1);

~~b)~~d) The Member or Approved Person performs the periodic review required under Rule 2.2.4~~; and~~(f) (i.e. no less frequently than once every 36 months); and

~~c)~~e) With respect only to ~~APs~~Approved Persons, where a client of the Member is reassigned from one ~~AP~~Approved Person to another (note that this applies only to Members that assign accounts to ~~APs).~~Approved Persons).

~~APs must assess the suitability of the investments within each client's account in the circumstances set out above. In addition to the suitability assessments performed by the AP, the Member's head office and the Branch Manager are required, in accordance with Policy No. 2, to review the suitability of investments in client accounts on a sample basis in certain circumstances. Attached to this Notice, as Appendix 2, is a chart summarizing the respective obligations of Approved Persons and branch and head office supervisory staff with respect to suitability reviews.~~

~~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.~~

Timing of Review

A suitability determination must be performed within a reasonable time of a trigger event. 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~~.

For pre-authorized purchases or systematic withdrawals pursuant to established plans, a suitability determination must be made prior to establishing the systematic plan, and upon the occurrence of a triggering event (i.e. for such plans, a suitability determination is not required prior to each purchase or withdrawal).

With respect to client transfers, the volume of accounts to be reviewed may be a relevant factor in determining reasonable time. Where an ~~AP~~Approved Person is transferring a large book of business to the Member, it may be reasonable to ensure that the suitability ~~assessments~~determinations are done within a year if there are no trades on the accounts.

If, however, one client transfers assets into an account at the Member from another dealer or financial institution, it is reasonable to expect that the suitability ~~assessment would be done relatively quickly.~~determination would be done relatively quickly. In some cases, such as when assets are transferred in from another Member, it may not be possible for Approved Persons to complete the suitability determination required in advance of opening an account for the client. In these circumstances, the Member and Approved Person should also have a process in place to restrict investment actions that can be taken by or on behalf of a client until the suitability determination has been completed (for example, by restricting the accounts to liquidating trades, transfers or disbursement).

Where the Member or registered salesperson becomes aware of a material change in the client's KYC information, the suitability ~~assessment~~determination 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.

> ~~Should a Member or an AP identify an account that contains unsuitable investments, they must bring this fact to the client's attention and discuss whether there has been any change to client circumstances that would warrant altering the KYC information. It is inappropriate to simply alter the KYC information in order to match the securities in the account without discussing the situation with the client. If, even after obtaining a justifiable KYC update, the account continues to be unsuitable, the AP should discuss this situation with the client and recommend rebalancing the account to correspond to the client's new KYC information. In following this process, the AP must act in accordance with the client's instructions. Trades must be placed only in accordance with client instructions and any advice given should be properly recorded, particularly if the client declines to follow the recommendation.~~

~~B. Suitability in General~~

~~An investment suitability analysis is mostly an objective analysis. To the extent that there is subjectivity in the analysis, the expectation of MFDA staff is that the Member and AP take the most conservative approach and act in the best interests of the client. The analysis generally involves matching~~***Account Type selected for client must be suitable and put the client's interest first***

When opening an account, Members and Approved Persons must ensure that the type of account recommended is suitable for the client and puts the client's interest first. In making this determination, the Member or Approved Person must take into consideration factors including compensation options, and the nature of the service offered to the client. In addition, Members and Approved Persons should explain the features and associated costs of different types of accounts that are available to the client at the Member (e.g. fee-based accounts, commission- based accounts, etc.).

C. Range of Possible Suitable Recommendations

A suitability determination by a Member or Approved Person, may result in a range of possible suitable recommendations or decisions for the client. However, when making a suitability determination, Members and Approved Persons must put the client's interest first, ahead of their own interests and any other competing considerations, such as a higher level of remuneration or other incentives, and must exercise their professional judgement when opting for one recommendation or decision among other suitable options.

D. Specific Factors

KYC Information

An aspect of the suitability determination involves comparing the characteristics of ~~an investment with~~ the ~~overall assets~~investments in the account to the ~~investor's stated investment needs as set out in the~~client's KYC information. These should be aligned. Where there is a discrepancy between the KYC information and the investments~~,~~ in the ~~investments will generally be considered unsuitable or~~ account, this may indicate that the client's KYC ~~information~~needs to be updated, or that the account may need to be ~~updated. In any event, such a situation should result in a supervisory inquiry.~~rebalanced.

Client risk ~~tolerance~~profile, investment needs and objectives~~,~~ and investment time horizon ~~noted in the KYC information give direct information regarding what is suitable for a client. These three elements must~~must be directly compared against the assets in the client's account ~~to ensure that the trades are suitable.~~. The other ~~categories (~~required KYC information including investment knowledge, ~~annual income, net worth, and age) serve two main functions. Firstly, they~~personal circumstances and financial circumstances, are ~~used in~~also key considerations when assessing the ~~suitability of any leveraged loans and, secondly, they can be used as a check against the three categories that give direct information regarding whether the investments are suitable for a client.~~reasonableness of suitability determinations made for clients. For example, ~~if~~ a ~~70 year-old~~senior client ~~is shown as having a high risk tolerance and little~~ or ~~no~~client with limited investment knowledge~~, it is indicative of a situation which would require follow up.~~ with a high risk profile should prompt a supervisory inquiry.

Regardless of the methodology used by the dealer to record KYC information, the Member should be able to demonstrate~~, using appropriate and accepted methodologies,~~ that its suitability process is sufficient to ~~reasonably ensure that recommendations or orders accepted are suitable for clients considering their particular KYC information.~~ support a suitability determination. Further, Members are responsible for ~~assessing~~making suitability ~~of recommendations made with~~determinations in respect ~~to~~of all recommendations that are made as part of the business of the Member. This would include ~~investment advice or~~ recommendations for investment products that may not meet the definition of a "security" under securities legislation ~~(for example, PPNs or charitable donations schemes with investment characteristics).~~.

~~When assessing suitability, only assets distributed or held by the Member can be considered in the analysis.~~

~~C. Risk Tolerance Suitability~~

~~A Member's system for identifying trades that exceed a client's stated risk tolerance depends on the Member's approach to recording risk tolerance. Where a Member uses a "tick the box" approach to recording risk tolerance, a trade in an investment with risk greater than the client's stated risk tolerance should be flagged for review and resolution.~~

~~Where a Member is using the percentage method for recording risk tolerance, a trade that results in an account with a greater percentage of low, medium to high risk investments than indicated on the KYC form should be flagged for a suitability review.~~

~~While generally in an examination MFDA staff will not query trades where the account has a greater percentage of lower risk investments, these situations may indicate that the KYC information on file requires an update or the client's objectives are not being met. Where a Member uses the model portfolio approach, an account that exceeds the pre-established thresholds should be flagged for review.~~

~~D. Use of Weighted Average of Fund Risk Ratings~~

~~Staff is aware of some Members using a simple weighted averaging process to assess suitability that involves:~~

- ~~*a)* Recording client risk tolerance on a scale of 0 to 9, either in absolute terms or as a range;~~
- ~~*b)* Risk rating mutual funds on a scale of 0 to 9, which may not specifically correspond to their prospectus risk ranking; and~~
- ~~*c)* Taking a weighted average of the risk ranking of each fund and comparing it to the client's score.~~

~~The weighted average of fund risk scores is not an appropriate method for assessing suitability. To illustrate an actual example, assume a Member categorizes clients as follows:~~

~~Low risk~~	~~0 to 3~~
~~Medium risk~~	~~4 to 6~~
~~High risk~~	~~7 to 9~~

~~A client is considered medium risk and is given a risk ranking of between 4 and 6. Assume the client has 50% high risk investments with a risk rating of 8, 30% medium risk investments with a risk rating of 5 and 20% low risk investments with a risk rating of 1. The overall risk of the portfolio would be calculated as follows:~~

~~High risk investments~~	~~50% x 8 =~~	~~4.0~~
~~Medium risk investments~~	~~30% x 5 =~~	~~1.5~~
~~Low risk investments~~	~~20% x 1 =~~	~~0.2~~
~~Weighted Average Risk of the Portfolio~~		~~5.7~~

~~The above portfolio would appear to be suitable using the weighted averaging methodology. However, mutual funds with an 8 ranking have included speculative and volatile funds and mutual funds with a 5 risk ranking have included growth funds. Such a portfolio could result in a significantly higher standard deviation than the industry average or industry guidelines in respect of a medium risk mutual fund.~~

~~It appears that the general concept being relied upon is that high and low risk investments always counteract each other, which is not necessarily true in all cases. Modern Portfolio Theory calculates the standard deviation of a portfolio as the weighted average of the standard deviations of each security in addition to components that account for the co-movement of returns of the individual securities.~~

~~The weighted average of fund ratings, while simple to use and easy to implement, is not an appropriate or effective method to prevent and detect unsuitable transactions.~~

~~E. Investment Objective Suitability~~

~~Investment objectives can be stated as a whole or as percentages. For example, a client can state an investment objective as "income" or 50% income and 30% growth and 20% aggressive growth. When assessing investment objective suitability, it is necessary to determine whether the particular investment or trade meets the objectives of the account.~~

~~F. Time Horizon Suitability~~

~~The characteristics of a particular investment should be suitable given the client's stated time horizon. Mutual funds are generally considered medium to long term investments.~~

~~A client's stated time horizon is most important when considering the fee structure of a mutual fund. Generally, it is considered unsuitable for a client to be put into a DSC fee fund and have a time horizon that is shorter than the DSC schedule. A time horizon suitability analysis of investments with liquidity restrictions should also be performed. If the stated time horizon is less than the liquidity restriction, the investment would not be suitable for the client.~~***Know Your Product***

Under Rule 2.2.5, Members and Approved Persons must understand the investment products they offer to their clients in order to fulfill their suitability obligation. MFDA Staff Notice MSN-0048 – *Know-Your-Product* provides further guidance to Members on their due diligence obligations when approving and offering an investment product for sale.

Concentration and Liquidity in a Client's Account

Over-concentration in any one security, sector or industry can have a significant impact on the risk and liquidity in a client's account. Members should determine appropriate concentration and liquidity thresholds for their clients and implement a process to supervise concentration in a client's account. Many Members set concentration limits expressed as a percentage of an account or of a client's total investments with the Member, and also set additional concentration limits expressed as a percentage of a client's total investable assets. For example, we suggest that Members implement supervisory policies and procedures to flag, at a minimum, a concentration limit of 25% of a client's total investments with the Member and an additional limit of 10% of a client's total investable assets.

Members should consider a number of factors when assessing concentration and liquidity, for example, the type of security, market conditions, and redemption or other liquidity restrictions. Generally, the higher the concentration in a particular type of security, sector or industry, the more steps the Member and Approved Person should take, and appropriately document, to demonstrate that the investment was suitable for the client and puts the client's interest first.

For example, Members should assess whether the client's investments are over-concentrated in:

- Illiquid exempt market securities as compared to more liquid securities,
- Securities of a single issuer, or group of related issuers, as compared to a broadly- based portfolio of issuers,

or

- Securities of an issuer, or group of related issuers, that provides exposure to a single industry or asset class, for example, real estate or precious metals, as compared with a broadly-based portfolio of issuers that provide exposure to diversified industries or asset classes.

Potential and actual impact of costs

Costs can have a significant impact on a client's return over time. Members and Approved Persons must assess the relative costs of the options available to clients at the Member when making a suitability determination, as well as the impact of those costs. This includes assessing the impact on the client's overall return of any compensation paid, directly or indirectly, to the Member, whether by the client, the Member, or a third party. Members must put their client's interest first when selecting from multiple suitable options available to the client, and must document the reasonable basis for their suitability determinations.

The term cost is interpreted broadly and includes all direct and indirect costs, fees, commissions and charges, including trailing commissions and any other kind of direct and indirect compensation which may be associated with a client purchasing, selling, holding or exchanging an investment product.

Consideration of a reasonable range of alternatives

Members and Approved Persons have an obligation to consider a reasonable range of alternative recommendations or decisions available to the Approved Person through the Member when making a suitability determination. What constitutes a reasonable range of alternative recommendations or decisions for a client will depend upon the circumstances, including the investments and services offered to the client, the degree of skill and proficiency of the Approved Person, and the client's particular circumstances.

~~G.~~E. Trade and Account Supervision, Inquiry Resolution

Members should have systems or processes to identify ~~trades inconsistent with the client's risk tolerance, investment objectives, and time horizon.~~unsuitable trades.

A Member's criteria for selecting trades for review at both the branch and head office, inquiry and escalation process, supervisory documentation requirements, and resolution options should be documented and clearly communicated to all levels of staff within the Member. ~~APs~~When issuing a supervisory inquiry, the reason for the inquiry, as well as timelines to respond and additional information required, should be documented and the progress monitored to ensure a timely resolution.

Approved Persons should know the criteria the Member uses in assessing suitability, actions the Member will take when a trade has been flagged for review and appropriate options for resolution. Branch Managers should also be trained on their obligations to maintain evidence of their supervisory review, including what information must be kept (signature, date, explanation of how the inquiry was resolved, and supporting documents when necessary). Head office staff responsible for performing trade supervision and branch reviews must also be trained on the head office trade supervision criteria, documentation standards, timelines for inquiry and resolution, and the escalation and disciplinary process. These staff members should also have the appropriate proficiency and qualifications to allow them to conduct effective trade supervision. Individuals who have successfully passed the examinations for designation as a Branch Manager or Chief Compliance Officer would generally be considered sufficiently qualified to perform trade supervision.

Outlined below are the requirements for trade review for branch and head office supervision, as set out in Policy No. 2. ~~Attached to this Notice, as Appendix 2, is a chart summarizing the respective obligations of Approved Persons and branch and head office supervisory staff with respect to suitability reviews.~~

a) Branch Office Supervision

A Branch Manager (or alternate) must review the previous day's trading for unusual trading activity. This review should include, at a minimum, all:

- Initial trades;
- Trades in exempt securities (excluding guaranteed investment certificates);
- Leveraging for accounts other than registered retirement savings plans or registered education savings plans;
- ~~Trades in accounts of family members operating under a power of attorney in favour of APs;~~
- Trades in accounts where the client is a Related Person, as defined by the *Income Tax Act* (Canada), of the Approved Person and the Approved Person has full or partial control or authority over the financial affairs of the client;
- Trades over $2,500 in moderate-high or high risk ~~investments~~investment products;
- Trades over $5,000 in moderate or medium risk ~~investments;~~investment products;
- Trades over $10,000 in all other ~~investments~~investment products; and
- Redemptions over $10,000.

When reviewing trades, including redemptions, it would also be advisable to determine whether the ~~AP~~Approved Person has maintained adequate notes and instructions on a sample basis.

b) Head Office

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:

- Trades over $5,000 in exempt securities (excluding guaranteed investment certificates), moderate-high or high risk ~~investments~~investment products or 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~~investment products;
- Trades over $50,000 in all other ~~investments~~investment products (excluding money market funds); and
- Redemptions over $50,000.

Redemptions should be reviewed to identify possible outside business activity where money may be leaving the Member for potentially inappropriate or unauthorized purposes, potential excessive trading where the money is being parked or held pending reinvestment, to assess the impact and appropriateness of redemption charges, where applicable, and to assess suitability in terms of the redemption's impact on the composition of the remaining portfolio. For example, a client may have a balanced objective and hold a combination of fixed income and equity mutual funds. If the client redeemed out the entire fixed income component of his or her portfolio, the remaining portfolio of equity mutual funds would be inconsistent with the client's balanced investment objective.

For the purposes of ~~Sections~~sections a) and b) above, the term "trades" does not include redemptions, except where specifically referenced.

c) Trend Analysis

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

- ~~excessive~~Excessive trading or switching between funds indicating possible unauthorized trading, ~~lack of suitability~~unsuitable trades, 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~~Excessive switches between no load funds and DSC or front load funds;
- ~~excessive~~Excessive switches between DSC funds and front load funds; and
- ~~excessive~~Excessive switches where a switch fee is charged.

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

- ~~a~~A review of all accounts generating commissions greater than $1,500 within the month;
- ~~a~~A quarterly review of reports on assets under administration ("AUA") comparing current AUA to AUA at the same time the prior year; and
- ~~a~~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.

The review of commission reports would not be relevant for ~~APs~~Approved Persons who are salaried employees. However, the review of AUA reports would still apply.

d) Inquiry and Resolution

Member policies and procedures to evidence trade supervision must go beyond merely requiring supervisory staff to sign and date a trade blotter or trade instruction form. Members must also have policies and procedures with respect to the trade inquiry process. The policy should include guidelines on the types of trades or account activity that should generate an inquiry, details on how inquiries are to be documented, timelines for ~~APs~~Approved Persons to respond to inquiries, procedures to track and follow up on open inquiries, and methods to resolve the inquiry. Appropriate resolution may include:

- Cancelling or reversing the trade or rebalancing the account, without cost to the client, to make it consistent with the client's KYC information; or
- Obtaining a new KYC form where ~~the trade was suitable but~~ the KYC information was outdated.

Where a new KYC form is obtained, it is important that the supervisor who queried the trade consider the reasonableness of the KYC update. For example, if there has been a short time frame since the last update or the KYC information has changed drastically, it is possible that the update is only being made to justify an unsuitable trade.

Members should also include an escalation procedure in their trade inquiry process. If an ~~AP~~Approved Person does not respond to an inquiry or does not provide sufficient justification for the trade within a reasonable period of time, the Member must take steps to resolve the query. The escalation procedure should include timelines to respond and the process that will be taken by the Member if the ~~AP~~Approved Person does not take steps to resolve the query. Members should also consider imposing increased supervision over trade activity of an ~~AP~~Approved Person where he or she has an inordinate number of trades being queried, or queries which raise concerns regarding the ~~APs~~Approved Person's competency or understanding of the Member's internal policies.

An appropriate audit trail of all trade supervision must be maintained. This includes not only initials of the supervisor and a date, but also documentation evidencing what trades were queried, the response received and resolution made.

~~H.~~F. Unsolicited Unsuitable Trades and Unsuitable Portfolios

~~MFDA Rule 2.2.1(d) requires that, where~~Where a client has requested a trade on an unsolicited basis which, in the view of the ~~AP~~Approved Person or Member, is unsuitable, the Member or ~~AP~~Approved Person must advise the client of this fact, recommend an alternative action that would satisfy the suitability requirements in Rule 2.2.6, and receive recorded confirmation of the client's instruction to proceed before executing such a transaction. The Member must maintain a record of the advice given and the client's authorization to proceed.

~~In some instances, accounts may be inconsistent with client KYC information, which is not a result of any action taken by an AP or Member. For example, a client transferring~~Should a Member or an Approved Person identify an account that contains unsuitable investment products, they must bring this fact to the client's attention and discuss whether there has been any change to client circumstances that would warrant altering the KYC information. It is inappropriate to simply alter the KYC information in order to match the investment products in the account without discussing the situation with the client. If this situation is not remedied after obtaining a KYC update that accurately reflects the client's circumstances, the Approved Person should discuss this with the client and recommend rebalancing the account to correspond to the client's new KYC information. In following this process, the Approved Person must act in accordance with the client's instructions. Trades must be placed only in accordance with client instructions and any advice given should be properly recorded, particularly if the client declines to follow the recommendation.

In some instances, and not as a result of any action taken by a Member or Approved Person, accounts may be unsuitable. For example, a client transferring assets into a Member may have unsuitable investments or may have employed a leveraging strategy that, in the view of the Member, is unsuitable or that is not ~~suitable or~~ consistent with ~~their~~the Member's leveraging guidelines. In these cases, the Member should follow the same process that is in place for unsolicited unsuitable trades and advise the client that the investments or leverage strategy ~~are unsuitable~~is not suitable, make recommendations to address the inconsistencies, and maintain a record of such advice and recommendations. For more guidance with respect to suitability obligations for unsolicited orders, please refer to MFDA Staff Notice MSN-0025 – *Suitability Obligations for Unsolicited Orders*.

~~I. Additional Concerns Regarding Trade Supervision and Suitability Assessments~~

~~MFDA staff has also identified the following concerns with respect to the suitability process of trade reviews conducted by Members:~~

- ~~Exempt products are not given a risk assessment and are not considered in the suitability analysis;~~
- ~~Suitability is assessed without considering all the KYC information. For example, a Member may only focus on risk tolerance and ignore time horizon or investment objectives;~~
- ~~Members are only performing trade reviews and are not performing trend analysis to identify trends of concern including significant redemptions;~~
- ~~Members are employing an unreasonable materiality threshold for assessing suitability;~~

- ~~Members do not have policies regarding their suitability process and, as a result, there are inconsistencies in how trades are selected and reviewed for suitability;~~
- ~~Members are not classifying hedge funds and exempt securities as high risk;~~
- ~~Lack of due diligence on exempt products, which results in a misunderstanding of key attributes of the offering;~~
- ~~Little or no guidance given to APs or supervisors as to attributes of exempt products offered to clients and the type of client that such products would be suitable for;~~
- ~~Trades of Branch Managers are not reviewed by head office;~~
- ~~Trade supervision is not performed within one business day;~~
- ~~Inadequate trade selection criteria;~~
- ~~Minimal or no policy on trade supervision at branch and head office;~~
- ~~Little or no training of supervisory staff on suitability criteria and supervisory process;~~
- ~~Branches are not performing trade supervision or documenting supervisory activity;~~
- ~~Inadequate documentation of trade inquiries made, follow-up and resolution;~~
- ~~Trade blotters used for supervision do not include KYC information or identify leveraged trades;~~
- ~~Supervisors accept AP explanations without objectively considering their reasonableness; and~~
- ~~Members do not have an escalation or discipline policy dealing with unsuitable trading practices (e.g. heightened supervision, fines, termination, etc).~~

~~4.~~3. LEVERAGING

Using borrowed funds to invest (or leveraging) is not suitable for all investors~~ and~~. Members ~~have the responsibility to ensure~~are responsible for ensuring that ~~all leveraging recommendations are~~ whenever a client borrows to invest, it is suitable for the client and ~~in keeping with~~puts the client's ~~KYC information, in accordance with MFDA Rule 2.2.1.~~ interest first.

A. Informing the Client

Clients must be provided with a balanced presentation of available options and the risks associated with the use of leverage must be clearly disclosed.

Many issues arise because of the client's failure to fully understand certain key considerations before borrowing money to invest, such as:

- The strategy should only be used by individuals who are comfortable with the general risks associated with leveraging;
- The value of the leveraged portfolio may fall below the value of the loan;
- There is a magnification of the investment risk where a leverage strategy is used;
- Even where returns on leveraged investments are positive, interest costs may exceed the returns received;
- Whether investment returns are positive or negative, clients must still pay back the loan plus the agreed interest, which may cause client hardship;
- The clients may be forced to realize losses as a result of the terms of secured loans;
- Any loans secured against a client's home can put the client's equity interest in the home at risk;
- If a client is relying on investment returns to cover borrowing costs and the investment falls in value, the client could default on the loan;
- A lender's assessment of a client's ability to repay an RRSP loan may be based on the presumption that the client will use the tax refund to pay back the loan; and
- A leverage strategy is not necessarily suitable simply because it is being used as a means to take advantage of tax deductions; there is specific tax legislation governing the deductibility of interest and, if the conditions are not complied with, it may lead to a reassessment.

Members should ensure that ~~APs~~Approved Persons provide this information to any clients to whom leveraging recommendations are made, and to clients who the ~~AP~~Approved Person otherwise knows are investing with borrowed funds.

B. Member and ~~AP~~Approved Person Responsibilities Regarding Leveraged Transactions

As noted in MFDA Staff Notice MSN-0008 – *Policies and Procedures Manual*, each Member's policies and procedures manual should address issues related to borrowing for the purchase of ~~securities.~~investment products. The manual should:

- Outline the requirement to deliver the risk disclosure documents to clients in accordance with MFDA Rule 2.6;

- Describe appropriate client circumstances for recommending the purchase of ~~securities~~investment products with borrowed funds (guidance is provided under "Assessing Suitability of Leveraging Recommendations" below);
- Describe the information required to be maintained in the client file to facilitate proper Member supervision, including lending documents, which should be consistent with KYC information on file for the client;
- Describe procedures for identifying and reviewing leveraged trades, as required by MFDA Policy No. 2; and
- Describe procedures for Member approval of ~~AP~~Approved Person arrangements with lenders to ensure the proper recording and supervision of leveraging recommendations.

~~The responsibility of the Member and AP in a given instance will depend on their level of involvement in the client's decision to employ a leverage strategy. Where the Member or AP~~Where the Member or Approved Person has made a specific recommendation to borrow money for the purpose of investing or becomes aware that the client is using a leverage strategy, the Member or ~~AP~~Approved Person 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 ~~AP~~Approved Person assists the client in completing the loan application, the Member must maintain copies of the lending documents in the file, including copies of the loan application. Supervisory staff should compare the client information recorded on the loan application to the information recorded on the KYC form and identify and resolve any discrepancies.

The Member's policies and procedures should also address situations where ~~APs~~Approved Persons have arrangements with lending institutions to finance leveraging strategies. Arrangements in which compensation is paid are referral arrangements pursuant to ~~Division 3 of Part 13 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*~~requirements under Rule 2.4.2, and must be documented and entered into between the Member and the financial institution. Even where ~~there is~~ no monetary compensation is paid, Members are expected to have policies and procedures in place to require ~~APs~~Approved Persons to inform them of any arrangement or agreement with a lender to comply with the ~~Members~~Member's general supervisory obligation to address any ~~actual~~material or ~~potential~~reasonably foreseeable conflict of interest. This would not include situations where clients arrange their own financing without the recommendation or advice of the ~~AP.~~Approved Person. Where clients do arrange their own financing and it comes to the attention of the Member or ~~AP~~Approved Person, the Member should have policies and procedures to flag the account and review such situations in accordance with its leveraging guidelines~~.~~

The Member should ensure that all ~~APs~~Approved Persons are fully aware of the negative, as well as the positive, aspects of leveraged investing so that full disclosure can be made to their clients. ~~APs~~Approved Persons must understand and observe the requirement to provide balanced, objective information to the client. In particular, where projections are provided to clients, any assumptions on which a projection is based must be clearly stated, with examples of positive and negative results.

C. Assessing the Suitability of Leveraging Strategies

All leverage recommendations must meet the criteria under Rule 2.2.6(1)(a) and (b).

The following guidelines are not intended to apply to loans obtained for the purpose of investing in an RRSP or RESP.

Leverage is not suitable for all investors and the appropriateness of a recommendation to use leverage must be assessed on a client-by-client basis, having regard to the client's age, financial circumstances, investment needs and objectives, risk ~~tolerance,~~profile, investment time horizon, the manner in which they intend to secure and repay their loan, and any other factors that are known at the time or reasonably ascertainable and may be relevant in the circumstances.

Members must have policies and procedures with respect to leveraging, including criteria that would indicate when it is an unsuitable strategy, and the approval process. MFDA staff also recommends pre-approval of leverage recommendations by supervisory staff.

The minimum criteria listed below and set out under Policy No. 2 are intended to prompt a supervisory review and investigation of a leverage strategy by the Member. Members must consider all the criteria in ~~assessing the~~making a suitability ~~of the leverage strategy~~determination. The triggering of the criteria does not necessarily mean that the leverage strategy is unsuitable.

Where an inconsistency with one of the criteria is identified, further due diligence is required to assess the suitability of the leverage recommendation, which may include obtaining detailed information on client cash flows, monthly expenses, and other debt or lending obligations. In addition, where the criteria are not met, or the information regarding the client's annual income or net worth appears inconsistent with the client's occupation, age, or other information, additional supporting documentation should be requested. –Evidence of all due diligence performed, including the supporting documentation obtained, should be maintained.

Minimum criteria set out under Policy No. 2 that require further supervisory review and investigation include the following:

a) Investment Knowledge

A leveraging strategy is not recommended for clients who have indicated that their investment knowledge is low or poor.

b) Risk ~~Tolerance~~Profile

~~A leveraging strategy should only be recommended where a client has a medium or higher risk tolerance. A leveraging strategy is generally not suitable for investing in low risk investments, as the cost of borrowing may be greater than the returns from the investment. Where a Member uses the percentage method for recording risk tolerance, leveraging would be suitable where the client has indicated that the majority of the account will be invested in medium and high risk investments.~~

The use of leverage is a high risk strategy. The Member should consider how much the client is investing, and in what they are investing. In our view, a client should not have a risk profile of less than "medium" (or a similar category). The use of leverage is not suitable for clients with a risk profile lower than "medium".

c) Age

A leveraging strategy is used mostly for long term growth investments. Most clients who are 60 years or older have a portfolio that is maximized for income generation and capital preservation, as opposed to long term growth. Further, when clients are at or nearing retirement, their earning potential and ability to withstand investment losses decreases. As such, leveraging is generally not considered suitable for these clients and a red flag must be raised and an objective ~~assessment~~determination of the KYC information should be provided.

d) Investment Time Horizon

A leveraging strategy is generally more appropriate for clients with a long term investment time horizon. This is because investing for the long term alleviates to some extent the risks of short and medium term market volatility. If a client is leveraged and has ~~a~~an investment time horizon of less than 5 years, this issue must be flagged for review.

e) Net worth

Where the total leverage amount exceeds 30% of a client's total net worth, the leverage recommendation must be flagged for further review. In some instances, it may be acceptable to exceed these thresholds, and this will require judgment. For example, it may be appropriate, in some circumstances, for a young client with very little liquid net worth, but with a high income to be leveraged. As always, this factor must be considered in conjunction with all others. Where these criteria are exceeded, Members must consider the client's ability to access assets in circumstances where the investments decline below the value of the loan and additional funds are required to meet the terms of the loan.

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. Where the net worth criteria in Policy No. 2 ~~is~~are triggered or close to being triggered, a leverage suitability ~~assessment~~determination should take into consideration the portion of the client's total net worth that is comprised of liquid assets.

f) Client's Income
A client's income must be sufficient to service all the client's debt and lease payments. This would include all loans of any kind, whether or not obtained for the purpose of investment. As a general guideline, the total debt and lease payments should not exceed 35% of the client's gross income, not including income generated from the leveraged investments. For example, a client with a gross income of $2,000 a month should not have loans that require monthly debt payments in excess of $700 a month.

Other Issues Regarding the Suitability of Leveraging
Clients should not be relying on the growth of mutual funds in the account to make payments on the leveraged loan, nor should the client have to make withdrawals from registered investments to make payments.

A Member and ~~AP~~an Approved Person cannot rely on the approval by the lending institution of the loan as an indication ~~of suitability.~~ that the recommendation to invest using borrowed funds is suitable or puts the client's interest first. Members and ~~APs~~Approved Persons must consider a client's financial circumstances when assessing the suitability of using borrowed funds to fund an investment ~~as part of their obligations under MFDA Rule 2.2.1.~~

. Members should also consider the employment status of the client before recommending a leverage strategy, for example, a leveraging strategy may not be suitable for individuals who are unemployed, retired or who do not have a stable income.

~~D. When is a Leverage Suitability Assessment Required?~~

~~The requirement to ensure that each order accepted or recommendation made for any account of a client is suitable for the client based on the essential facts relative to the client and any investments within the account includes recommendations to borrow to invest.~~

~~Members and APs must also ensure that the suitability of the use of borrowing to invest is assessed whenever:~~

~~*a)* a client transfers assets purchased using borrowed funds into an existing account at a Member;~~

~~*b)* a Member or AP becomes aware of a material change in a client's KYC information, as defined in Rule 2.2.4; and~~
~~*c)* With respect only to APs, a client of the Member is reassigned from one AP to another (note that this applies only to Members that assign accounts to APs).~~

~~Attached to this Notice, as Appendix 2, is a chart summarizing the respective obligations of Approved Persons and branch and head office supervisory staff with respect to suitability reviews.~~

~~E. Additional Concerns Regarding Supervision of Leveraging~~

~~MFDA staff has also identified the following concerns with respect to the supervision of leveraging conducted by Members:~~

- ~~Loan documentation submitted to the financial institution varies significantly from the KYC information on file for the client;~~
- ~~No policies and procedures with respect to criteria to assess suitability of leveraging for APs or supervisory staff;~~
- ~~No policies and procedures in place (at the Member) regarding referrals to lending institutions or from mortgage brokers relating to leveraging programs;~~
- ~~Inadequate controls to identify leveraged accounts for supervisory purposes;~~
- ~~Misleading advertising or unrealistic projections used to market leveraging strategies; and~~
- ~~Projections only depict positive returns without any examples of potential negative returns.~~

~~5. COMMON MISCONCEPTIONS~~

~~Some common misconceptions identified by MFDA staff include the erroneous notion that disclosure or client waivers justify an unsuitable recommendation. For example, a recommendation to a client with a medium risk tolerance to purchase a high risk investment is unsuitable, even if the client has been provided with disclosure that shows the investment is high risk.~~

~~Similarly, the fact that a client was given a prospectus that fully disclosed the risk level of the fund is not a valid defense by a Member or AP to an unsuitable trade or recommendation. If an AP recommends securities that are not suitable for a particular client, then disclosure to the client is irrelevant to the suitability obligation.~~

~~The AP's failure may have been the result of not knowing the client, not knowing the securities, or an error in the suitability determination but, once the improper recommendation has been made, it does not matter whether or how the Member or AP discloses the material negative~~

~~factors, or whether the client claims to understand and accept the risks involved in the investment.~~

~~It should also be noted that the existence of a signed order or trade form does not in any way lessen Member's and AP's suitability obligation and does not constitute a valid defense to an unsuitable trade or recommendation. Unsuitable trades can only be made on an unsolicited basis in accordance with Rule 5.1(b) and 2.2.1 and MFDA Staff Notice MSN-0025 – *Suitability Obligations for Unsolicited Orders*.~~

~~As stated above, suitability must be analyzed for each individual account. The fact that the client may have other assets in other accounts, or with other institutions, should not be taken into account.~~

~~DOCs 326182v2~~

~~APPENDIX 1: EXAMPLE OF KYC INFORMATION~~

~~Please complete the following information regarding your personal circumstances. We will use this information to ensure that any recommendations we make regarding investments are suitable for you.~~

~~DATE OF BIRTH:~~ ________________
~~(DD/MM/YYYY)~~

~~INVESTMENT KNOWLEDGE~~

~~Which of the following categories best describes your knowledge of investing?~~

- ~~Extensive~~ ________
- ~~Moderate~~ ________
- ~~Limited~~ ________

~~TIME HORIZON~~

~~Indicate the period from now to when you will need to access a significant portion of the money you invest in this account.~~

- ~~Less than 1 yr.~~ ________
- ~~1 – 3 yrs.~~ ________
- ~~4 – 5 yrs.~~ ________
- ~~6 – 9 yrs.~~ ________
- ~~10 yrs. or more~~ ________

~~CLIENT(S) INCOME~~ ~~(includes spouse ☐)~~

~~Please note your approximate annual income from all sources.~~

~~$0 - $24,999~~	________	~~$100,000 - $149,999~~	________
~~$25,000 - $49,999~~	________	~~$150,000 - $199,999~~	________
~~$50,000 - $74,999~~	________	~~$200,000 or more~~	________
~~$75,000 - $99,999~~	________		

~~CLIENT(S) NET WORTH~~ ~~(includes spouse ☐)~~

~~Please provide an estimate of the value of your assets and liabilities.~~

~~Estimated Liquid Assets (eg. investments, cash)~~	____________
~~+ Estimated Fixed Assets (eg. real estate)~~	____________
~~- Estimated Liabilities (eg. mortgage, car loan)~~	____________
~~= Estimated Net Worth~~	____________

~~RISK TOLERANCE~~

~~This section documents your willingness and ability to assume risk and should reflect the relative weighting of the types of investments you wish to hold in the account. The value of the investments we recommend should not exceed the allocation thresholds described below.~~

~~**Low** *(Low risk investments demonstrate a low volatility and are for investors who are willing to accept lower returns for greater safety of capital and may include such investments as Canada Savings Bonds, GICs and money market mutual funds.)*~~ ________%

~~**Low to Medium** *(Low to Medium risk investments demonstrate a low to medium volatility but a higher volatility than those described above and may include bond or balanced funds.)*~~ ________%

~~**Medium** *(Medium risk investments demonstrate a medium volatility and are for investors that are looking for moderate growth over a longer period of time and may include Canadian dividend, Canadian equity, U.S. equity and certain international equity funds.)*~~ ________%

~~**Medium to High** *(Medium to High risk investments demonstrate a medium to high volatility and are for investors that are looking for long term growth and may include funds that invest in smaller companies, specific market sectors or geographic areas.)*~~ ________%

~~**High** *(High risk investments demonstrate a high volatility and are for investors who are growth oriented and are willing to accept significant short term fluctuations in portfolio value in exchange for potentially higher long term returns and may include labour-sponsored venture capital funds or funds that invest in specific market sectors or geographic areas such as emerging markets, science and technology, or funds that engage in speculative trading strategies including hedge funds that invest in derivatives, short sell or use leverage.)*~~ ________%

~~Total~~ ~~100%~~

~~INVESTMENT OBJECTIVES~~

~~**Income** *(Your objective is to generate current income from your investments and you are less concerned with capital appreciation. Investments that will satisfy this objective include fixed income investments such as funds that invest in bond or money market instruments.)*~~ ________%

~~**Growth** *(Your objective is capital appreciation and current income from investments is not a requirement. This may lead you to hold a relatively high proportion of funds that invest in equities if you also have a higher risk tolerance and long term time horizon.)*~~ ________%

~~**Balanced** *(Your objective is a combination of income and growth. An account with a balanced objective should typically include at least 40% in fixed income investments and no more than 60% in equity mutual funds.)*~~ ________%

~~**Total**~~	~~100%~~

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~~APPENDIX 2: SUITABILITY REVIEW~~

~~Suitability Review Trigger Event~~	~~Investment Suitability~~			~~L~~
	~~Registered Salesperson~~	~~Branch Office~~	~~Head Office~~	~~Registered Salesperson~~
~~Transfers – Rule 2.2.1(e)(f)(i)~~	~~Review all accounts within a reasonable time, but in any event no later than the time of the next trade~~	~~No review~~	~~Review client accounts on a sample basis within a reasonable time, but in any event no later than the time of the next trade~~	~~Review all accounts 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~~
~~Material Change – Rule 2.2.1(e)(f)(ii)~~	~~Review all accounts no later than one business day after notice of the change in information is received from the client~~	~~Review accounts where Member becomes aware of material change that results in a significant decrease in client risk tolerance, time horizon, income, net worth, or more conservative investment objectives, no later than one business day after notice of the change in information is received from the client~~	~~No review~~	~~Review all accounts no later than one business day after notice of the change in information is received from the client~~

~~Suitability Review Trigger Event~~	~~Investment Suitability~~			~~L~~	
	~~Registered Salesperson~~	~~Branch Office~~	~~Head Office~~	~~Registered Salesperson~~	
~~Change in Registered Salesperson – Rule 2.2.1(e)(f)(iii)~~	~~Review all accounts within a reasonable time, but in any event no later than the time of the next trade~~	~~No review~~	~~No review~~	~~Review all accounts 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~~	
~~Order or Recommendation – Rule 2.2.1(c)~~	~~Review prior to recommendation or acceptance of the order~~	~~Review:~~ • ~~initial trades,~~ • ~~trades in: exempt securities, accounts of family members of registered salespersons operating under a POA in favour of the registered salesperson,~~ • ~~trades over: $2,500 in moderate-high or high risk investments, $5,000 in moderate or medium risk investments, and $10,000 in all other investments, and~~ • ~~redemptions over $10,000~~ ~~one business day after trade~~	~~Review:~~ • ~~trades over $5,000 in exempt securities (excluding GICs), moderate-high or high risk investments,~~ • ~~trades over $10,000 in moderate or medium risk mutual funds, and~~ • ~~trades over $50,000 in all other investments (excluding money market mutual funds),~~ • ~~redemptions over $50,000~~ ~~one business day after trade~~	~~Review prior to recommendation or acceptance of the order~~	