



Client Focused Reform amendments to MFDA Staff Notice MSN-0048 come into effect on December 31, 2021.

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MFDA STAFF NOTICE

KNOW-YOUR-PRODUCT

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 is intended to clarify the obligations of Members and Approved Persons pursuant to MFDA Rule 2.2.5 (“Know-Your-Product”).

Introduction

Members and Approved Persons must have an understanding of the investment products that are purchased and sold for, or recommended to, their clients, obtained through a robust KYP process, in order to make the suitability determination that is required under MFDA Rule 2.2.6 (“Suitability Determination”).

The Member must establish, maintain and apply policies, procedures and controls relating to the know your product process, in accordance with its business model, the types of investment products offered, the proficiency of its Approved Persons, and the nature of the relationships that the Member and its Approved Persons have with clients. These policies, procedures and controls should include appropriate processes for assessing and approving, as well as monitoring for significant changes to, investment products that are made available to clients.

Member Due Diligence / Investment Product Approval

Members must perform a reasonable level of due diligence on investment products prior to their approval for sale by Approved Persons. Members must have written policies and procedures in place that describe in detail the steps to be followed in the due diligence process.

Due diligence must be completed on all investment products being considered for sale by the Member before the investment products are approved. Member procedures should provide for

different levels of analysis for different types of investment products. The extent of the assessment, approval and monitoring processes required may vary depending on the structure, features and risks of investment products being considered or made available by the Member. Members may tailor their processes to the types of investment products being considered and the complexity and risks of those investment products, and their policies and procedures should set out the different levels of assessment, approval and monitoring for different types of investment products, as appropriate. For example, a Member's KYP process for less complex and risky types of investment products may be less extensive than the process for more complex and risky types of investment products, such as those that are novel, not transparent in structure, or that involve leverage, options, or other derivatives. Investment products sold under a prospectus exemption may require a more extensive review and approval process because of the limited disclosure available about them and the less liquid nature of such investment products. Investment products that are presently being sold by Members are subject to the requirements of Rule 2.2.5 ("Know-Your-Product"), and such a review must be performed before continuing to sell the investment products.

In determining whether to approve an investment product for sale, Members should not merely rely on the representations of the issuer, or on the fact that the investment product appears to be similar to others, or that other firms are already offering the investment product. Additional due diligence may be necessary where there are reasons to question the validity of an issuer's information or where information provided about the investment products is not sufficient to permit a meaningful assessment of the investment products. An in-depth assessment of an investment product should take place where any issues are identified during the review process. In all cases, the approval process must be independent and objective. Members are advised that simply making inquiries will not be sufficient to discharge their responsibility to conduct due diligence. Members must properly follow up on any questions they have raised until they have been satisfied that they have a complete understanding of the investment products they propose to sell. Members should consider whether any restrictions or controls, such as concentration limits or controls on the use of the investment product in client portfolios, are required for any investment products they are considering making available to clients. Members should also assess whether any modifications need to be made to their compliance or other systems to support particular investment products, and whether additional training or proficiency requirements are necessary in order for their Approved Persons to understand the investment products and make appropriate suitability determinations.

To be effective, the due diligence review process should involve:

- a review of any offering documents;
- a review of any marketing materials related to the investment product;
- consideration of MFDA Rules and securities regulations that may apply in the sale of the investment product;
- consideration of the general structure and features of the investment product, including the overall complexity, transparency and uniqueness of the investment product, the basis of the investment product's return; and the likelihood of achieving its investment objectives and any expected returns, the time horizon and liquidity restrictions, and the use of leverage;
- an assessment of the risks associated with the investment product;

- an assessment of the initial and ongoing costs of acquiring, owning, and disposing of the investment product, as well as the impact of those costs on performance, client returns or otherwise, including:
 - fees paid to registrants or other parties, such as commissions, sales charges, trailer fees, management fees, incentive fees, referral fees and redemption fees;
 - embedded costs, such as expenses.
- an assessment of the conflicts of interest, if any, inherent in the investment product, arising, for example, from the compensation structure (for example, the commissions and other compensation to be paid to the Member and Approved Person for selling the investment product), related-party issues or other factors, including an assessment of how any conflicts of interest are being addressed by the issuer;
- consideration of competitive investment products that may be less costly or less risky;
- a review of the issuer's financial position and history;
- an assessment of management qualifications and track records;
- an assessment of any custodian, investment manager, sponsor, or guarantor, or significant counterparty associated with the investment product; and
- maintaining a thorough written record of the results of the Member's due diligence.

It is critical that the Member develops an understanding of all features of the investment product. Issues such as liquidity of the investment product and the nature of any underlying investments and their inherent risks must be examined before assigning a risk ranking to the investment product. The Member should develop guidelines or an investor profile for which the investment product would be generally suitable, including risk levels, investment time horizon, income and net worth. The Member should also clearly identify investors for whom the investment product is not suitable. Concentration limits should be assigned to investment products and/or general classes of investment products where appropriate.

As a reminder, the fact that an investment product is included on a Member's approved investment product list does not in any way diminish the obligations of Members and Approved Persons to ensure that each recommendation made for any account of a client is suitable for the client and puts the client's interest first, and is in keeping with the client's investment objectives. Members must provide their Approved Persons with information gathered about investment products that have been assessed and approved to be made available to clients, to assist Approved Persons in complying with their KYP obligations. Members should also provide their Approved Persons with any necessary training and tools to assist their Approved Persons in complying with their KYP obligations.

Members are expected to have the appropriate skills and experience to perform the necessary assessment of all investment products to be made available to clients. As a best practice, a committee involving senior management of the Member should be empowered with ultimate

authority in the investment product approval process, to ensure that all business units of the Member have signed off on the investment product prior to sale.

Approved Persons' KYP obligations

Approved Persons must take reasonable steps to understand investment products purchased or sold for, or recommended to, clients, including the structure, features and risks of the investment products as well as the initial and ongoing costs of the investment products and the impact of those costs. Investment products that are more complex or risky may require a more detailed consideration by Approved Persons. An understanding of all investment products that Approved Persons purchase or sell for, or recommend to, clients is necessary in order for Approved Persons to make the suitability determination that is required by MFDA Rule 2.2.6 ("Suitability Determination").

Approved Persons are also expected to have, based on their proficiency, a general understanding of the types of investment products that are available through the Member for the Approved Persons to purchase or sell for, or recommend to, clients. This is required in order for the Approved Persons to meet their suitability determination obligations, including the requirement to consider a reasonable range of alternatives as part of making a suitability determination for a client.

Approved Persons must not purchase investment products for or recommend investment products to clients unless those investment products have been approved by the Member to be made available to clients. However, the fact that an investment product is "approved" by the Member is not enough to discharge an Approved Person's obligation to take reasonable steps to understand the investment product being purchased or sold for, or recommended to, a client by the Approved Person.

Monitoring of Approved Investment Products

A Member's KYP process should address monitoring for any significant changes to the business environment, or market conditions that would affect the risks or other aspects of investment products which have already been approved by the Member.

In the event of any such change, it is appropriate for the Member to revisit their approval of or restrictions or controls on the investment product(s). Approved Persons and supervisory staff should be aware of such changes, and consideration should be given as to whether the change(s) requires a new suitability determination to be made for clients holding investment products which have been impacted.

Additional Considerations Regarding Investment Products of related and connected issuers

Members and Approved Persons are not relieved of their KYP obligations in respect of investment products of related and connected issuers. Where a Member offers investment products of related and connected issuers as well as other investment products, we expect that the investment products of related and connected issuers will be subject to the same KYP process as those of other issuers. We remind Members and Approved Persons of their obligation to address conflicts in the best interest of their clients, including those that arise as a result of making investment products of related and connected issuers available to clients.

Additional Considerations Regarding 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 investment products should be considered to be high risk. It should be noted that these investment products 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 other mutual fund investment products, such as leveraging and short selling. These facts alone often justify a high risk ranking.

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

Members must, after due inquiry, satisfy themselves that the conditions of any exemption apply before trading in reliance on an exemption and maintain documentation to support their determination. Where there is uncertainty regarding the applicability of an exemption, a Member must take appropriate measures which may include consultation with the relevant securities regulatory authority or legal counsel. In addition, all local rules and applicable registration requirements of the relevant securities regulatory authorities must be satisfied prior to selling the investment products. These conditions may vary significantly between jurisdictions and may include proficiency requirements, notice to or specific approval from regulators or amendment of the Member's registration.

Members should be particularly careful when examining suitability issues in relation to exempt securities. It should be noted that the classification of an investor as a "sophisticated purchaser" or an "accredited investor" does not negate the obligations of the Member with respect to suitability determination. Where securities to be sold pursuant to exemptions from the prospectus requirements under securities legislation are made available to clients, we expect that Members will consider training their Approved Persons and supervisory staff on the characteristics and concerns related to exempt securities, to ensure that their Approved Persons understand those investment products and recommend them only in appropriate circumstances.

Members should also have policies and procedures in place with respect to the information to be provided to clients, to help ensure that clients fully understand the investment products being offered before entering into any transaction. The client should be clearly advised where an investment product is being sold under an exemption. It is important that the client also understands the implications of any restrictions that may apply with respect to liquidity and the potential absence of a secondary market for such investment products. Finally, the client should be aware that an offering memorandum that may be provided prior to the sale of some investment products (e.g. certain exempt securities), is not a prospectus, and that certain protections, rights and remedies that may exist under securities legislation in relation to prospectus offerings, including statutory rights of rescission and damages, may not be available to the client.

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