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For distribution to relevant parties within your firm

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By-Laws, Regulations and Policies

Policy No. 2 Minimum Standards for Retail Account Supervision

The Board of Directors of the Association has approved the attached amendments to Policy No. 2, to be effective immediately.

In 1997 the Joint Industry Compliance Group[1] struck a Sub-Committee to review Policy No. 2 Minimum Standards for Retail Account Supervision ("the Policy") in order to revise and update the Policy.

The Sub-Committee concluded that there was a lack of clarity and a common understanding of the purpose and extent of a daily or monthly account review. It also found that in many cases the current standards resulted in large numbers of accounts requiring review, such that supervisory resources were strained and the thoroughness of reviews was questionable.

Consequently, the minimum commission amount for branch office monthly reviews has been increased from $1,000 to $1,500 and the head office reviews from $2,500 to $3,000.

Another amendment also addresses accounts which pay set fees rather than commissions. Members offering such accounts are required to develop a procedure to determine which of these accounts require monthly review.

The most significant change is the inclusion of a mechanism for allowing a Member firm to apply for SRO approval for another form of account supervision. Commission levels alone are a poor basis for determining whether an account requires review. Their sole advantage is that they are readily available as a basis for selecting accounts and relate to the level of activity in an account.

[1] The Joint Industry Compliance Group was renamed the Compliance and Legal Section in January of 2001.

However, other calculations or methods, may be more appropriate by focussing supervisory attention on a small number of high-risk accounts. For example, use of a commission to equity ratio would eliminate high value accounts for which the current commission level represents a miniscule consideration. Some firms are also developing methods of classifying securities so as to enable them to compare automatically clients' holdings against their recorded investment objectives.

The proposed changes also clarify that the review is intended to be a preliminary screening to identify situations that require further investigation. It is not intended that the trading in every account meeting the review criteria be thoroughly analyzed, because in many cases it is immediately apparent that there is no basis for concern about the trading activity.

A copy of the amendment is attached.

Kenneth A. Nason
Association Secretary

POLICY NO. 2

MINIMUM STANDARDS FOR RETAIL ACCOUNT SUPERVISION

Introduction

This Policy establishes minimum industry standards for retail account supervision. These standards were developed by the Joint Industry Compliance Group (now the Compliance and Legal Section).

These standards represent the minimum requirements necessary to ensure that a Member has in place procedures to properly supervise retail account activity. The Policy does not:

(a) relieve Members from complying with specific SRO by-laws, rules, regulations and policies and securities legislation applicable to particular trades or accounts; or

(b) preclude Members from establishing a higher standard of supervision and in certain situations a higher standard may be necessary to ensure proper supervision.

Many of the standards in this Policy are taken from existing By-laws, Regulations and Policies of the Association and of other self-regulatory organizations. Securities legislation was generally not canvassed. To ensure that a Member has met all applicable standards, Members are required to know and comply with Association and other self-regulatory organization by-laws, rules, regulations and policies and applicable securities legislation which may apply in any given circumstance.

The following principles have been used to develop these minimum standards:

1. The term "review" in this Policy has been used to mean a preliminary screening to detect items for further investigation or an examination of unusual trading activity or both. It does not mean that every trade meeting the selection process of this Policy must be investigated. The reviewer must use reasonable judgement in selecting the items for further investigation.

2. It has been assumed that Members have or will provide the necessary resources and qualified supervisors to meet these standards.

3. The compliance with the know-your-client rule and suitability of investment requirements is primarily the responsibility of the registered representative. The supervisory standards in this Policy relating to know-your-client and suitability are intended to provide supervisors with a check-list against which to monitor the handling of these responsibilities by the registered representative.

A Member shall, for accounts where no commission is generated for trades placed by a client (such as a fee-based account where no commission is charged), develop supervisory policies for the review of such accounts at the branch and head office in lieu of the commission levels specified herein.

A Member may, with the written approval of its SRO, establish policies and procedures to carry out the supervision of client accounts pursuant to this Policy using criteria set out in, and by the persons designated by, such policies and procedures. Such policies and procedures may differ from this Policy in establishing the criteria used in selecting accounts for review and in the allocation of supervisory duties between Head Office and the Branch provided that, in the opinion of the SRO, the Member's policies and procedures are appropriate to supervise trading of its clients.

I. ESTABLISHING AND MAINTAINING PROCEDURES, DELEGATION AND EDUCATION

Introduction

Effective self-regulation begins with the Member establishing and maintaining a supervisory environment which both fosters the business objectives of the Member and maintains the self-regulatory process. To that end a Member must establish and maintain procedures which are supervised by qualified individuals. A major aspect of self-regulation is the ongoing education of staff in all areas of sales compliance.

Establishing Procedures

1. Members must appoint designated principals who have the necessary knowledge of industry regulations and Member policy to properly perform the duties.

2. Written policies must be established to document supervision requirements.

3. Written instructions must be supplied to all supervisors and alternates to advise them on what is expected of them.

4. All policies established or amended should have senior management approval.

Maintaining Procedures

5. Evidence of supervisory reviews must be maintained. Evidence of the review, such as inquiries made, replies received, actions taken, date of completion etc. must be maintained for seven years and on-site for 1 year.

6. An on-going review of sales compliance procedures and practices must be undertaken both at head office and at branch offices.

7. Closer supervision of trading by approved persons who have had a history of questionable conduct must be carried out both in the Branch and at Head Office.

Delegation

8. Tasks and procedures may be delegated but not responsibility.

9. The Member must advise supervisors of those specific functions that cannot be delegated. However, the accepting of discretionary accounts and the approval of new accounts may be delegated to qualified individuals.

10. The supervisor delegating the task must ensure that these tasks are being performed adequately and that exceptions are brought to his/her attention.

11. Those to whom tasks are delegated must have the qualifications to perform them and should be advised in writing what is expected.

<u>Education</u>

12. The Member's current sales practices and policies must be made available to all sales and supervisory personnel. Members should obtain and record acknowledgements from all sales and supervisory personnel that they have received, read and understood the policies and procedures relevant to their responsibilities.

13. Introductory and continuing education should be provided for all approved persons.

14. Information contained in compliance-related bulletins from the Association and other SROs and Regulatory Organizations must be communicated to all sales and other approved persons. Procedures relating to the method and timing of distribution of compliance-related bulletins must be clearly detailed in the Member's written procedures.

II. OPENING NEW ACCOUNTS

Introduction

To comply with the "Know-Your-Client" rule each Member must establish procedures to maintain accurate and complete information on each client. The first step towards compliance with this rule is completing proper documentation when opening new accounts. Accurate completion of the documentation when opening a new account allows both the registered representative and the supervisory staff to conduct the necessary review to ensure that recommendations made for any account are appropriate for the client and in keeping with his investment objectives. Maintaining accurate and current documentation will allow the registered representative and the supervisory staff to ensure that all recommendations made for any account are appropriate for the client and in keeping with the client's investment objectives.

A. Documentation

1. A New Account Application Form (NAAF) must be completed for each new account. Such forms shall be duly completed to conform with the "Know-Your-Client" rule.

2. The new account must be approved by the branch manager or the designated director, partner or officer, in writing prior to the initial trade or promptly thereafter (next day). A NAAF must not be approved by the branch manager or the designated director, partner or officer until it is complete. ‘Complete’ means that all information necessary to assess suitability and creditworthiness has been obtained (and does not mean that the client must have signed the NAAF if the Member requires that the client sign the NAAF). Alternate procedures for securing interim approval will be acceptable to prevent undue delays provided the branch manager applies prompt final approval following the initial trade.

3. Where the client is an employee of another dealer, written approval by the employer to open an account must be obtained prior to the opening of such an account. Such accounts must be designated as non-client accounts.

4. A complete set of documentation must be maintained by the Member and registered representatives must maintain a copy of the NAAF.

5. The registered representative must update the NAAF where there is a material change in client information. Such update must be approved in the manner provided in paragraph (2).

6. When there is a change of registered representative, the new registered representative must verify the information on the NAAF to ensure it is current. There should be a signed acknowledgment by the new RR and branch manager that the NAAF has been reviewed. It is acceptable to make a photocopy of the old NAAF (provided that the NAAF was approved within two years of the review) and have the registered representative and branch manager initial any changes.

7. Account numbers must not be assigned unless they are accompanied by the proper name and address of the client and such name and address must be supported by the NAAF no later than the following day.

B. <u>Pending Documents</u>

1. Members must have procedures in place to ensure supporting documents are received within a reasonable period of time of opening the account.

2. Incomplete NAAFs and documentation not received must be noted, filed in a pending documentation file and be reviewed on a periodic basis.

3. Failure to obtain required documentation within 25 clearing days must result in positive actions being taken. The nature of the positive action must be specified in the Member's written procedures.

C. <u>Client Master Files</u>

1. Entering and amending client master files must be controlled and accompanied by proper documentation.

2. All hold mail must be authorized by the client in writing and be controlled, reviewed on a regular basis and maintained by the responsible supervisor.

3. Returned mail is to be properly investigated and controlled by a person who is independent of the sales function although such person may be located within a branch.

4. For supervisory purposes, "non-client" accounts, RRSP accounts, managed accounts, discretionary accounts and restricted accounts must be readily identifiable.

III. BRANCH OFFICE ACCOUNT SUPERVISION

Introduction

Each branch manager must undertake certain activities within the branch for purposes of assessing compliance with regulatory requirements and the Member's policies. These activities should be designed to identify failures to adhere to required policy and procedure and provide a means of revealing and addressing undesirable account activity.

A. Daily Reviews

1. The branch manager (or designate) must review the previous day's trading using any convenient means. This review is undertaken to attempt to detect the following:

   - lack of suitability;
   - undue concentration of securities;
   - excessive trade activity;
   - trading in restricted securities;
   - conflict of interest between registered representative and client trading activity;
   - excessive trade transfers, trade cancellations etc. indicating possible unauthorized trading;
   - inappropriate / high risk trading strategies;
   - quality downgrading of client holdings;
   - excessive / improper crosses of securities between clients;
   - improper employee trading;
   - front running;
   - account number changes;
   - late payment;
   - outstanding margin calls;
   - violation of any internal trading restrictions.

2. In addition to transactional activity, branch managers must also keep themselves informed as to other client related matters such as:

   - client complaints;
   - cash account violations;
   - undisclosed short sales;
   - transfers of funds and securities between unrelated accounts or between pro and client accounts or deposits from pro to client accounts
   - trading under margin.

B. Monthly Reviews

1. Client and branch personnel monthly statements must be reviewed on a monthly basis and should encompass areas of concern as discussed in the daily activity review.

   It is recognized that it may not be possible to review each statement produced. However, branch managers must review all monthly statements which produce gross commissions of $1,500 or more for the month.

2. All non-client accounts generating a statement must be reviewed on a monthly basis.

3. This review should be completed within 21 days of the period covered by the statement unless precluded by unusual circumstances.

IV. HEAD OFFICE ACCOUNT SUPERVISION

Introduction

A two-tier structure is required to adequately supervise client account activity. While the head office or regional area level of supervision by its nature cannot be in the same depth as branch level supervision, it should cover all the same elements.

A. Daily Reviews

1. The criteria to be used to conduct daily head office reviews are the following:

   - stock trades with a value over $5,000 and a price under $5.00 per share;
   - stock trades with value over $20,000 and a price at or over $5.00 per share;
   - bond trades over $100,000 value per trade;
   - non-client trading;
   - client accounts of producing branch managers;
   - all client accounts not reviewed by a branch manager;
   - trade cancellations;
   - trading in restricted accounts;
   - trading in suspense accounts;
   - account number changes;
   - late payment;
   - outstanding margin calls.

2. Daily reviews should be completed within a day unless precluded by unusual circumstances.

B. Monthly Reviews

1. The criteria to be used to conduct monthly head office reviews are, among other things, the following:

   - clients' statements which generated more than $3,000 commission during the month;
   - where a branch manager is unable to conduct a review, all client and non-client accounts not reviewed by such branch manager which generated more than $1,500 commission during the month. This includes the accounts of producing branch managers.

2. Concentration of securities must be reviewed.

3. For all reviews evidence should be kept of inquiries, responses and actions.

4. Monthly reviews should be completed within 21 days of the period covered by the statement unless precluded by unusual circumstances.

V. OPTION ACCOUNT SUPERVISION

Introduction

Each Member dealing in options or Exchange traded commodity or index warrants must have an approved designated registered options principal (DROP) with overall responsibility for the opening of new option accounts and the supervision of account activity to ensure that all recommendations made for any account are and continue to be appropriate for the client and in keeping with his/her investment objectives. In addition, there should be an alternate registered options principal (AROP) to assist in supervisory activities and to carry out the functions of the DROP in his/her absence. All supervisory reviews must be conducted by options qualified personnel. Any branch trading in options must have a branch manager who is options qualified.

A. Account Opening and Approval

1. The option trading agreement and option account approval form must be completed, signed and on hand prior to the first trade. This applies to new accounts or existing accounts approved for other products.

2. The option trading agreement contents must meet or exceed Association requirements.

3. All accounts must be approved in writing by the option qualified branch manager or the DROP or the AROP.

4. The option account approval form must indicate any trading restrictions imposed.

B. Daily Reviews

1. Branch offices must review all option daily trading activity for suitability, exercise limits, concentration, commission activity, and exposure of uncovered positions.

2. Head office must review on a daily basis all opening option trading activity in excess of ten contracts in any one account. In all options accounts, Head Office must monitor all trading to ensure that positions or exercise limits are not exceeded.

C. Monthly Reviews

1. Branch offices must review on a monthly basis all option activity based on the same criteria as for regular equity trading activity.

2. Head office must review on a monthly basis all option activity based on the same criteria as for regular equity trading activity.

D. <u>DROP Responsibilities</u>

1. All discretionary and managed accounts must be reviewed by the DROP on a daily and monthly basis.

2. The DROP must establish procedures to ensure clients are notified of impending expiry dates.

3. The DROP must establish procedures ensuring the dissemination of new developments in the trading and regulation of options contracts in a prudent and appropriate manner; and the dissemination to all clients of any changes in a firm's business policy.

4. The DROP must ensure that only registered individuals engage in trading or advising in respect of options.

5. All advertising and market letters to more than 10 clients relating to options, must be approved by the DROP.

6. Solicitation of clients to use option programmes must have DROP approval.

VI. FUTURES/FUTURES OPTIONS ACCOUNT SUPERVISION

Introduction

Each Member dealing in futures must have an approved designated registered futures principal (DRFP) with overall responsibility for the opening of new futures accounts and the supervision of account activity. In addition, there should be an alternate registered futures principal (ARFP) to assist in supervisory activities and to carry out the functions of the DRFP in his/her absence. The DRFP must ensure that only registered individuals engage in trading or advising in respect to futures and that all recommendations made for any account are and continue to be appropriate for the client and in keeping with his/her investment objectives. These minimum standards also apply to futures contract options and the designated registered futures options principal (DRFOP).

A. Account Opening and Approval

1. All accounts must be approved by a branch manager qualified as a futures contract supervisor, DRFP or ARFP prior to trading.

2. All clients must acknowledge in writing receipt of the information statement and summary disclosure statement prior to trading.

3. All clients must sign a futures contract trading agreement or letter of undertaking prior to trading.

4. Before granting approval to a client as a hedger procedures must be present for establishing acceptability of a client as a hedger including use of hedge letter or statement and verification procedures.

5. Any trading restrictions which apply to the account must be written on the new client account form.

B. Supervision

1. Daily Reviews

Members must conduct daily reviews of all futures and futures options trading activity. This review is undertaken to attempt to detect the following:

- excessive day trading resulting in trading large numbers of contracts;
- trading while under margin;
- trading futures options without approval;
- trading beyond margin or credit limits;
- cumulative losses exceeding stated risk capital (the aggregate of cumulative profits and cumulative losses);
- suitability;
- inappropriate trading strategies;

- position and exercise limits;
- front running;
- conflicts of interest;
- excessive commission activity;
- all guaranteed accounts.

2. Monthly Reviews

Members must conduct monthly reviews for futures and futures options trading activity. For example, a Member must review for:

- speculative trading in hedge accounts;
- cumulative losses exceeding stated risk capital (the aggregate of cumulative profits and cumulative losses);
- trading beyond approved limits;
- continual awareness of pending delivery months;
- acceptability of a client as hedger;
- all guaranteed accounts.

C. Discretionary Accounts

1. Futures discretionary accounts must meet all the requirements for equity discretionary accounts. In addition to the requirements for equity discretionary accounts a DRFP must conduct the following additional activities for futures and futures options.

2. Discretionary authority must be accepted in writing by DRFP.

3. DRFP must review monthly financial performance of each account.

VII. DISCRETIONARY AND MANAGED ACCOUNT SUPERVISION

Introduction

Simple discretionary accounts are accounts where the discretionary authority has not been solicited.

Managed accounts are investment portfolios solicited for discretionary management on a continuing basis where the Member has held itself out as having special skills or abilities in the management of investment portfolios.

The Member must consent to accepting discretionary accounts and have the proper documentation and supervisory procedures in place to handle such accounts. A policy under which discretionary accounts are handled must be developed by the Member and distributed to all approved persons.

A. Simple Discretionary Accounts

1. Request for discretion must be approved in writing by a partner, director or officer (note: officer approval allowed only for IDA and CDNX Members) appointed as the designated person.

2. A discretionary account agreement must be signed by the client and the Member and must include any restrictions to the trading authorizations which must be agreed to by the partner, director or officer.

3. No approved person may exercise discretionary authority over a client unless the account is maintained with the employer of the approved person.

B. Entry of Orders

1. All orders for discretionary accounts handled by registered representatives must be approved by a partner, director, branch manager or officer (if the officer is a designated person) prior to the order being entered.

2. If securities of the Member, or that of its affiliates, are publicly traded no discretionary account may hold those securities.

C. Account Supervision

1. Discretionary client account reviews must include all discretionary accounts handled by registered representatives, branch managers, partners, directors and officers.

2. Persons conducting reviews must have adequate "Know-Your-Client" information readily available for each discretionary account.

3. The Member must identify in its books and records discretionary accounts to ensure that proper supervision can occur.

4. Orders initiated for client accounts by producing branch managers and partners, directors and officers must be reviewed no later than next day by head office.

D. Termination of Agreement

Either the client or the Member may cancel the authorization for discretion provided that it is in writing, giving an effective date which allows the client to make other arrangements. The Member must give the client 30 days notice.

E. Managed Accounts

1. The Member must be approved by the Association to handle managed accounts and comply with all the requirements which are specifically detailed in the by-laws, regulations, rulings and policies of the Association. Only qualified portfolio managers may handle managed accounts.

2. The client must sign a managed account agreement.

3. Member must accept managed accounts in writing signed by a designated partner, director or officer. The authorization must indicate the client's investment objectives.

4. Member must designate in writing one of the partners, directors or officers to assume supervisory responsibility for each managed account and the client must be informed in writing of the identity of that individual or any subsequent changes thereto.

5. In a managed account the Member cannot without the written consent of the client:

    - Invest in an issuer in which the responsible person is an officer or director. No such investment may be made unless such office or directorship has been disclosed to the client;

    - Invest in a security which is being bought or sold from a responsible person's account to a managed account;

    - Make a loan to a responsible person or to an associate.

6. The Member must receive and acknowledge in writing cancellation by the client. The Member may terminate the arrangement in writing provided that it is not earlier than 30 days from the time of mailing.

VIII. CLIENT COMPLAINTS

A. Each Member must establish procedures to deal effectively with client complaints.

1. The Member must acknowledge all written client complaints.

2. The Member must convey the results of its investigation of a client complaint to the client in due course.

3. Client complaints involving the sales practices of a Member, its partners, directors, officers or employees must be in writing and signed by the client and then handled by sales supervisors or compliance staff. Copies of all such written submissions must be filed with the compliance department of the Member.

4. Each Member must ensure that registered representatives and their supervisors are made aware of all complaints filed by their clients.

B. All pending legal actions must be made known to head office.

C. Each Member must put procedures in place so that senior management is made aware of complaints of serious misconduct and of all legal actions.

D. Each Member must maintain an orderly record of complaints together with follow-up documentation for regular internal/external compliance reviews. This record must cover the past two years at least.

E. Each Member must establish procedures to ensure that breaches of the by-laws, regulations, rules and policies of the SROs as well as applicable securities legislation are subjected to appropriate internal disciplinary procedures.

F. When a Member finds complaints to be a significant factor, internal procedures and practices should be reviewed, with recommendations for changes to be submitted to the appropriate management level.