



July 20, 2017

MFDA POLICY NO. 8

PROFICIENCY STANDARD FOR APPROVED PERSONS SELLING EXCHANGE TRADED FUNDS (“ETFs”)

Purpose

Under Rule 1.2.3 (Education, Training and Experience), an Approved Person must not perform an activity that requires securities registration unless the Approved Person has the education, training, and experience that a reasonable person would consider necessary to perform the activity competently, including understanding the structure, features, and risks of each security that the Approved Person recommends. A similar requirement exists under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (“NI 31-103”).

Conventional mutual funds are those that are traded as a primary distribution with the issuer. In contrast, ETFs are mutual funds that are traded in the secondary market on an exchange. The purpose of this Policy is to set out minimum requirements that Members and Approved Persons must meet to ensure that advice and transactions in respect of the sale of ETFs by Approved Persons satisfy the proficiency, experience, and related requirements under Rule 1.2.3 and NI 31-103. Requirements under this Policy do **not** apply to the sale of conventional mutual funds that invest in ETFs.

Background

MFDA Members and their Approved Persons are permitted to sell ETFs that meet the definition of a mutual fund. However, there are important differences between ETFs and conventional mutual funds. With the exception of the Canadian Securities Course (“CSC”), existing courses and examinations used by Approved Persons to satisfy proficiency requirements under NI 31-103, in respect of the sale of conventional mutual funds, **do not** adequately address the sale of ETFs. As a result, additional measures must be taken to ensure that advice and transactions in respect of the sale of ETFs by Members and their Approved Persons meet the proficiency, experience, and related requirements under Rule 1.2.3 and NI 31-103.

ETF Proficiency and Training

Members must ensure that each Approved Person advising or transacting in ETFs has adequate proficiency, education, and training. In order to satisfy requirements under Rule 1.2.3, Approved Persons must receive appropriate training from the Member in respect of the following:

- information about the characteristics, features, benefits, and risks of ETFs; and
- how ETFs will be offered through the Member.

Member Policies and Procedures

Members are responsible for performing a reasonable level of due diligence on ETFs prior to their approval for sale. As part of this due diligence, Members are required to determine if the ETF meets the definition of a mutual fund. Where ETFs are sold by a Member, the Member must have appropriate policies and procedures regarding their sale. Approved Persons must receive specific training on those aspects of the Member's policies and procedures that deal with advising and transacting in ETFs. Such training must, at a minimum, include:

- detailed product information in respect of the ETFs approved for sale by the Member;
- how market quotes will be obtained;
- the types of trades accepted and the information required for each trade accepted;
- the disclosure information required for each transaction;
- how evidence of trade instructions, whether executed or unexecuted, and disclosures will be maintained; and
- how trade orders will be processed.

ETF Product Training for Approved Persons

As noted above, there are existing courses and examinations used by Approved Persons to satisfy proficiency requirements under NI 31-103 in respect of the sale of conventional mutual funds. Some of the information in such courses overlaps with information that Approved Persons would be required to know and understand for the purpose of providing advice and transacting in ETFs. Training must focus on unique aspects of ETFs that Approved Persons must understand in respect of the particular ETF products offered through the Member. In addition, Approved Person training in this area must highlight key differences between ETFs and conventional mutual funds. Attached as Appendix "A" to this Policy is a chart that sets out how new information and existing topics/concepts should be addressed as part of ETF product training for Approved Persons.

ETF product training for Approved Persons may be satisfied by courses offered through independent course providers, or training offered through the Member. In either case, the training must, at a minimum, address all of the matters included in the chart set out in Appendix "A".

Independent Course Providers

The following courses would be acceptable to meet ETF product training requirements for Approved Persons:

- *"Exchange Traded Funds for Mutual Fund Representatives"* – (Canadian Securities Institute);
- *"The Exchange-Traded Funds Course"* – (IFSE Institute);
- *"Exchange Traded Funds for Representatives of Mutual Fund Dealers"* – (Smarten Up Institute).

ETF Product Training Provided by Member

Where ETF product training for Approved Persons is provided by the Member, the training must include an examination to be successfully completed by the Approved Person. The Member must keep appropriate records of such training, as required under MFDA Rule No. 5 (Books, Records and Reporting). Examples include, but are not limited to, the following:

- attendance records;
- evidence of training sessions;
- content of training materials; and
- results of formal examinations.

Appendix “A” ETF Product Training for Approved Persons – Chart

Below is a chart that sets out how new information and existing topics/concepts must, at a minimum, be addressed as part of ETF product training for Approved Persons.

Legend:

New Information	Content should be explained in detail. Generally a higher level of detail is expected. Should include comparison of ETFs and conventional mutual funds.
Existing Topics and Concepts	Existing topics and concepts should be explained in the context of ETFs. Should include comparison of ETFs and conventional mutual funds.

General Topic	Sub-Topics	Comment	Percentage Allocation
Introduction to ETFs	Definition of an Exchange-Traded Fund	Provide an ETF definition. Explain how they have attributes of both conventional mutual funds and stocks.	15
	Registration/licensing requirements and limitations	Review the registration requirements to sell mutual funds and the limitations of registration for Dealing Representatives. Review products that Dealing Representatives can and cannot sell.	
	Description of ETFs that may be sold by Approved Persons. For example, index tracking, actively managed, and quasi-active/quasi-passive ETFs	Describe in detail the types of ETFs that may be sold by Dealing Representatives.	
	Description of ETFs that may not be sold by Approved Persons. For example, leverage and inverse ETFs	Describe in general the types of ETFs that may not be sold by Dealing Representatives.	
Regulation of ETFs	Offering Documents <ul style="list-style-type: none"> • (National Instrument 41-101 – General Prospectus Requirements) Disclosure Requirements <ul style="list-style-type: none"> • Delivery of ETF disclosure document, as prescribed under securities legislation • Continuous Disclosure Investment Restrictions <ul style="list-style-type: none"> • Investment restrictions applicable to ETFs Independent Review Committee <ul style="list-style-type: none"> • Role and responsibility 	Generally describe the regulation of ETFs including the offering documents, disclosure requirements, investment restrictions and the role of the Independent Review Committee. May include a summary of how the regulation of ETFs is similar/different than conventional mutual funds.	10

General Topic	Sub-Topics	Comment	Percentage Allocation
Characteristics of ETFs	Description of investment management styles: <ul style="list-style-type: none"> • Active vs. Passive • Quasi-Active/Quasi-Passive • Indexing <ul style="list-style-type: none"> ○ What are indices?* ○ Tracking an Index <ul style="list-style-type: none"> ▪ Physical vs. Synthetic ▪ Full Replication vs. Sampling ▪ Tracking Error 	Describe Passive vs. Active investment management styles. Describe Quasi-Passive/Active investment management styles. Provide examples of each style. Define “Index” and describe in detail the different methods for tracking an Index. Explain, and give examples of, tracking errors.	20
	Creation and Redemption of Units <ul style="list-style-type: none"> • Designated Brokers/Dealers/Market Makers • New ETFs <ul style="list-style-type: none"> ○ In-kind creation ○ In-cash creation • Existing ETFs <ul style="list-style-type: none"> ○ Additional unit creation ○ Redemption of units ○ When number of units may change 	Describe generally the various roles and responsibilities of: Designated Brokers; Dealers; Market Makers. Describe in detail how new ETFs are created and funded. Describe how new units are created for existing ETFs. Describe how existing ETF units are redeemed. Describe circumstances where ETF units may be created or redeemed.	
	Operating Costs <ul style="list-style-type: none"> • Management fees • Operating expenses • Trading expenses • Trailing commissions 	Generally describe the various operating costs that can apply to ETFs with a focus on differences between ETFs and conventional mutual funds.	
	Features and Benefits <ul style="list-style-type: none"> • Professionally Managed • Low cost • Transparency • Tax Efficiency • Liquidity • Diversification 	Generally describe the features and benefits of ETFs with a focus on differences compared to conventional mutual funds. Explain that some features may only apply to certain ETFs (e.g. some ETFs may not be diversified).	

General Topic	Sub-Topics	Comment	Percentage Allocation
	<p>General Risks</p> <ul style="list-style-type: none"> • Market Risk <ul style="list-style-type: none"> ○ Equity Risk ○ Interest Rate Risk ○ Currency Risk • Credit Risk • Foreign Investment Risk • Style Risk • Concentration Risk • Counter-party Risk • Tracking Error • Risk that market price differs from NAV <p>Compare ETFs to:</p> <ul style="list-style-type: none"> • Conventional Mutual Funds • Closed-End Funds • Exchange -Traded Notes 	<p>Generally describe, with examples, each risk that can apply to ETFs.</p> <p>Explain in detail the risk of market price. Explain how market price differs from NAV pricing and that market price risk applies to ETFs and not conventional mutual funds.</p> <p>Provide a summary of key differences and similarities between ETFs and Conventional Mutual Funds, Closed-End Funds, and Exchange -Traded Notes.</p>	
Exchange Trading	<p>Introduction to Financial Markets</p> <ul style="list-style-type: none"> • Describe Primary Market • Describe Secondary Markets* <ul style="list-style-type: none"> ○ Auction Markets ○ Dealer (Over-The-Counter) Markets <p>Trading on an Exchange</p> <ul style="list-style-type: none"> • ETF Pricing <ul style="list-style-type: none"> ○ Market pricing <ul style="list-style-type: none"> ▪ Continuous during market open hours ○ NAV pricing <ul style="list-style-type: none"> ▪ End of day calculation ▪ Daily, Weekly, Monthly ○ Risk that market price differs from NAV • Quotes system <ul style="list-style-type: none"> ○ What is a Bid? ○ What is an Ask? ○ Bid/Ask Spread ○ Last Trade Price ○ Market Open/Market Close Price 	<p>Define the terms “Primary Market” and “Secondary Market”.</p> <p>Describe in detail the various Secondary Markets focusing on the markets where ETFs will be traded. Details should include type of markets, market hours and any specific trading rules and requirements.</p> <p>Explain that ETFs have both a market price and a NAV calculation.</p> <p>Explain the difference between calculating a NAV and market price.</p> <p>Explain that ETFs may not trade at their NAV.</p> <p>Define the terms “Bid”, “Ask” and the “Bid/Ask spread”.</p> <p>Explain in detail how to properly quote an ETF.</p> <p>Define the terms “Last Trade Price”, “Market Open” and “Market Close”.</p>	40

General Topic	Sub-Topics	Comment	Percentage Allocation
	<ul style="list-style-type: none"> • Market Depth and Liquidity <ul style="list-style-type: none"> ○ What is a Board Lot/Odd Lot? ○ Define Market Depth ○ Liquidity ○ Role of Market Makers 	<p>Define terms “Board Lot”, “Odd Lot”, “Market Depth”.</p> <p>Explain liquidity and the role of Market Makers for exchange traded securities.</p>	
	<ul style="list-style-type: none"> • Distributions <ul style="list-style-type: none"> ○ Define the term “ex-distribution” ○ Describe distribution re-investment plans 	<p>Define the term “ex-distribution” and explain what it means for trading purposes.</p> <p>Describe distribution re-investment plans for ETFs.</p>	
	<ul style="list-style-type: none"> • UMIR Rules • Trading Halts • Circuit Breakers 	<p>Provide an overview of UMIR Rules and who has to follow them.</p> <p>Explain trading halts and circuit breakers including their purpose and when they are triggered.</p>	
	<p>Order Instructions</p> <ul style="list-style-type: none"> • Types of orders (Market, Limit, Stop Limit etc.) <ul style="list-style-type: none"> ○ Order Documentation ○ Risks and benefits of each order type ○ Best practices for order entry (e.g. in cases of buying or selling large number of shares) 	<p>Describe the various types of orders including the information required for each order as well as the risks and benefits.</p> <p>Describe situations where certain order types may be better than others.</p>	
	<p>Order Entry</p> <ul style="list-style-type: none"> • Order Processing <ul style="list-style-type: none"> ○ Best Execution ○ Exchange rules for placement and execution ○ Changing Trade Instructions ○ Cancelling Trade Instructions ○ Trade Settlement ○ Confirmations ○ Transaction costs ○ Trading as Principal vs. Agent 	<p>Describe how orders must be processed on exchanges including best execution requirements (e.g. immediate execution), exchange rules, and how orders are filled.</p> <p>Describe how to change and cancel open orders.</p> <p>Discuss settlement, confirmations and costs.</p> <p>Briefly explain trading as Principal vs. Agent.</p>	

General Topic	Sub-Topics	Comment	Percentage Allocation
Investing in ETFs	Review existing obligations for: <ul style="list-style-type: none"> • Know-Your-Client • Know-Your-Product • Suitability Obligation 	<p>Explain that existing obligations for KYC, KYP and suitability apply to the sale of ETFs.</p> <p>Explain that not all ETFs provide the same level of information as conventional mutual funds, such as risk rating, and that this information would have to be assessed by the Member in order to satisfy existing obligations.</p>	15
	Portfolio Management <ul style="list-style-type: none"> • Alpha and Beta • Efficient Market Hypothesis • Describe different investment strategies for ETFs 	<p>Briefly explain the concepts of Alpha, Beta and Efficient Market Hypothesis.</p> <p>Describe in detail the roles an ETF can fill when constructing a portfolio.</p>	
	Review the following and how they apply to ETFs: <ul style="list-style-type: none"> • Splits and Consolidations • PACs, SWPs • DRIPs • Taxation <ul style="list-style-type: none"> ○ Income ○ Capital Gains and Losses ○ Dispositions • Custody <ul style="list-style-type: none"> ○ Nominee name (“street form”) vs. client name 	<p>Review these common topics with a focus on how they are applicable to trading in ETFs.</p> <p>Describe in detail nominee name account records, including a comparison of how they differ from client name account records.</p>	

**Additional resource materials, that provide more detail on different trading exchanges and common market indices, may be helpful for Approved Persons.*

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