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MFDA Bulletin

Compliance

For Distribution to Relevant Parties within your Firm

2015 DSC Sweep Report

Supervision, Suitability and Disclosure of Funds with Sales Charges

On February 19, 2015, MFDA issued Bulletin #0631-C disclosing our intention to perform a targeted examination sweep of Member trading in deferred sales charge funds ("DSC Sweep"). The results of the DSC Sweep including our key findings and recommendations are contained in the attached 2015 DSC Sweep Report.

This strategic initiative was part of our continued focus on suitability and particular focus on protecting senior investors. The DSC Sweep specifically focused on the suitability of sales charges considering client time horizon and age.

While the majority of MFDA Member assets under administration are in funds without sales charges, we consider suitability of sales charges to be a significant aspect of a registrant's overall suitability obligation and therefore encourage Members to review and consider the recommendations provided.

DM #456494

2015 DSC Sweep Report

Supervision, Suitability and Disclosure of Funds with Redemption Charges

December 18, 2015

DM #442390

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Introduction

In 2015 MFDA conducted a targeted examination sweep of Member deferred sales charge trading activity. The purpose of the sweep was to specifically focus on the suitability of sales charges.

MFDA staff reviewed trading activity from a sample of Members who trade in deferred sales charge and/or low load sales charge funds (collectively referred to as "DSC"). Members chosen for the sweep were then asked to submit transaction data for a 12-month period. MFDA staff then selected a sample of DSC purchase and redemption transactions from each Member for further detailed review. The sample was selected on a risk-basis and focused on transactions that were more likely to raise a suitability concern given client time horizon and age. Accordingly, given the targeted nature of the sweep, the findings discussed in this report are not representative of the activity of all Members.

In addition to reviewing selected DSC trades, MFDA reviewed Member trade supervision practices, supervisory inquiry processes, time horizon categories and disclosure practices. All Members (not just those selected for the sweep) were asked to submit any documented policies and procedures they had in place relating to suitability of DSC trading. These policies and procedures were reviewed as part of this project.

The report has been categorized into three areas: Time Horizon, Client Age and Disclosure. Each section of the report outlines key observations, highlights policies and procedures that some Members have implemented to supervise DSC trades and provides MFDA staff recommendations and guidance to Members for the supervision of DSC trading.

Part I - Time Horizon

i) Policies and Procedures

MFDA staff reviewed Members' written policies and procedures relating to assessing suitability of DSC trades considering the client's time horizon.

We noted that the majority of Members who sell DSC funds had policies and procedures requiring the client's documented time horizon be at least as long as the redemption schedule. For example, one Member's policy stated "A client's stated time horizon is an important point to consider when supervising suitability of the portfolio. A client with a stated time horizon should never, under any circumstance, be put into a DSC fund in which the fee schedule is greater than the time horizon." In another example, one Member's policy stated "The client's time horizon is a key consideration when the advisor makes a recommendation or accepts a client-initiated trade. A fund sold on a seven year DSC schedule would not be suitable for a client with a 4 – 5 year time horizon."

Although the majority of Members had policies and procedures regarding the suitability of selling DSC funds considering time horizon, there were a few Members that did not. We also noted instances where Members' policies and procedures did not consider the reasonableness of a client's time horizon considering the client's age.

ii) General Observations

Purchases

MFDA Rule 2.2.1(c) requires each Member and Approved Person to use due diligence to ensure that each order accepted or recommendation made, including recommendations to borrow to invest, 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. The accurate collection of the client's time horizon is an essential component of the KYC process and it is imperative that supervisors consider this information when assessing suitability.

MFDA staff reviewed Member trading data and client KYC information to determine if there were any DSC purchases where the client's documented time horizon was not consistent with the redemption schedule. The focus of this assessment was on clients greater than 60 years of age.

Overall, we noted that the majority of purchases in DSC funds involved clients with a medium or long-term time horizon (typically 5 – 10 years or over 10 years). However, we identified instances where clients had purchased DSC funds where the client's time horizon was shorter than the DSC schedule of the fund purchased.

<u>Redemptions</u>

We identified transactions where the client incurred redemption charges and had a shorter time horizon than the mutual fund redemption schedule. In many of these instances, the client's time horizon had not changed from the time of the original purchase in the account.

iii) Supervisory Inquiry Process

The quality of supervisory inquiries and responses relating to the suitability of time horizon for DSC transactions varied between Members. Members with effective practices had detailed supervisory procedures in place for identifying and querying the suitability of DSC transactions and adequately resolving inquiries. Where Members did not have effective procedures, either inquiries were not issued where time horizon was shorter than the redemption schedule, inquiries were issued but did not identify all the potential suitability concerns, or inquiries were issued but not adequately resolved.

For example, where redemption charges were incurred, in some cases the inquiry only focused on whether the redemption charges were disclosed to the client rather than considering the suitability of the initial recommendation to purchase the DSC fund. For purchases, some inquiries were closed based on the Approved Person's response that the client's account also included front-end load and mature DSC funds with no explanation of the client's liquidity needs.

iv) Collection of KYC Information

As part of the DSC sweep, we reviewed Member time horizon categories. We noted that the majority of Members have time horizon categories that allow supervisors to properly supervise DSC trading activity.

However, we noted a few instances where it would be difficult for Members to assess DSC suitability given the Members' time horizon categories. For example, one Member had a time horizon category of 0 – 5 years and permitted the purchase of low load funds which typically have a 2 – 3 year redemption schedule. We also noted one Member that permitted clients with a 4 – 9 year time horizon to purchase DSC funds even though the typical DSC schedule is between 5 – 7 years.

Good Practices and Recommendations

- **Policies and procedures to assess the reasonableness of the client's time horizon in comparison to the client's age at account opening or when updating KYC information.**
- **Policies and procedures for supervisors to query instances where the client's time horizon is less than the mutual fund redemption schedule.**
- **Back office systems or reports that flag purchases where the client's time horizon is shorter than the mutual fund redemption schedule.**
- **Time horizon categories on the KYC form that allow for an accurate assessment of the suitability of DSC transactions.**

Part II – Client Age

i) Policies and Procedures

MFDA staff reviewed Members' written policies and procedures for adequacy as it related to suitability of DSC transactions considering the client's age.

We noted a few Members that had written procedures or practices to prohibit or query DSC purchases based on client age. In one example, a Member used age 65 as its criteria while others used age 70. In general, however, Members did not have a documented policy for assessing suitability of DSC trades based on the client's age. Additionally, we noted that Member policies and procedures did not consider the suitability of DSC purchases for accounts in a withdrawal stage. For example, most Members did not have policies and procedures or guidance regarding suitability of DSC purchases in RRIF accounts.

ii) General Observations

Purchases

One of the primary focuses of this sweep was to review DSC trading activity for senior investors. We noted a number of DSC purchases for clients who were seniors, including clients over 70 years old.

Redemptions

In our risk-based sample, the most common reasons redemption charges were incurred were due to transfers-out in cash and the liquidation of an estate.

iii) Supervisory Inquiry Process

We noted some Members did consider client age as a factor when also querying time horizon. However, in general Members did not issue inquiries specifically relating to the client's age. Overall, there was a lack of consistency across Members on how to supervise transactions involving seniors who purchased DSC funds.

Where inquiries were issued regarding client age, in some instances the inquiry was not adequately resolved. For example, we noted instances where an inquiry was closed based on the Approved Person's assertion that the client was in good health.

Good Practices and Recommendations

- **Policies and procedures to specifically consider client age when assessing the suitability of DSC purchases.**
- **Policies and procedures for supervisors to consider the suitability of DSC purchases in RRIF accounts.**
- **Procedures to query trades where clients incur significant redemption charges and specifically consider the suitability of the initial DSC purchase.**
- **A supervisory inquiry log that adequately tracks the type of query, the name of the Approved Person and response details which can be used by supervisors to identify potential trends or patterns.**

Part III - Disclosure of Redemption Charges

i) Policies and Procedures

Members had documented policies and procedures requiring disclosure of redemption charges to clients at the time of the redemption. Many Members require the disclosure to be documented on the trade order form. One Member's written policy states "Before accepting any order, the Mutual Fund Representative must disclose the charges the client will pay for the purchase, sell, switch or transfer, or a reasonable estimate if the actual amount is not known at the time of the disclosure."

We identified a few Members who have not updated their policies and procedures manual to meet the new additional fee disclosure requirements of MFDA Rule 2.4.4. In addition to disclosing transaction charges, as of July 15, 2014 MFDA Rule 2.4.4 was amended to also require disclosure at the time of purchase where a security was sold on a DSC basis and any trailing commissions that apply.

ii) General Observations

We noted that the majority of Members are relying on the trade order form to disclose transaction charges to clients, and in most cases, an approximate dollar amount is provided. Some Members also permit this information to be disclosed to clients verbally with detailed notes of the client discussion being maintained on file. We generally noted where disclosure was provided to clients, either on the trade order form or verbally, that Approved Persons were maintaining adequate evidence of disclosure on file.

The Members included in the sweep each had a general process in place to disclose redemption charges to clients. However, we noted a few instances where the Member was not able to provide evidence that fee disclosure was provided to the client. In some of these cases, the Member incorrectly assumed that disclosure of the redemption charge was not required for a redemption executed by the client's estate even though the transaction was processed through the Member.

<u>Good Practices and Recommendations</u>

- **Written policies and procedures to disclose fee and transaction charges to clients.**
- **Procedures to test whether disclosure was provided to clients where the client incurred significant redemption charges.**
- **Training of Approved Persons and supervisors on disclosure requirements.**

Conclusion

Members should have adequate procedures to supervise and assess the suitability of DSC trades considering both client time horizon and age and procedures to disclose sales charges both at the time of purchase and redemption. As suitability continues to be an area of focus for the MFDA, particularly as it relates to senior investors, we will continue to review these issues in future compliance examinations.

We encourage Members with additional questions or those seeking guidance in enhancing their supervision and suitability of DSC policies and procedures to contact their assigned MFDA Compliance Manager for further assistance.