

IIROC NOTICE

Rules Notice Guidance Note- Draft

Please distribute internally to:

Dealer Member Rules

Internal Audit
Legal and Compliance
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Know your client and Suitability Guidelines

This Guidance Note does not purport to amend statutory requirements or applicable IIROC Dealer Member Rules relating to the know your client and suitability obligations. Rather, it sets out IIROC's interpretation, expectations and suggested best practices relating to the know your client and suitability requirements as currently reflected in the IIROC Dealer Member Rules. The Guidance Note also discusses these requirements in relation to the proposed Client Relationship Model and the recent Amendments to implement the CSA Registration Reform Project.

OVERVIEW OF THE REQUIREMENTS

Dealer Members and Registered Representatives are reminded that compliance with the suitability requirements is fundamental to compliance with general business conduct standards and is essential to good business practice. The suitability requirement is also complementary to the fundamental obligation under securities legislation for all dealers and their representatives to deal fairly, honestly and in good faith with clients.

The first step towards satisfying the suitability requirements is to satisfy the new account application and know your client requirements.



COMPLIANCE WITH KNOW YOUR CLIENT REQUIREMENTS

New account application requirements

Pursuant to current IIROC Dealer Member Rules, a new account application is required for each customer¹. IIROC Dealer Member Rule 1300.2 requires that each account be opened pursuant to a new account form which includes, at a minimum, the applicable information required by Form 2, also referred to as the New Account Application Form. The information set out in Form 2 includes, among other things, the client's personal information, financial information, risk tolerance, investment objectives, and disclosure of whether the client is an insider of a public corporation.

Dealer Members should note that the recent amendments to IIROC Rules to implement the Registration Reform project eliminated the use of the word "form" to recognize that account applications, *and the collection of KYC information*, is frequently completed/done electronically.

Conditions under which one account application may be used for more than one account:

As per the recent amendments to implement the CSA Registration Reform Project, Dealer Member Rule 2500 has been amended to allow one account application to be obtained for each customer². IIROC takes the position that a single account application may be used for a client or for multiple accounts held by the same client provided that:

- The client's investment objectives and risk tolerance are identical for all of the accounts covered by the application;
- In the case of individuals, the beneficial owner is identical for all of the accounts or in the case of non-individual accounts, the entity is identical for all of the accounts;
- The client understands that the accounts on the same account application will be assessed for suitability on a multiple account or portfolio basis; and
- The Dealer Member has the ability to conduct supervision, including reviewing orders for suitability and updating KYC information, on a multiple account or client basis.

Accordingly, subject to the above noted considerations, the same account application may be used for multiple accounts of the same client such as a client's cash, margin and certain registered accounts on the basis that the beneficial owner is identical for all of these accounts. IIROC staff are considering proposing the above noted conditions as rule amendments.

¹ IIROC Dealer Member Rule 2500

² Recent amendments to implement the CSA Registration Reform Project approved by the IIROC Board of Directors on June 25, 2009 were implemented on September 28, 2009.



Examples of accounts where a separate account application would be required:

Based on the above noted conditions, a separate account application would be required for a client's joint account, corporate account and trust account.

Joint account - The beneficial owners of a joint account are not identical to the beneficial owner of an individual account.

Corporate account - Although the ultimate beneficial owner of a personal corporation may be the same individual as the client who has a cash or margin account, the same account application can not be used on the basis that the account holder recorded is the Corporation, rather than the beneficial owner / shareholder. The information recorded on the account application is the Corporation's information. Furthermore, the shareholders (beneficial owners) of a corporation are separate and distinct from the corporate legal entity. The contractual relationship is between the Dealer Member and the Corporation.

Trust accounts - "In Trust For" accounts also require a separate account application as they have different interests and objectives. There is no contractual relationship between the Dealer Member and the beneficial owner(s) of the trust. The "In Trust For" account is directed and controlled by the trustee, and subject to the terms of the trust.

Know your client information

Registered Representatives are reminded that the client's investment objectives, and risk tolerance must be assessed based on the client's financial and personal circumstances. The stated investment objectives and risk tolerance must be reasonable in light of those circumstances. The reasonableness of such information should be reviewed by the Registered Representative and the Dealer Member during the account opening and account approval process.

Time horizon

As per Dealer Member Rule 1300, a client's investment objectives, risk tolerance, investment knowledge and financial situation must be considered when assessing suitability of orders and recommendations. Furthermore, in order to meet the "know your client" requirements, Registered Representatives need to understand the client's personal circumstances which include understanding the client's time horizon. The client's age is one indication of the client's time horizon. Although time horizon is not a separate requirement, in order to properly assess and record a client's investment objectives and risk tolerance, Registered Representatives should consider the client's time horizon. Time horizon should be determined by considering when the client will need to access some or all of their money. Where a client identifies his / her time horizon, the Registered Representative has the responsibility to assess its feasibility and reasonableness in comparison to the client's age, risk tolerance, and other particular circumstances.



Periodic updates and review

The account application information must be updated any time there is a material change in a client's circumstances³. The following procedures are considered Best Practices for satisfying this requirement:

- Registered Representatives periodically, or at a minimum annually, inquire with each client as to whether there are any material changes in the client's circumstances. It is acceptable for a Registered Representative to make such inquiries when the Registered Representative meets a client to review his/her portfolio, or corresponds with the client to discuss other account related matters.
- Registered Representatives conduct periodic suitability reviews, at a minimum annually, and use the review discussion as an opportunity to inquire with the client as to whether there are any material changes in the client's circumstances.
- The Dealer Member, as part of its account opening documentation, clearly informs clients of the client's obligation to notify their respective advisors any time there is a material change in their circumstances.

As noted above, the account application will need to be updated anytime there is a material change in a client's circumstances.

Dealer Members and Registered Representatives should note that under the proposed Client Relationship Model, in order to comply with the suitability requirements, the positions held in the client's account(s) would have to be reviewed any time the KYC information is updated as a result of a material change in the client's circumstances⁴.

COMPLIANCE WITH THE SUITABILITY ASSESSMENT REQUIREMENTS

Pursuant to IIROC Dealer Member Rules, orders and recommendations need to be reviewed to ensure that they are suitable for the particular client⁵. Suitability needs to be considered in light of other investments within the client's account or portfolio, and in relation to his / her financial condition, investment knowledge, investment objectives and risk tolerance.

The suitability analysis starts before the order is even received, recommended or executed. The Dealer Member and Registered Representatives, at the time of account opening, should ensure that the account type (margin, trust, option accounts, etc.) is suitable for the client in relation to his / her particular circumstances. Secondly, the Dealer Members and Registered Representatives need to understand the risks and other characteristics associated with securities they approve or recommend

³ IIROC Dealer Member Rule 2500

⁴ IIROC Dealer Member Rule 1300 as per proposed Client Relationship Model

⁵ IIROC Dealer Member Rule 1300



for sale.

Furthermore, as per the proposed Client Relationship Model, IIROC Dealer Member Rules are proposed to be amended to require a suitability analysis whenever one or more of the following triggering events occur:

- any time there is a material change in the customer's circumstances;
- when there is a change in the registered representative, investment representative, or portfolio manager; or
- when securities are received into the client's account by way of deposit or transfer.

In the interim, Dealer Members and Registered Representatives are encouraged to adopt the practices outlined above to enhance compliance with the existing suitability requirements.

Product suitability

The suitability assessment obligations include a requirement to know and understand the characteristics and risks associated with any product approved or recommended to clients. Dealer Members have the responsibility to assess the risks associated with the products that Dealer Members approve for sale. Registered Representatives should understand, and be able to clearly explain to the client, the reasons that a specific security is appropriate and suitable for the client.

Please refer to the "Best Practices for product due diligence" Guidance Note 09-0087 published on March 25, 2009 which sets out IIROC's expectations regarding procedures and criteria that Dealer Members should consider when assessing and introducing products that they approve or recommend for sale. As explained in the Guidance Note, adequate procedures for reviewing products before they are offered to clients can greatly enhance the ability to detect unsuitable recommendations.

Unsuitable investments

Dealer Members and Registered Representatives have a general suitability requirement with respect to orders they accept or recommend⁶. As previously stated, once the Client Relationship Model proposal is in effect, the suitability assessment requirements will continue after the order is executed, upon the occurrence of various triggering events⁷.

As part of the general suitability requirements, whenever an unsuitable investment is identified within an account, there is a responsibility to take appropriate action. An unsuitable investment may be identified by the Registered Representative at the time of updating the client's account information, to reflect a material change in the client's circumstances as required by IIROC Dealer Member Rule 2500,

⁶ Dealer Member Rules 1300 and 2500

⁷ Proposed Client Relationship Model



or when conducting a periodical suitability review as discussed on page 4 of this Guidance Note. The Dealer Member may identify an unsuitable investment within an account when conducting supervisory activities, including account activity reviews as required by Dealer Member Rule 2500. The responsibility to take appropriate action when an unsuitable investment is identified within an account is consistent with Dealer Member Rule 2500 which explains that the meaning of the term “review” includes a preliminary screening to detect items for further investigation.

An account may include an unsuitable investment for a variety of reasons including a previously executed unsolicited order, or an unsuitable recommendation by a former Registered Representative. Furthermore, a sector related change or material change in an issuer’s circumstances may cause a shift in the risk associated with a particular security. Where an unsuitable investment is identified within an account, the Registered Representative should take appropriate measures to ensure the client receives advice considering the client’s objectives, risk tolerance, and other particular circumstances. An appropriate measure or course of action may include contacting the client in a timely manner to recommend changes. Where a client does not want to dispose of the unsuitable investment, it may be appropriate to recommend changes to other investments within the account in order to ensure the suitability of the overall portfolio. Registered Representatives should consult their Supervisor or Compliance Department regarding the Dealer Members’ internal policies in handling unsuitable investments.

Unsolicited unsuitable orders

Where a Registered Representative receives an unsolicited order that is unsuitable in relation to the client’s objectives, risk tolerance and other particular circumstances, it is not sufficient to merely mark the order as unsolicited. The Registered Representative needs to take appropriate measures to deal with the unsuitable order. The extent of the Registered Representative’s obligation partially depends on his/her relationship with the client. Appropriate measures may include providing clients with cautionary advice and documenting the details of the cautionary advice, or recommending changes to other investments within the account. Registered Representatives should consult their Supervisor or Compliance Department regarding the Dealer Member’s internal procedures in dealing with the above noted circumstances, including whether it is appropriate to refuse the order.

Inappropriate updates

When an unsuitable investment is identified within a client’s account or an unsuitable order is received from the client, the Registered Representative should discuss with the client whether there have been any changes to the client’s circumstances that would warrant amendments to the KYC information. Registered Representatives should note that it is inappropriate to update or alter the client’s KYC information in an effort to justify the suitability of an investment, order or recommendation that is otherwise unsuitable for the client.



Best practices for maintaining a suitable client portfolio

The following are recommended Best Practices that will contribute to maintenance of a suitable client portfolio:

- Considering whether a suitability review should be conducted when there are significant market changes and conducting such review where appropriate;
- Conducting a suitability review where there is a material change of risk associated with an issuer, whose securities are held by specific customers; and
- Written policies and procedures regarding the need to conduct a suitability review at the time of transfer to a new advisor, transfer to a new Dealer Member, or where there is a material change in a customer's circumstances. As noted above, these events would trigger a suitability review under the proposed Client Relationship Model.

The suitability assessment requirements in IIROC Dealer Member Rule 1300 are triggered at the time of acceptance of an order or making a recommendation. As discussed above, the Proposed Client Relationship Model amendments will also introduce the obligation to conduct suitability reviews when certain triggering events occur in order to ensure that the client's portfolio remains appropriate for him/her. It is advantageous to clients, firms and the industry overall, and consistent with good business practices, that Registered Representatives and Dealer Members conduct suitability reviews using a more holistic approach as suggested above.

Comments on the draft Suitability Guidelines may be delivered in writing or by fax or e-mail within 75 days of the date of this notice to:

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