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MFDA Bulletin

Enforcement

For Distribution to Compliance and Supervisory Staff, Approved Persons and Other Relevant Parties within your Firm

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Suitability - Research Paper on Canadian Securities Regulatory Authority Decisions

The suitability requirement, broadly speaking, refers to the obligation on an Approved Person to determine whether a particular investment is appropriate for a particular client.[1] Approved Persons who fail in their suitability requirement put their clients at risk of financial losses that can place them in extreme hardship.

The suitability requirement is written into MFDA Rule 2.2.1. That Rule provides the core of the suitability requirement. It states that each Approved Person shall 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".

To provide additional guidance for Members and Approved Persons, the MFDA has developed a research paper that canvasses disciplinary decisions of Canadian securities regulatory authorities including the MFDA and other self-regulatory organizations, for current information about the suitability requirement as is relevant to the activity of Approved Persons.

[1] *Re Lamoureux*, 2001 LNABASC 433 at p 14 (QL).

Mutual Fund Dealers Association of Canada
Association canadienne des courtiers de fonds mutuels

SUITABILITY - RESEARCH PAPER ON CANADIAN SECURITIES REGULATORY AUTHORITY DECISIONS

January, 2017

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Introduction

The suitability requirement, broadly speaking, refers to the obligation to determine whether a particular investment is appropriate for a particular client.[1] Approved Persons who fail in their suitability requirement put their clients at risk of financial losses that can place them in extreme hardship. The gravity of the suitability requirement is conveyed through its heavy emphasis in securities industry courses, industry training, as well as rules and sanctions.[2]

Mutual Fund Dealers Association of Canada ("MFDA") Staff have developed this research paper to provide an additional source of guidance on the suitability requirement for Members and Approved Persons. The research paper canvasses disciplinary decisions of Canadian securities regulatory authorities, including the MFDA and other self-regulatory organizations, for current information about the suitability requirement as is relevant to the activity of Approved Persons. The research paper does not deal with the regulatory obligations of Members or supervisory personnel. The research paper addresses regulatory decisions only and does not include decisions under common or civil law which may apply to Members or Approved Persons.

This research paper provides general information on regulatory suitability decisions for reference purposes only and does not constitute legal advice. Approved Persons should seek assistance from their Member on suitability obligations. Members and Approved Persons requiring legal advice on the matters referred to in this research paper should obtain legal advice from a qualified practitioner. Legal citations have been included for information only.

This research paper does not constitute a procedure, guideline or other document of a similar nature, and does not create any procedural rights or entitlements in the MFDA discipline process. While every effort has been made to provide a representative summary of the case law on this issue, it is acknowledged that not every case has been surveyed. Disciplinary cases involving suitability will be decided individually and on their own merit by an MFDA Hearing Panel. While this document generally reflects the understanding of MFDA Staff regarding past decisions, the document does not necessarily reflect current or future practices in the handling of all suitability cases against Approved Persons. The document reflects material available until January, 2017 and will be updated every two years.

This document does not reference all applicable MFDA and Canadian Securities Administrators ("CSA") requirements and guidance relating to suitability. For more information about those requirements and guidance, see Appendices "A" and "B".

[1] *Re Lamoureux*, 2001 LNABASC 433 at p 14 (QL).
[2] *Re Mytting*, 2012 IIROC 45 at para 36.

General

The general suitability requirement under the MFDA Rules is contained in Rule 2.2.1 (a) to (c), which reads as follows:

> **"Know-Your-Client".** Each Member and Approved Person shall use due diligence:
>
> (a) to learn the essential facts relative to each client and to each order or account accepted;
>
> (b) to ensure that the acceptance of any order for any account is within the bounds of good business practice;
>
> (c) 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 requirement is similar to requirements of Canadian securities regulatory authorities including other self-regulatory organizations. For a complete reproduction of MFDA Rule 2.2.1 see Appendix "B".

Importance of the Suitability Requirement

The suitability requirement has been described as an essential component of consumer protection, and a basic obligation of an Approved Person.[3] Failure to satisfy the suitability requirement has been described by the Ontario Securities Commission as an "extremely serious matter",[4] and amongst the most serious allegations an Approved Person can face.[5] The obligation to ensure that investment recommendations made to clients are suitable is particularly important where those clients have insufficient investment experience and sophistication to enable them to recognize and assess the risks involved in an investment.[6]

The Suitability Requirement Cannot be Avoided or Transferred

An Approved Person's obligation to ensure that an investment recommendation is suitable for a client rests with that Approved Person[7] - it cannot be substituted, avoided, or transferred to the client, including through the use of an acknowledgement from a client that they are aware of the risks associated with a particular investment.[8]

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[3] *Re E.A. Manning Ltd. et al.*, 1995 LNONOSC 377 at p 44 (QL).
[4] *Ibid* at p 44 (QL).
[5] *Re Daubney*, 2008 LNONOSC 338 at para 213.
[6] *Supra* note 1 at p 23 (QL).
[7] *Ibid* at p 23 (QL).
[8] *Ibid* at p 21 (QL). See also *Re Popovich*, 2015 LNCMFDA 48 at para 162. Members also have a suitability obligation imposed by MFDA Rule 2.2.1(c) which requires them to use due diligence to ensure each order accepted

Suitability Analysis

Canadian securities regulatory authorities have developed a three-stage process by which the suitability of a particular investment should be assessed.[9]

> Stage One: Due Diligence
> Use due diligence to know the client and know the product.
>
> Stage Two: Apply Judgment
> Apply sound professional judgment to establish suitability of the product or strategy for the client.
>
> Stage Three: Disclosure
> Disclose the negative as well as positive aspects of the proposed investment to the client.
>
> Sequence
> Each of these stages must occur in sequence.[10]

The terms "Know Your Client" and "Suitability" are sometimes used interchangeably, but in this research paper are used in the context noted above.

Stage One: Due Diligence

Stage One involves the Approved Person engaging in due diligence to know the clients and the products involved.[11] This is often referred to as fulfilling the "Know Your Client" and "Know Your Product" obligations. The due diligence requirements referred to in this stage are of great importance considering that Stage Two (Apply Judgment) can only be fulfilled once an Approved Person knows enough about a client and an investment product to know whether they are a match.[12]

Know Your Client

The phrase "Know Your Client" refers to the obligation to learn and fully understand a particular client's circumstances. Previous disciplinary decisions have dealt with some of those circumstances, which are listed below:

a. personal financial situation;[13]
b. income;[14]
c. net worth;[15]
d. liquid assets;[16]

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or recommendation made in a client account is suitable for that particular client. See *Re Farm Mutual Financial Services Inc.*, 2009 LNCMFDA 12 at para 55.

[9] *Supra* note 5 at para 17. See also *Re Laurie*, 2015 LNCMFDA 119 at para 30 and *Re Karas*, 2015 LNCMFDA 158 at para 19.

[10] *Supra* note 1 at p 20 (QL).

[11] *Ibid* at p 21 (QL).

[12] *Ibid* at p 14 (QL).

[13] *Ibid* at p 14 (QL).

[14] *Ibid* at p 21 (QL). See also *Re Brown*, 2015 LNCMFDA 32 at para 24.

[15] *Ibid* at p 21 (QL). See also *Re Brown*, 2015 LNCMFDA 32 at para 24.

e. employment status;[17]
f. current and continuing financial obligations;[18]
g. age relative to retirement;[19]
h. risk tolerance;[20]
i. investment objectives;[21]
j. investment time horizon;[22] and
k. investment experience.[23]

Some of this information may already be captured through compliance with MFDA Policy No. 2 (Minimum Standards for Account Supervision). That Policy requires that for each account of an individual, the Member must obtain information sufficient to allow for the operation of the account and sufficient to determine the essential facts relative to each client. This includes, at a minimum, many of the circumstances outlined above, as well as:

a. identifying information about the client and information about the account;
b. date of birth;
c. employment information;
d. number of dependents;
e. investment knowledge;
f. for non-registered leveraged accounts, details of the net worth calculation, specifying liquid assets plus any other additional assets less total liabilities; and
g. information required by other laws and regulations applicable to the Member's business as amended from time to time including information required for relevant tax reporting, information required for compliance with the *Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations*, and any authorization necessary to provide information to the MFDA under applicable privacy legislation.

The Member may also require clients to provide any additional information that it considers relevant. For an excerpt of the relevant section of MFDA Policy No. 2 discussed here, see Appendix "C".

Canadian securities regulatory authorities have made it clear that this obligation to know the client refers to the client and not those associated with the client. For example, an Approved Person should not attribute to the client, characteristics of friends or family members regarding things such as investment experience or sophistication.[24]

The Role of KYC Forms and Procedures

An Approved Person may have access to a variety of forms and procedures made available through a Member, for instance, to assist in collecting information about a client. Past

[16] *Ibid* at p 21 (QL). See also *Re Brown*, 2015 LNCMFDA 32 at para 24.
[17] *Supra* note 5 at para 19.
[18] *Re Pretty*, 2014 LNCMFDA 6 at para 92.
[19] *Ibid* at para 92.
[20] *Supra* note 1 at p 21 (QL). See also *Re Brown*, 2015 LNCMFDA 32 at para 24.
[21] *Ibid* at p 21 (QL). See also *Re Brown*, 2015 LNCMFDA 32 at para 24.
[22] *Supra* note 5 at para 19.
[23] *Supra* note 1 at p 14 (QL).
[24] *Re Popovich*, 2015 LNCMFDA 48 at para 160. See also *Re DeVuono*, 2012 LNCMFDA 103 at para 68.

disciplinary decisions are very clear however that such forms only assist an Approved Person in satisfying a due diligence obligation, or provide reminders or evidence of efforts that were undertaken or not undertaken to satisfy the obligation.[25] Completing the forms alone will not be a guarantee that adequate due diligence was conducted. Past disciplinary decisions have also made it clear that following "Know Your Client" procedures with minimal effort or reflection will not satisfy the obligation either.[26] Mischaracterization of a client's information by an Approved Person during the Know Your Client process in a way that is designed to validate an otherwise unsuitable investment recommendation has been described as being a serious breach of an Approved Person's obligations.[27]

Accuracy and Completeness

Information collected as part of due diligence to know a client must be accurate and complete or else an Approved Person may be at risk of not satisfying his or her "Know Your Client" obligations. An Approved Person will not meet "Know Your Client" requirements if only some facts are learned, and vital ones are disregarded.[28] An Approved Person must also be honest with respect to the information put into the documents and systems relating to suitability,[29] and must not be careless in the preparation of New Account Application Forms.[30]

An Approved Person must also be prepared to assess the validity of any information they collect. For example, an Approved Person should be aware of the possibility that a client may provide inaccurate characterizations of things such as investment knowledge, risk tolerance or investment objectives on account opening.[31]

Know Your Product

An Approved Person must take steps to know the attributes of products that they are considering recommending to clients, including their associated risks.[32] Approved Persons are also expected to have an understanding of the market.[33] As with the suitability obligation more generally, the obligation to know the product rests with the Approved Person. It cannot be assumed by, or transferred to, third parties such as clients or persons associated with the issuer.[34]

As there is not a great deal of commentary on Approved Persons' know your product obligations in the disciplinary decisions of Canadian securities regulatory authorities, reference to Member obligations may be helpful. Members, as part of their suitability obligation imposed by MFDA Rule 2.2.1(c) also have a duty to understand the product being recommended to clients.[35] Members must, at a minimum, have in place detailed written policies and procedures that

[25] *Supra* note 1 at p 18 (QL).
[26] *Ibid* at p 18 (QL).
[27] *Supra* note 24 at para 161.
[28] *Supra* note 18 at paras 92-97.
[29] *Re Eley*, 2014 IIROC 52 at para 52.
[30] *Supra* note 18 at para 95-97.
[31] *Re Gareau*, 2011 IIROC 53 at para 125.
[32] *Supra* note 1 at p 21 (QL).
[33] *Re Pretty*, 2014 LNCMFDA 6 at para 92.
[34] *Supra* note 1 at p 35 (QL). See also *Re Rumball*, File No. 201521 at paras 3-35.
[35] *Re Farm Mutual Financial Services Inc.*, 2009 LNCMFDA 12 at paras 55 and 56. See also MSN-0048 (Know Your Product).

describe the steps to be taken as part of this due diligence process.[36] Members should ask whatever questions are necessary until they are satisfied they have a complete understanding of any products they propose to sell. In doing this, Members should not simply rely on representations of a product issuer.[37] MFDA Staff Notice 0048 – Know Your Product provides guidance on the roles of the Member and the Approved Person in the Know Your Product process.

Stage Two: Apply Judgment

Stage Two involves an Approved Person using information obtained under the "Know Your Client" and "Know Your Product" obligations, and applying "sound professional judgment"[38] to identify appropriate investment products or strategies for a particular client.[39] This stage is sometimes described as the suitability determination.

Recommendation

In one disciplinary decision of a Canadian securities regulatory authority, it was suggested that the judgment as to whether a particular investment product is suitable for a particular client will be made to a large measure by comparison of the risks associated with the investment product against the risk profile of the investor.[40] Another way of phrasing this is to say that the suitability determination should involve a determination of whether a proposed investment meets a client's investment objectives while staying within the level of risk acceptable to that client, as determined by the client's comfort level and overall circumstances.[41]

The recommendation must also be suitable in light of all other client circumstances, for example where a client's investment objective is preservation of principal and time horizon is short term.[42] See the "Suitability and Leverage" portion of this paper for additional considerations.

Only those considerations which are "reasonably foreseeable" at the time the investment is contemplated need to be considered as part of the analysis[43] and the suitability determination must be made with a view to the conditions at the time of the investment recommendation.[44] Of note is that the possibility of a market downturn at any time is a reasonably foreseeable event to an Approved Person, though it might not be to an investor.[45]

Even where a client has described himself or herself as high risk, that does not mean an Approved Person can then rely on that to make otherwise unsuitable investment

[36] *Ibid* at para 58.
[37] *Ibid* at para 59.
[38] *Supra* note 1 at p 21 (QL).
[39] *Supra* note 18 at para 100.
[40] *Supra* note 1 at p 23 (QL).
[41] *Ibid* at p 22 (QL). See also *Re Popovich*, 2015 LNCMFDA 48 at para 163.
[42] See *Re Fried*, 2014 LNCMFDA 84 at paras 42, 59 of Appendix "A".
[43] *Ibid* at p 24 (QL).
[44] *Re Bateman*, 2014 IIROC 38 at para 24.
[45] *Supra* note 24 at para 164.

recommendations.[46] Approved Persons also cannot rely on the defense that an unsuitable investment ultimately proved to be successful.[47]

Compensation Structure

Decisions of Canadian securities regulatory authorities have commented on the appropriateness of deferred sales charges ("DSC") in particular situations,[48] and have noted that investments which incur DSC fees are typically inappropriate for clients with time horizons shorter than the DSC terms.[49] In one case, it was held that the repetitive and excess use of DSC funds and the recommendation of inappropriate investment choices amounted to a breach of an Approved Person's obligation to his clients.[50]

Transactions Proposed by a Client

MFDA Rule 2.2.1(d) requires that where a client proposes a transaction that is not suitable, including a transaction involving leverage, the Member or Approved Person must advise the client of this and maintain a record of that advice.

Past disciplinary decisions provide additional context. They note for example that Approved Persons have a responsibility to warn clients and to even "protect them against themselves."[51] They suggest that Approved Persons might be required to take some of the following steps in this type of situation:[52]

a. providing a full, clear, written risk assessment to the client;
b. referring the client's situation to the Member's compliance unit and requesting an assessment;
c. referring the client's situation to a third party for an assessment;
d. seeking out clear, unambiguous, written instructions from the client on how they wish to proceed; and
e. in some situations, considering withdrawal of services to the client where the client's instructions are destructive to their own self-interest.

These steps might be kept in mind by an Approved Person that is fulfilling his or her requirements under MFDA Rules 2.2.1(e) or (f). Those rules require a suitability assessment in particular circumstances, for example where a client has transferred assets into a Member account from elsewhere. The Rules require that where investments or a leveraging strategy in a client's account are determined to be unsuitable the Member or Approved Person must advise the client of this and make recommendations to address the issue, as well as keep a record of the advice given.

[46] *Re Harding*, 2011 IIROC 65 at para 26.
[47] *Supra* note 1 at p 24 (QL).
[48] *Re Darrigo*, 2014 LNIIROC 48 at para 18.
[49] *Re Argosy Securities Inc*., 2016 LNONOSC 211 at para 99.
[50] *Re Darrigo*, 2016 LNONOSC 301 at paras 17 and 33.
[51] *Supra* note 31 at para 143.
[52] *Ibid* at paras 143-144.

Stage Three: Disclosure

Stage Three is reached when an Approved Person is at the point where they are ready to recommend a particular securities transaction to a client.[53] At this stage, the Approved Person is required to disclose material negative and positive factors involved in the transaction to the client for the purpose of assisting them in making an informed decision about whether to proceed.[54]

Disclosure of Material Negative Factors

Disclosure of material negative factors (risks) involved in a transaction must be based on an Approved Person's objective assessment of the circumstances of the investment and the client, and cannot be based on the Approved Person's optimism in the investment.[55] An Approved Person's description of securities as being "speculative" or involving "significant risks" is only a partial and not very informative description of the risks involved in an investment.[56] The responsibility of an Approved Person to disclose negative risk factors regarding an investment to a client increases where the risks of the investment increase.[57] It is important, however, to remember that disclosure of material negative and positive factors in this stage of the suitability analysis will not remedy a situation where an Approved Person has incorrectly determined that certain securities are suitable for a particular client in Stage Two.[58]

Client Comprehension

Past disciplinary decisions have made it clear that disclosure of material negative factors to a client is not enough to satisfy an Approved Person's suitability requirement. An Approved Person must ensure that the client understands the risks involved, particularly where the client has relatively little investment experience.[59] Past disciplinary decisions have noted in the case of offering memoranda that they can be a valuable source of information to a sophisticated investor, but that other investors may require considerable explanation to become aware of the risks described in them.[60] The same logic might be extended to state that an Approved Person who provides mutual fund prospectus or Fund Facts documents to a client would need to explain the risks described in them to the client.

Documenting Disclosure

Where an Approved Person has made disclosure of material negative and positive factors about an investment recommendation to a client, care should be taken to document this. Canadian securities regulatory authorities have noted that in determining whether a client has been made aware of the risks involved in a particular investment, they will consider the documents presented to the client, the sophistication of the client, the circumstances in which disclosure documents such as an offering memorandum were received, and the signing of any

[53] *Supra* note 1 at p 21 (QL).
[54] *Ibid* at p 21 (QL). See also *Re Karas*, 2015 LNCMFDA 158 at para 19 and *Re Brown*, 2015 LNCMFDA 32 at para 24.
[55] *Re Bilinski*, 2002 LNBCSC 1 at para 346.
[56] *Supra* note 1 at p 36 (QL).
[57] *Supra* note 31 at para 149.
[58] *Supra* note 1 at p 21 (QL). See also *Re DeVuono*, 2012 LNCMFDA 103 at para 74.
[59] *Supra* note 5 at para 201.
[60] *Supra* note 1 at p 36 (QL).

acknowledgement (with the weight of that acknowledgement varying depending on its content and the circumstances in which it was signed).[61]

Sequence

Canadian securities regulatory authorities state in their disciplinary decisions that each stage of the suitability analysis must be carried out in sequence.[62] Failure to follow each stage might occur in situations where, for example, an Approved Person suggests a product to a client before collecting information on the client's characteristics and circumstances. This could result in KYC documentation being inaccurately tailored to meet a product recommendation.

Suitability and Leverage

Evaluation of the suitability of a leveraging strategy is part of an Approved Person's obligations when it comes to assessing suitability.[63] It is also a responsibility which cannot be transferred, for instance by relying on granting of a loan by a lender as approval for a client to engage in a leveraging strategy.[64] MFDA Rule 2.2.1(c) states that Members and Approved Persons shall use due diligence to ensure that recommendations to clients that they borrow to invest are suitable.

In situations where a leveraging strategy is being contemplated there are additional obligations imposed on an Approved Person in each stage of the suitability analysis described above. These additional obligations are described in the sections that follow.

Stage One: Due Diligence

Know Your Client

In *Re Arseneau*, which involved leveraging, the disciplinary panel identified a number of factors that should be known about a client, having to do with their characteristics and knowledge. An Approved Person should consider these when performing the Stage One due diligence obligation, in addition to those mentioned earlier in this document:[65]

a. current and continuing financial obligations;
b. financial situation after retirement if retirement would occur during the term of the investment;
c. purpose of the investment;
d. ability to repay the borrowed amount in the event of market changes to the value of the mutual fund or its distribution;
e. knowledge and understanding of borrowing to invest; and
f. understanding of Return of Capital mutual funds (where relevant).

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[61] *Ibid* at p 36 (QL).
[62] *Supra* note 1 at p 20 (QL).
[63] See e.g. *Re Arseneau*, 2012 LNCMFDA 93 at para 57 [*Re Arseneau*]. Note that this decision was released before the MFDA amended Rule 2.2.1(c) on February 22, 2013 to explicitly state that Approved Persons must ensure that recommendations to borrow to invest are suitable. See MFDA Bulletin 0560-P, available at http://www.mfda.ca/regulation/forms/RuleAmendments.pdf.
[64] *Ibid* at para 45.
[65] *Ibid* at para 43. Note that MSN-0069 (Suitability) also advises that any factors that are known at the time or reasonably ascertainable, and may be relevant in the circumstances, should be considered.

In *Re Popovich*, the disciplinary panel prepared a more extensive set of factors that an Approved Person should consider when recommending a leveraged strategy:[66]

a. whether the client has sufficient income or unencumbered liquid assets to be able to:
    i. withstand a market downturn without jeopardizing their financial security (including their ability to maintain their home);
    ii. meet a margin call (if potentially applicable);
    iii. satisfy all loan obligations (both principal and interest) associated with the strategy without relying on anticipated income from the investments; and
b. whether there is any reason to expect the client's current sources of income to be reduced in the short term bearing in mind the client's stage of life (age, anticipated retirement date, etc.), employment status and personal circumstances (e.g. disability, pregnancy, any known risk of imminent anticipated job loss, etc.).

An Approved Person should reflect on their motivations for conducting due diligence on a client. In one case, a dim view was taken of an Approved Person who questioned clients in detail about their financial circumstances, with particular regard to their liquid and illiquid assets, for the purpose of assessing how much money they could borrow to fund their investments, as opposed to assessing the client's ability to recoup any market losses.[67]

Know Your Product

When considering due diligence obligations, an Approved Person should consider the features of a leveraging strategy to be part of the product.[68] This would raise the same *Know Your Product* considerations outlined above with regard to investment recommendations.

Stage Two: Apply Judgment

Factors Making a Leveraging Strategy Unsuitable in Past Instances

In a past decision, the Ontario Securities Commission noted that a particular leveraging strategy it described as being excessive was unsuitable for a set of investors for the following reasons:

a. the investors had insufficient income or unencumbered liquid assets to respond to any market downturns;[69]
b. the investors' home was their main asset;[70]
c. the investors were retired, about to be unemployed, or close to retirement with few earning years left to make up any losses;[71]

[66] *Supra* note 24 at para 165.
[67] *Supra* note 5 at para 202.
[68] *Ibid* at para 24.
[69] *Supra* note 5 at para 204.
[70] *Ibid* at para 204.
[71] *Ibid* at para 204.

d. the investors had a stated desire for conservative investments that would not threaten their financial security;[72]
e. a decision was made to only sell the investors DSC funds, which meant that an investor who was forced to sell early at a loss to cover a margin call was faced with additional costs at the time of redemption;[73]
f. investors concerned about excessive leverage were advised that they could, in the event of a market downturn, cash in their investments quickly – a strategy which could not be executed in practice;[74]
g. the minimum investment required was too large a portion of the client's net worth to allow for appropriate asset allocation;[75]
h. the high risk nature of the investment made it unsuitable for leveraged investing;[76] and
i. the strategy did not offer the tax benefits that the Approved Person thought it did.[77]

Stage Three: Disclosure

An Approved Person recommending a leveraging strategy to a client must disclose all salient material relevant to the strategy, including negative factors.[78] Any such disclosure should be offered in a balanced way with a view to being objective and providing complete disclosure.[79] Given that leveraging can magnify losses, the importance of disclosure to a client is critical.[80]

It is imperative to ensure that clients understand the risks involved with borrowing to invest, including the risk of using collateral and making investments with borrowed money.[81] Approved Persons should also alert clients to the fact that the value of their investment and any distributions from it could fluctuate downwards and that distributions may not be enough to pay any amounts owing on their investment loan.[82]

Suitability and Concentration

Approach to Concentration Risk in Case Law

The importance of diversifying a portfolio has been commented on in past decisions of Canadian securities regulatory authorities. An Investment Industry Regulatory Organization of Canada ("IIROC") Hearing Panel in *Re Biduk* stated:[83]

> That principle [the danger of an investor concentrating securities in a given sector of the economy] recognizes the old saying: "Don't put all your eggs in one basket". Diversification is the key. That is why relatively small and, more importantly,

[72] *Ibid* at para 204.
[73] *Ibid* at para 205.
[74] *Ibid* at para 205.
[75] *Ibid* at para 205.
[76] *Ibid* at para 205.
[77] *Ibid* at para 205.
[78] *Re Adeola*, 2015 LNCMFDA 10 at para 58.
[79] *Ibid* at para 58.
[80] *Supra* note 5 at para 25.
[81] *Ibid* at para 25.
[82] *Supra* note 63 at para 47.
[83] *Re Biduk*, 2013 IIROC 19 at para 87 [*Re Biduk*].

> inexperienced/unsophisticated investors are generally better-off in professionally managed conservative mutual funds, and even there in those that are more-diversified rather than less-diversified.

The IIROC Hearing Panel in *Re Biduk* described concerns about concentration as encompassing issues around concentration in a particular sector of the economy (i.e. many securities but one sector), and concentration in a few volatile securities:[84]

> …the Canadian investment industry has always recognized the inherent danger of an investor concentrating his/her holdings of securities in a given sector of the economy; let alone in the volatile securities of only one or two issuers in that given sector.

In previous Canadian securities regulatory authority discipline cases, Approved Persons have been found to be in breach of suitability obligations for overweighting client portfolios in a few volatile securities,[85] overweighting client portfolios in speculative securities generally,[86] and overweighting client portfolios in one sector as a whole even though many securities were involved.[87]

Conclusion

Past disciplinary decisions canvassed as part of this resource document confirm the significant importance placed on an Approved Person's responsibility to meet the suitability requirement by Canadian securities regulatory authorities. They also reinforce that Approved Persons should be aware that a failure to satisfy any obligations of the three-stage suitability analysis including the order in which it is performed could result in disciplinary action against them.

[84] *Ibid* at para 86.
[85] See *Re Graham*, [2005] IDACD No 21 and *Re Biduk*.
[86] See *Re Armstrong*, [2003] IDACD No 19.
[87] See *Re Brodie*, 2013 IIROC 12.

APPENDIX "A"

Requirements and Guidance Relating to Suitability

MFDA Rules and Policies

- MFDA Rule 2.2.1
- MFDA Policy No. 2 - Minimum Standards for Account Supervision

MFDA Staff Guidance

- MFDA Staff Notice 0025 – Suitability Obligations for Unsolicited Orders
- MFDA Staff Notice 0048 – Know Your Product
- MFDA Staff Notice 0069 – Suitability
- MFDA Staff Notice 0070 – Misleading Communications Regarding Leverage
- MFDA Staff Notice 0074 – Leverage Risk Disclosure
- MFDA Bulletin #0611-C – MFDA Discussion Paper on the Use of Investor Questionnaires
- MFDA Bulletin #0612-C – MFDA Webcast on the Discussion Paper and Sample Questionnaire

Other

- National Instrument 31-103 - Registration Requirements and Exemptions, particularly Part 13, Division 1, "Know your client and suitability"
- CSA Staff Notice 33-315 – Suitability Obligation and Know Your Product

APPENDIX "B"

MFDA Rule 2.2.1 (January 19, 2017)

2.2.1 **"Know-Your-Client".** Each Member and Approved Person shall use due diligence:

(a) to learn the essential facts relative to each client and to each order or account accepted;

(b) to ensure that the acceptance of any order for any account is within the bounds of good business practice;

(c) 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;

(d) to ensure that, notwithstanding the provisions of paragraph (c), where a transaction, including a transaction involving the use of borrowed funds, proposed by a client is not suitable for the client based on the essential facts relative to the client and the investments in the account, the Member or Approved Person has so advised the client before execution thereof and the Member or Approved Person has maintained evidence of such advice;

(e) to ensure that the suitability of the investments within each client's account is assessed:

(i) whenever the client transfers assets into an account at the Member;

(ii) whenever the Member or Approved Person becomes aware of a material change in client information, as defined in Rule 2.2.4; or

(iii) by the Approved Person where there has been a change in the Approved Person responsible for the client's account at the Member;

and, where investments in a client's account are determined to be unsuitable, the Member or Approved Person so advises the client and makes recommendations to address any inconsistencies between investments in the account and the essential facts relative to the client and the Member or Approved Person maintains evidence of such advice and recommendations;

(f) to ensure that the suitability of the use of borrowing to invest is assessed:

(i) whenever the client transfers assets purchased using borrowed funds into an account at the Member;

(ii) whenever the Member or Approved Person becomes aware of a material change in client information, as defined in Rule 2.2.4; or

(iii) by the Approved Person where there has been a change in the Approved Person responsible for the client's account at the Member;

and, where the use of borrowing to invest by the client is determined to be unsuitable, the Member or Approved Person so advises the client and makes recommendations to address the inconsistency between the use of borrowed funds and the essential facts relative to the client and the Member or Approved Person maintains evidence of such advice and recommendations.

APPENDIX "C"

MFDA Policy No. 2 (Minimum Standards for Account Supervision) (January 19, 2017)

[Excerpt]

Documentation of Client Account Information

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

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

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

   (a) name;

   (b) type of account;

   (c) residential address and contact information;

   (d) date of birth;

   (e) employment information;

   (f) number of [dependents];

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

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

   (i) investment knowledge;

   (j) risk tolerance;

   (k) investment objectives;

   (l) time horizon;

   (m)income;

   (n) net worth;

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

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

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