



*Client Focused Reform amendments to MFDA Staff Notice MSN-0069 come into effect on December 31, 2021.*

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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 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*.

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# MUTUAL FUND DEALERS ASSOCIATION OF CANADA KYC AND SUITABILITY

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## 1. KNOW YOUR CLIENT (“KYC”)

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

In order to meet requirements under MFDA Rule 2.2.1 (“Know-Your-Client”), Members and Approved Persons 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 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 Approved Persons are reminded that KYP is an essential component of making the suitability determination. Guidance on how to meet obligations under Rule 2.2.5 (Know-Your-Product), is set out under MSN-0048.

Members and Approved Persons are required to take reasonable steps to learn the essential facts relative to each client and to each order or account accepted and ensure they have sufficient information to support a suitability determination. What is sufficient is to be determined in accordance with Section II of Policy No. 2 *Minimum Standards for Account Supervision*, which sets out minimum requirements for the collection of KYC information, and notes that, depending on the circumstances, a Member or Approved Person may need to collect additional information to fully 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.

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. 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. 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 timeframes to update the information and a description of the approval process for updates;
- Ensure sufficiency of KYC information prior to opening or trading in an account, or otherwise making a suitability determination;
- Detect or prevent inconsistent KYC information in use by 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 sufficient KYC information, the Member should have a process in place to restrict investment actions that can be taken by or on behalf of a client (for 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. KYC Information**

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.

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.

#### ***b) 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.

*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***

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 to allow for comparison for suitability and supervisory purposes against the type of investments that will be purchased 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 within the account. This can be done by using percentages or descriptions of the investor profile and recommended asset allocation.

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***

Investment time horizon is the period from now to when the client will need to access a significant portion of the money invested. 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 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 investment 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 Profile***

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, investment time horizon, risk profile 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 profile should relate to the account and should not be collected separately for each individual account holder.



## **C. 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, in the case of each account, for adequacy, reasonableness and consistency, and, with respect to different accounts, inappropriate uniformity.

### ***Adequacy***

Members must have controls in place to ensure accounts are only opened if adequate KYC information is obtained. KYC is adequate when it provides sufficient information to allow the Member and Approved Person to make a suitability determination. In cases where a Member has accounts that have already been opened and KYC information is not adequate, the accounts should be restricted (for example, by restricting the accounts to liquidating trades, transfers or disbursements).

### ***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 should not also have a “low” risk profile. In some instances, Members have incorporated edit checks into their trading systems that prohibit inconsistent KYC information from being entered or accepted.

### ***Uniformity***

When approving new accounts, KYC amendments or performing branch examinations, Member supervisory staff should be alert to situations where Approved Persons have a significant number of client accounts with the same or very similar KYC information. Approved Persons are to document KYC information based on actual client circumstances, and should not document KYC information solely to fit their investment strategy or recommendations.

## **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 profile and investment time horizon.

#### ***Account vs. Client KYC***

A Member should collect KYC Information separately for each account. A client may have different risk 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 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 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 determination. For example, if a Member uses a percentage method for identifying risk 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 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. SUITABILITY PROCESS**

### **A. Suitability 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 2.2.6 requires that a suitability determination be performed for each order accepted or recommendation made for any account of a client. This means that the suitability determination must be performed for trades that are recommended by the 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*.

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 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 a client's account 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 Approved Person becomes aware of a material change in a client's KYC information that could result in an investment or the client's account not satisfying the suitability criteria under Rule 2.2.6(1);
- d) The Member or Approved Person performs the periodic review required under Rule 2.2.4(f) (i.e. no less frequently than once every 36 months); and
- e) With respect only to Approved Persons, where a client of the Member is reassigned from one Approved Person to another (note that this applies only to Members that assign accounts to Approved Persons).

### ***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.

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 Approved Person is transferring a large book of business to the Member, it may be reasonable to ensure that the suitability 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 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 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.

### ***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 the investments in the account to the client's KYC information. These should be aligned. Where there is a discrepancy between the KYC information and the investments in the account, this may indicate that the client's KYC needs to be updated, or that the account may need to be rebalanced.

Client risk profile, investment needs and objectives and investment time horizon must be directly compared against the assets in the client's account. The other required KYC information including investment knowledge, personal circumstances and financial circumstances, are also key considerations when assessing the reasonableness of suitability determinations made for clients. For example, a senior client or client with limited investment knowledge 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 that its suitability process is sufficient to support a suitability determination. Further, Members are responsible for making suitability determinations in respect of all recommendations that are made as part of the business of the Member. This would include recommendations for investment products that may not meet the definition of a "security" under securities legislation.

### ***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.

## E. Trade and Account Supervision, Inquiry Resolution

Members should have systems or processes to identify 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. 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.

### *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 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 investment products;
- Trades over \$5,000 in moderate or medium risk investment products;
- Trades over \$10,000 in all other investment products; and
- Redemptions over \$10,000.



When reviewing trades, including redemptions, it would also be advisable to determine whether the 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 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 investment products;
- Trades over \$50,000 in all other 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 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 trading or switching between funds indicating possible unauthorized trading, 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 switches between no load funds and DSC or front load funds;
- Excessive switches between DSC funds and front load funds; and
- Excessive switches where a switch fee is charged.

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

- A review of all accounts generating commissions greater than \$1,500 within the month;
- A quarterly review of reports on assets under administration (“AUA”) comparing current AUA to AUA at the same time the prior year; and
- 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 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 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 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 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 Approved Person does not take steps to resolve the query. Members should also consider imposing increased supervision over trade activity of an Approved Person where he or she has an inordinate number of trades being queried, or queries which raise concerns regarding the 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.

## **F. Unsolicited Unsuitable Trades and Unsuitable Portfolios**

Where a client has requested a trade on an unsolicited basis which, in the view of the Approved Person or Member, is unsuitable, the Member or 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.

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 consistent with 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 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*.

## **3. LEVERAGING**

Using borrowed funds to invest (or leveraging) is not suitable for all investors. Members are responsible for ensuring that whenever a client borrows to invest, it is suitable for the client and puts the client's 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 Approved Persons provide this information to any clients to whom leveraging recommendations are made, and to clients who the Approved Person otherwise knows are investing with borrowed funds.

## **B. Member and 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 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 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 Approved Person arrangements with lenders to ensure the proper recording and supervision of leveraging recommendations.

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 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 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 Approved Persons have arrangements with lending institutions to finance leveraging strategies. Arrangements in which compensation is paid are referral arrangements pursuant to requirements under Rule 2.4.2, and must be documented and entered into between the Member and the financial institution. Even where no monetary compensation is paid, Members are expected to have policies and procedures in place to require Approved Persons to inform them of any arrangement or agreement with a lender to comply with the Member's general supervisory obligation to address any material or reasonably foreseeable conflict of interest. This would not include situations where clients arrange their own financing without the recommendation or advice of the Approved Person. Where clients do arrange their own financing and it comes to the attention of the Member or 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 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. 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 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 making a suitability 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 Profile***

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 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 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 are triggered or close to being triggered, a leverage suitability 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 an Approved Person cannot rely on the approval by the lending institution of the loan as an indication that the recommendation to invest using borrowed funds is suitable or puts the client's interest first. Members and Approved Persons must consider a client's financial circumstances when assessing the suitability of using borrowed funds to fund an investment. 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.

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