

IIROC NOTICE

Rules Notice Guidance Note Dealer Member Rules

Please distribute internally to:

Internal Audit
Institutional
Legal and Compliance
Retail
Senior Management
Training

Contacts:

Richard J. Corner
Vice President, Member Regulation Policy
416 943-6908
rcorner@iroc.ca

Sherry Tabesh-Ndreka
Senior Policy Counsel, Member Regulation Policy
416 943-4656
stabesh@iroc.ca

**12-0109
March 26, 2012**

Know your client and suitability - Guidance

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 existing requirements in the IIROC Dealer Member Rules, as recently amended to implement the Client Relationship Model project (“CRM”).

While the best practices set out in this Guidance Note are intended to present acceptable methods that can be used to comply with the aforementioned IIROC requirements, they are not the only acceptable methods. Dealer Members may use alternative methods, provided that those methods demonstrably achieve the overall objective of the Rules. In any event, Dealer Members are encouraged to adopt a risk based approach when setting internal compliance procedures.

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 Dealer Members and their representatives to deal fairly, honestly and in good faith with clients. The fundamental obligation includes a duty to disclose known or discoverable risks to the investor before entering into any transaction.



Most of the issues discussed in this Guidance Note apply to retail clients in an advisory relationship; however, some of the principles discussed may also be applicable when dealing with other types of clients or relationships. As previously noted, the Guidance Note does not purport to amend statutory requirements or applicable IIROC Dealer Member Rules relating to the “know your client” and suitability obligations. Accordingly, if a Rule does not apply to a particular type of client then any discussion or guidance provided with respect to that Rule will also not apply. For example, the following obligations and requirements apply to all clients:

- the obligation to deal fairly, honestly and in good faith with clients; and
- the requirement to update know your client information at the time of material change .

On the other hand, the following obligations and requirements either do not apply to certain clients or are applied differently to certain clients:

- the requirement to determine a client’s investment objectives and risk tolerance does not apply to institutional clients, as they are subject to a different suitability standard, or to clients who trade through order execution-only accounts.
- while the general suitability assessment requirements for managed accounts are the same as those for advisory accounts, there are additional supervision requirements that must be adhered to in order to ensure that the investment objectives of each client are being diligently followed.

COMPLIANCE WITH KNOW YOUR CLIENT REQUIREMENTS

The first step in satisfying IIROC’s suitability requirements is to satisfy the new account application and “know your client” requirements.

Collection of “know your client” information - New account application requirements

Pursuant to current IIROC Dealer Member Rules, a new account application is required for each client. IIROC Dealer Member Rule 1300.2 requires that each account be opened pursuant to a new account application which includes, at a minimum, the collection of 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. The information collected regarding risk tolerance and investment objectives should be sufficiently precise to enable the Dealer Member and the Registered Representative to meet their suitability assessment obligations.

Dealer Members should note that the recent amendments to IIROC Dealer Member Rules to implement the Registration Reform project eliminated the use of the word “form” from the term “new account application form” to recognize that the completion of account applications and the collection of “know your client” information is frequently completed/done electronically.

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

Dealer Member Rule 2500 allows a Dealer Member to obtain one account application for multiple



accounts (e.g. a client's cash, margin and certain registered accounts) of the same client. The use of a single account application may be appropriate provided that:

- in the case of individuals, the account beneficial owner is the identical individual for all of the accounts;
- in the case of non-individuals, the account beneficial owner is the identical legal entity for all of the accounts;
- the client's investment objectives, time horizon and risk tolerance are identical for all of the accounts;
- the Dealer Member has the ability to supervise each of the accounts, including the review of "know your client" information updates and orders for suitability purposes, on a multiple-account basis; and
- the client understands and acknowledges that the information collected in the one application will be used to assess suitability on a multiple-account basis.

Given these conditions, not all accounts of the same client can necessarily be opened using a single account application.

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

As explained above, in order to be able to rely on a single account application for multiple accounts of the same client, the beneficial owner of each account must be identical. Accordingly, a separate account application would be required if that same client held a beneficial interest in a joint, corporate or 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 cannot be used to open a corporate account, given that the account holder is the corporation and not the corporation's beneficial owner / shareholder. The information required to complete the account application is therefore, the corporation's information. Furthermore, the shareholders (beneficial owners) of a corporation are separate and distinct from the corporate legal entity. The contractual relationship arising out of the creation of the account is between the Dealer Member and the corporation.

Trust accounts - Formal and informal "In Trust For" accounts also require a separate account application as they have unique investment objectives that are determined by the trustee, in accordance with the terms of the trust. Furthermore, there is no contractual relationship between the Dealer Member and the beneficial owner(s) of the trust. Rather, the contractual relationship is between the Dealer Member and the trustee, who is required to operate the account in accordance with the terms of the trust.



Know your client information items to be collected and assessed

Under the current rules, there are several questions that Registered Representatives must ask their clients in order to satisfy their “know your client” obligation and equip themselves to conduct a proper suitability assessment. Some of the information collected, such as client net worth, age and investment experience, can be readily obtained from the client. Other factors, such as a client’s risk tolerance and investment objectives may, however require further discussion and assessment. Registered Representatives are reminded that the client’s investment objectives and risk tolerance are two separate but related factors; each factor must be assessed based on the client’s financial and personal circumstances and 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. For example, designating an 80% high risk tolerance for an elderly client may be unreasonable if the client has a modest net worth and has opened the account to invest a substantial portion of her net worth. On the other hand, the 80% high risk tolerance may not be unreasonable if the elderly client has a substantial net worth and opens an account to invest a small fraction of her net worth.

Time horizon

As per Dealer Member Rule 1300.1, a client’s current financial situation, investment knowledge, investment objectives and time horizon, risk tolerance and the account’s current investment portfolio composition and risk level must be considered when assessing the suitability of orders and recommendations. 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. 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, investment objectives, risk tolerance, and other particular circumstances.

Periodic updates and review

The account information must be updated any time there is a material change in a client’s circumstances. The following procedures are considered best practices for satisfying this requirement:

- Registered Representatives periodically inquire with each client as to whether there are any material changes in the client’s circumstances. It is also acceptable for a Registered Representative to make such inquiries when the Registered Representative meets a client to review his/her portfolio, otherwise corresponds with the client to discuss other account related matters or annually contacts the client to verify the accuracy of the account information.
- The Dealer Member, in 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.



- Where Registered Representatives conduct periodic suitability reviews, use the review discussion as an opportunity to confirm with the client as to whether there are any material changes in the client's circumstances.

COMPLIANCE WITH THE SUITABILITY ASSESSMENT REQUIREMENTS

Pursuant to IIROC Dealer Member Rules, orders need to be assessed to ensure that they are suitable for the particular client; all recommendations must be suitable for the client. Suitability of orders and recommendations need to be considered based on factors including the client's current financial situation, investment knowledge, investment objectives and time horizon, risk tolerance and the account's current investment portfolio composition and risk level. Dealer Members are reminded that the factors set out in Dealer Member Rules 1300.1(p) and (q) are not exhaustive. The issue of whether the requisite suitability analysis should consider other investments in a client's *account* or *accounts* is discussed later in this Guidance Note. The regulatory obligation to ensure that orders and recommendations are suitable includes not only an obligation to ensure that the specific investment product is suitable for the client but also that the order type, trading strategy and method of financing the trade recommended and/or adopted are also suitable for the client. As an example, the risk profile of a client who fully pays for a position in a specific security as a core long term holding is significantly different from the risk profile of a client buying the same security on margin, as part of a day trading strategy.

Dealer Members are also reminded that 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 appropriate for the client given the client's particular circumstances.

Furthermore, Dealer Members and Registered Representatives need to understand the risks and other characteristics associated with the investment products they approve or recommend for sale.

Product suitability

The suitability assessment obligations include a requirement to know and understand the characteristics and risks associated with any investment 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.

Furthermore, pursuant to section 3.4 of NI 31-103 and its Companion Policy, understanding the structures, features and risks of each security recommended to a client (known as know-your-product ("KYP")) is a proficiency requirement. This requirement is imposed in addition to the suitability obligation and is applicable even where there is an exemption from the suitability obligations.

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

IIROC Notice 12-0109 – Rules Notice – Guidance Note – Dealer Member Rules – Know your client and suitability



Members should consider when assessing and introducing products that they approve or recommend for sale. As explained in that Guidance Note, adequate procedures for reviewing products before they are offered to clients can greatly enhance the ability to detect unsuitable recommendations.

Account suitability vs. multiple account suitability

Consistent with the collection of “know your client” information for multiple accounts, a single set of “know your client” information may be used, for suitability assessment purposes, for multiple accounts held by the same client. Suitability may be assessed for multiple accounts held by the same client provided that:

- the beneficial owner is the identical individual or legal entity for all of the accounts;
- the client’s investment objectives, time horizon and risk tolerance are identical for all of the accounts;
- the Dealer Member has the ability to supervise accounts, including the review of “know your client” information updates and orders for suitability purposes, on a multiple-account basis; and
- the client understands and acknowledges that the information collected in this single set of “know your client” information will be used to assess suitability on a multiple-account basis.

To clarify, the question of whether suitability must be assessed on either a single account or multiple-account basis will depend on: (i) whether the client has identical objectives, time horizon and risk tolerance for all of those accounts; (ii) the client’s agreement or understanding with the Dealer Member in that regard; and (iii) the Dealer Member’s ability to supervise on a multiple-account basis. Once that has been decided, the basis upon which suitability will be assessed should be evidenced on the client’s account application and applied consistently throughout the relationship. This would also mean that once a Dealer Member sets up the account on a certain basis (for example that suitability of orders and recommendations will be assessed on a multiple-account basis) the Dealer Member and Registered Representative cannot assess suitability on a different basis from time to time (for example on a single account basis).

Unsuitable investments

An unsuitable investment and/or recommendation is one that is inconsistent with the client’s personal circumstances including current financial situation, investment knowledge, investment objectives and time horizon, risk tolerance and the current investment portfolio composition and risk level of the other investments within the client’s account or accounts at the time of the investment and/or recommendation.

Dealer Members and Registered Representatives have a general suitability requirement with respect to orders they accept or trades they recommend. Dealer Members and Registered Representatives also have a statutory obligation to deal with clients fairly, honestly and in good faith. As a result, whenever an unsuitable investment is identified within an account, either at the time of the investment is recommended or the investment order is accepted or subsequent to that time, there



is an obligation 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 IROC Dealer Member Rule 2500, or when conducting a periodic suitability review. 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 obligation 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, for instance there may have been 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. In any event, Registered Representatives are encouraged to contact the client in order to discuss their concerns and to document any actions that they take in response to the issue. Registered Representatives should consult their Supervisor or Compliance Department personnel regarding the Dealer Member's 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, time horizon 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 client must, at a minimum, be advised against proceeding with the 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. In any event, Registered Representatives are encouraged to document any actions that they have taken. If the Registered Representative is unsure of how to deal effectively with an unsuitable order, they should consult their Supervisor or Compliance Department personnel in order to understand the Dealer Member's internal procedures for dealing with this issue.

Inappropriate updates

When a potentially unsuitable investment is identified within a client's account or a potentially



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 "know your client" information.

Registered Representatives should note that it is inappropriate to update or alter the client's "know your client" information in an effort to justify the suitability of an investment, order or recommendation that is otherwise unsuitable for the client.

To clarify, the Registered Representative should remind the client of the "know your client" information previously collected and update that information only if there is a material change in the client's circumstances. The Registered Representative should not be soliciting the client's consent to change their "know your client" information if the purpose of the change is solely to create the appearance of a suitable order.

New triggering events requirements

Recent amendments to Dealer Member Rule 1300.1 require that a suitability analysis also be performed whenever one or more of the following triggering events occur:

- Securities are received into the client's account by way of deposit or transfer;
- There is a change in the Registered Representative or Portfolio Manager responsible for the account; or
- There is a material change in to the client's life circumstances or objectives that has resulted in revisions to the client's "know your client" information as maintained by the Dealer Member;

The principles set out in this Guidance Note apply to the suitability assessment that must be performed when one or more of the above noted triggering events occur.

Best practices for maintaining a suitable client account

It is advantageous to clients, Dealer Members and the industry as a whole, as well as consistent with good business practices, that Registered Representatives and Dealer Members conduct more holistic suitability reviews.

In other words, Dealer Members are encouraged to adopt best practices which would not only allow them to comply with the current order / recommendation-triggered suitability assessment requirements set out in IIROC Dealer Member Rule 1300.1, but also assist in the ongoing maintenance of a suitable client portfolio. The best practices would include considering:

- Adopting policies and procedures requiring, when appropriate, periodic suitability reviews of client accounts;
- Conducting suitability reviews of accounts that may be affected by significant market events; and
- Conducting suitability reviews of accounts holding securities of an issuer that has undergone a material change in its risk profile.