Summary of Public Comments Respecting Proposed Amendments to MFDA Rule 2.2.1 ("Know-Your-Client") and Policy No. 2 *Minimum Standards for Account Supervision* and Responses of the MFDA

On July 8, 2011, the British Columbia Securities Commission published proposed amendments to MFDA Rule 2.2.1 ("Know-Your-Client") and Policy No. 2 *Minimum Standards for Account Supervision* (the "**Proposed Amendments**") for a 90-day public comment period.

The public comment period expired on October 6, 2011.

Eight submissions were received during the public comment period:

1. Kenmar Associates ("Kenmar")
2. J.C. Hood Investment Counsel Inc. ("J.C. Hood")
3. Royal Mutual Funds Inc. ("RMFI")/Phillips, Hager & North Investment Funds Ltd. ("PH&N")
4. The Investment Funds Institute of Canada ("IFIC")
5. BMO Investments Inc. ("BMOII")
6. Desjardins Group ("Desjardins")
7. Canadian Foundation for Advancement of Investor Rights ("FAIR")
8. Joe Killoran

A copy of the comment submission may be viewed on the MFDA website at: http://www.mfda.ca/regulation/comments.html#221.

The following is a summary of the comments received, together with the MFDA's responses.

General Comments

Kenmar, FAIR and Desjardins expressed general support for the intent of the Proposed Amendments. A number of commenters cited examples of unsuitable leverage practices generally or unsuitable advice/practices encountered as a result of calls received from investors.

Several commenters agreed that MFDA Policies are an effective means of ensuring consistent and objective minimum industry standards, but expressed the view that certain aspects of Policy No. 2 are overly prescriptive and would be better suited as guidance to Members. BMOII suggested that such prescriptive elements be included in the Leverage Supervision Guide as suggested practices. RMFI/PH&N and BMOII noted that Policies should be principles-based to allow Members the flexibility to implement policies and procedures that correspond to their business models and risks.

IFIC and BMOII noted that dealers have implemented robust compliance systems to supervise the use of leverage and, as a result, the Proposed Amendments should regulate the use of leverage without creating duplicative or burdensome requirements. IFIC and BMOII expressed support for the use of a risk-based approach when ensuring compliance for the use of leverage, as dealers should focus their resources on resolving higher risk issues as opposed to complying with prescriptive rules.

FAIR recommended that there should be a presumption that leverage is unsuitable for retail investors, with the onus on salespeople to prove that leverage is suitable and that clients understand the risks. FAIR was of the view that some Approved Persons and firms suggest the idea of leverage to consumers and persuade consumers to borrow money to invest by presenting a misleading picture of the risks and benefits of leverage. FAIR suggested that advisors and firms are incented to do so because of a misalignment between the interests of the financial intermediary and those of the consumer.

MFDA Response

Staff acknowledges support for the Proposed Amendments and comments citing examples of unsuitable leverage advice/practices. The Proposed Amendments, in conjunction with the revised leverage risk disclosure in MR-0074 *Leverage Risk Disclosure*, guidance in MR-0069 *Suitability Guidelines* and the Leverage Supervision Guide, have been developed to address such issues and staff is satisfied that they meet their regulatory objectives. We note that, as a result of guidance issued by the MFDA and the efforts of Members to date, compliance systems to supervise leverage generally have been implemented at Member firms.

Policy No. 2 currently sets out a general obligation for Members to have policies and procedures to assess the suitability of leverage, but does not set minimum criteria in this area. The Proposed Amendments to Policy No. 2 are intended to codify the guidance in MR-0069 for the purpose of establishing such minimum criteria. Most Members currently comply with the guidelines in MR-0069 and MFDA staff is of the view that including minimum criteria in the Policy will ensure consistent and objective minimum industry standards for assessing leverage suitability for the benefit of Members and investors. Policy No. 2 currently uses a combination of prescriptive and principles based requirements.

In the view of staff, a general presumption of leverage unsuitability across all retail clients does not take into account the requirement to consider the circumstances of each client, as required under MFDA Rules and securities legislation. As set out under Rule 2.2.1, as revised, the suitability of orders accepted or recommendations made, including leverage recommendations and transactions involving the use of borrowed funds, must be determined having regard to the essential facts relative to the client and any investments in the account.

Rule 2.2.1

Rule 2.2.1(f)(iii) – Requirement for Leverage Suitability Review on Change in Approved Person Responsible for Client Account

IFIC agreed that an Approved Person should be familiar with leveraging strategies used in accounts under their name, but questioned whether a full suitability review of the leveraged account is required in such circumstances. IFIC noted that the leveraging strategy would have been reviewed previously within the dealer and approved in accordance with the dealer's policies and procedures. The change of Approved Person would not cause a leveraging strategy that was previously reviewed and found to be suitable and compliant to become non-compliant. IFIC recommended that this requirement be removed from Rule 2.2.1 and section III (Registered Salespersons) of Policy No. 2.

BMOII supported IFIC's comments and noted that its accounts are not assigned to specific Approved Persons and clients can be served by any appropriately registered Approved Person at the Member. BMOII sought confirmation that, in such circumstances, the Proposed Amendments are not intended to require any Approved Person who handles the account to re-assess the suitability of a leverage strategy.

MFDA Response

Under current Policy No. 2, Approved Persons are already required to review the client's KYC information where they have been assigned responsibility for a client's account. This requirement follows from the obligation under Rule 2.2.1(e)(iii) for the suitability of investments within each client's account to be assessed by the new Approved Person when there has been a change in the Approved Person responsible for the client's account at the Member. Proposed Rule 2.2.1(f)(iii) will clarify that the requirement to assess suitability in such circumstances also applies to the use of leverage. If accounts are not assigned to individual Approved Persons, the requirement in proposed Rule 2.2.1(f)(iii) would not apply.

Policy No. 2

Part III – Assessing Suitability of Investments and Borrowing to Invest ("Leveraging") Strategies

Proposed Leverage Suitability Criteria too Low

FAIR expressed the view that several of the minimum criteria for leverage suitability outlined in the Proposed Amendments are too low to adequately protect investors. FAIR recommended additional protections relating to investment knowledge, risk tolerance, net worth, gross income, employment status and ability to withstand loss. FAIR also questioned the applicability of using net worth in evaluating leverage suitability, since many people have high net worth due to the value of their homes.

MFDA Response

The proposed “red flags” under subsections 1(a)-(f) are not indicators that the use of leverage, in any given situation, is suitable. Rather, they are minimum criteria that are intended to trigger further supervisory review and investigation to determine if the use of leverage in any given situation is suitable. The triggering of one or more red flags is intended to give rise to a requirement for further investigation into leverage suitability, having regard to the client’s circumstances as a whole, and does not stop or conclude such investigation. The red flags are intended to ensure that Members have an appropriate minimum supervisory structure and controls for assessing the suitability of leverage. These criteria have been developed based on issues with the assessment of leverage suitability that staff has become aware of as a result of its experience to date. Members may elect to use more stringent minimum criteria.

As noted above, staff is of the view that a general presumption or restriction respecting leverage across all retail clients does not take into account the obligation to consider the circumstances of each client, as required under MFDA Rules and securities legislation. As set out under Rule 2.2.1, as revised, the suitability of orders accepted or recommendations made, including leverage recommendations and transactions involving the use of borrowed funds, must be determined having regard to the essential facts relative to the client and any investments in the account.

Reference to Risk Tolerances/Inconsistencies between MR-0069 and IFIC Risk Classification Guidelines

Kenmar recommended that the MFDA clarify the meaning of “MEDIUM” as applied to risk in the Proposed Amendments. In addition, Kenmar noted that MR-0069 currently states that the risk ranking of a mutual fund should be determined with reference to the mutual fund’s prospectus. However, risk categories assigned and disclosed in the prospectus by some fund companies are based on the IFIC Risk Classification Guidelines, which determine the risk volatility of a fund based on standard deviation and are not intended for use in determining suitability (i.e. the appropriateness of any given mutual fund having regard to the risk tolerance of individual investors). Kenmar noted that the Canadian Securities Administrators have permitted the IFIC risk classifications to be used in the Fund Facts, a point of sale document that is, presumably, intended to reflect individual investor risk (i.e. suitability) and not risk volatility based on standard deviation. Kenmar recommended that the MFDA act quickly to resolve this conflict.

MFDA Response

Rule 2.2.5 (Relationship Disclosure) requires that, on account opening, Members provide all clients with core information about the nature of their relationship with the Member and its Approved Persons. Subsection 2.2.5(e) requires disclosure defining the various terms with respect to the KYC information collected by the Member and describing how this information will be used in assessing investments in the account.

Appendix 1 to MR-0069 (Example of KYC Information) sets out and provides explanations in respect of the various risk tolerance ranges. Where the Member is using the concept of volatility, the client should be provided with a clear explanation as to what types of investments would be suitable for their portfolio.

Investment Knowledge

FAIR recommended that, in order to use leverage to invest, retail investors should be required to meet a minimum level of investment knowledge regarding financial markets and the risks associated with leverage. FAIR suggested that this knowledge could be independently certified, or certified by dealers that are Members of the MFDA, and, therefore, are backed by a compensation fund and subject to a strict liability standard.

MFDA Response

In accordance with the requirements of Rule 2.2.1, it is the Member and Approved Person that are responsible for ensuring that each order accepted or recommendation made, including recommendations to borrow to invest, are suitable for the client. Staff is concerned that the suggestion for a minimum level of investment knowledge could, in certain circumstances, operate to shift responsibility away from the Member and Approved Person to the investor in a manner that takes away from existing levels of investor protection. Staff is of the view that the potential for such a shift in responsibility is inconsistent with the regulatory objectives of the Proposed Amendments and the current obligations of Members and Approved Persons under Rule 2.2.1, MFDA Rules generally and securities legislation.

Total and Liquid Net Worth

Subsection 1(e) requires further supervisory review and investigation where the total leverage amount exceeds 30% of the client's total net worth. Desjardins noted that MR-0069 references this requirement, adding that the investment loan should not exceed 50% of a client's *liquid net worth*. Desjardins sought clarification as to whether the MFDA still intends to use the concept of "liquid net worth" in assessing leverage suitability and, if not, this reference should be removed from MR-0069.

MFDA Response

Staff intends to make appropriate amendments to MR-0069 to ensure that it is consistent with Policy No. 2, as revised, once the Proposed Amendments have been approved.

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. Staff notes that the guidance set out in MR-0069 indicating that the investment loan should not exceed 50% of a client's liquid net worth has not been included in Policy No. 2. With respect to how liquid net worth should be used, MR-0069 will be amended to provide guidance that where the net worth red flag in

subsection 1(e) is triggered or close to being triggered, a leverage suitability assessment should take into consideration the percentage of total net worth that is liquid and the amount that a loan represents as a percentage of liquid net worth.

Ability to Withstand Loss

Kenmar and FAIR recommended that the list of factors requiring further supervisory review and investigation, as currently set out in proposed subsections 1(a)-(f), be amended to include client loss capacity/loss tolerance.

MFDA Response

The concept of client loss capacity/loss tolerance is already addressed under the discussion of "risk tolerance" in MR-0069. In clarifying how this term should be understood and determined, MR-0069 notes that Members and Approved Persons should consider risk tolerance to be the *lower of the investor's willingness to accept risk and the investor's ability to withstand declines in the value of his or her portfolio* (i.e. risk tolerance should be determined as the lesser of both criteria). As there are instances where Members and Approved Persons may be determining client risk tolerance as a result of a combination of other KYC criteria, MR-0069 clarifies that while other KYC criteria, such as income, net worth and time horizon, should be considered and discussed with clients when assisting them in understanding risk tolerance and how they factor into risk and return, *these criteria should not override the client's ultimate assessment of their actual willingness and ability to accept risk.*

Gross Income – Inconsistency between Proposed Amendments and MR-0069

Under subsection 1(f), further supervisory review and investigation is required when total debt and lease payments exceed 35% of the client's gross income. RMFI/PH&N noted that the addition of *total lease payments* is in contrast with Part 4.C(f) of MR-0069, which currently only references *debt payments*, and expressed the view that subsection 1(f) should remain consistent with the general guideline in MR-0069. If both debt and lease payments must be considered for the purposes of this subsection, RMFI/PH&N suggested that the debt to income ratio be increased, to account for the more comprehensive calculation. RMFI/PH&N also noted that clarification as to what total debt and total lease payments include should be removed from this subsection, so as to allow Members the flexibility to set their own standards based on their business models and risks.

MFDA Response

The inclusion of "lease payments" along with debt was intended to clarify that the calculation should include any ongoing, material financial obligation (e.g. mortgage, rental or lease payments), as all such payments would impact a client's borrowing ability

(i.e. the ability of the client to service the loan) and the availability of income for investment purposes.

In addition, staff notes that Members have the flexibility to use a more comprehensive cash flow analysis and adopt a higher threshold, provided that it is consistent with the regulatory objectives of this section and Policy No. 2 generally.

Leverage Suitability – Objective of Supervisory Review (Section 2)

Section 2 notes that the objective of the supervisory review is to *assess* the suitability of the leveraging strategy. IFIC and BMOII noted that a requirement to "assess" confuses the roles of the Approved Person and branch/head office supervisory staff. It was suggested that the role of the Approved Person should be to perform the suitability assessment, while the role of branch/head office supervisors should be to review and confirm the suitability assessment performed by Approved Persons. IFIC recommended that the word "assess", as used in this section and Part IV (Branch Office Supervision), "Other Reviews", be changed to "confirm" to indicate the correct role for the supervisory review. IFIC also recommended that the second sentence of section 2 be removed, as conflicts of interest should be handled through the dealer's conflict of interest policies and MFDA Rule 2.1.4.

BMOII expressed the view that Members must be given flexibility to determine when a rationale is required to be documented, with reference to the "red flags" set out in section 1. BMOII suggested that Members should be permitted to determine which red flags would warrant further inquiry into the rationale of the strategy and then should be required to document their rationale for approval only if the Member approves the strategy despite the presence of red flags selected by the Member.

MFDA Response

For the purpose of greater clarity, staff will amend this section by adopting "review" in place of "assess".

The second sentence of section 2 specifies how the supervisory review and investigation of leverage suitability must be conducted by restating general obligations under Rules 2.1.4 and 2.1.1. Such information would not be inconsistent with anything in a dealer's conflict of interest policies and staff is of the view that its inclusion in this section is necessary and appropriate in clarifying minimum regulatory standards.

The red flag criteria set out under this section represent minimum standards for further supervisory review and investigation in respect of leverage suitability that have been adopted based on staff's review of Member practices and compliance experience to date. In each case where any of the red flag criteria are triggered and a leverage strategy is approved, the analysis and rationale must be documented. The level of analysis/assessment and documentation required in any given situation will depend upon

different variables, including the number of red flag criteria triggered and the extent of variance from the specified triggering red flag(s).

Leverage Suitability – Requirement for Member to Review and Maintain Documents to Facilitate Proper Supervision (Section 4)

Desjardins noted that subsection 4(a) does not specify the frequency at which outstanding loan value information needs to be updated in the Member's books and records. Desjardins noted that such information is not available through FundServ and therefore cannot be updated on an ongoing basis.

RMFI/PH&N noted that the level of detail proposed under 4(b), which requires supervisory staff to compare the client's KYC information with all other information received in respect of the loan and follow up on any material inconsistencies, is appropriate where the Member or registered salesperson assists the client in completing the loan application, but is not suitable in all cases.

With respect to the proposed requirements of 4(c), which requires Members to review and maintain details in support of income and net worth calculations, RMFI/PH&N, BMOII and Desjardins noted that the obligation for Members to maintain client information relating to all of their existing debt/investment loan payments is too onerous to be a requirement in all instances. RMFI/PH&N and BMOII recommended that these subsections be excluded from Policy No. 2 and incorporated into the Leverage Supervision Guide as best practices. Desjardins noted that there are individuals that for privacy reasons do not wish to provide evidential information regarding income or assets held external to the dealer.

MFDA Response

Staff would expect Members and Approved Persons to make specific inquiries of clients when they become aware of any investment loan(s) or when they make a leverage recommendation to the client.

Apart from these specific situations, Members and Approved Persons should make reasonable inquiries ***of clients*** to obtain information/updates in respect of outstanding loan values whenever updates to a client's KYC information are made. There is no requirement that Members obtain this information from third parties. We understand that, as a best practice, many Members currently have arrangements with financial institutions to obtain such information.

The requirements of proposed subsection 4(b) are intended to apply to information that should already be on hand and available to the Member and Approved Person. Thus, for example, if the Approved Person did not help the client to complete loan documentation, staff would not expect the Approved Person to obtain documentation in respect of such information. However, staff would expect the Approved Person to make reasonable inquiries of the client and compare information received from such inquiries to the

client's KYC information for the purpose of assessing leverage suitability. The intent of proposed subsection 4(c) is not to require documentary evidence supporting income, net worth or investment loan payments (e.g. loan documentation, T4s, etc). Rather, the subsection is intended to require the individual data components that make up the income and net worth calculations specified under subsections 1(e) and 1(f) (e.g. value of loan payments and total net worth). The individual figures making up income and net worth must be shown separately so that it is clear how each of the income and net worth calculations was arrived at. We have amended the language of subsection 4(c) to clarify this intent.

Registered Salespersons – Suitability Triggering Events (Section 2)

Under section 2, where there is a transfer of assets into an account at the Member, a suitability assessment must be performed *no later than the time of the next trade*. IFIC noted that this requirement should include the exclusion for automatic transactions, such as PACs and SWPs and that this exclusion should be added to section 3 and Part V (Head Office Supervision), section 1 (Daily Reviews).

MFDA Response

The purpose of the suitability triggers is to ensure that the suitability of investments in each client account is assessed on the occurrence of key triggering events. With respect to the suggestion that an allowance be made for automated transactions to continue without a suitability assessment being made, there is no exception from suitability obligations under current MFDA Rules or securities legislation with respect to trades made under automatic payment plans.

In addition, staff notes that the use of leverage generally magnifies investment risk. Thus, where a transfer of assets into an account at the Member involves automated transactions using borrowed funds, all such transfers, from the perspective of a risk-based approach, should be subject to the prescribed suitability assessment.

Part IV (Branch Office Supervision) and Part V (Head Office Supervision)

Daily Reviews/Other Reviews

RMFI/PH&N, BMOII and Desjardins noted that proposed amendments to Part IV (Branch Office Supervision), Daily Reviews, (section 2) and Part V (Head Office Supervision), Daily Reviews (section 1), Other Reviews (section 1) apply to accounts *other than registered retirement savings plans or registered education savings plans* and sought clarification as to whether the intent of these amendments is to also exclude registered retirement income funds and registered disability savings plans and include tax-free savings accounts. If so, RMFI/PH&N suggested certain drafting revisions.

FAIR recommended that branch or head office review be required for leveraged trades and leverage recommendations relating to RRSPs and RESPs.

MFDA Response

The review requirements of this section apply to leveraged trades/leverage recommendations for all accounts, with specific exclusions for RRSPs and RESPs as, in the experience of MFDA staff, borrowing to invest in these registered products is not subject to the same risks or abuse.

Borrowing to invest in RRSPs or RESPs is, as a general matter, a limited, short-term strategy. People do not keep borrowing to invest in such plans, as their investment is capped at their contribution limit. In addition, in the case of RRSPs, risk is further mitigated by the availability of a tax refund to pay down the investment loan. Conversely, borrowing to invest in an open account is, as a general matter, a less limited and longer-term strategy. Interest on borrowed funds is deductible, an investor may continue to borrow so long as they make their interest payments and the ability to continue to invest is not capped by contribution limits. Where staff has observed leverage strategies involving RRIFs, such strategies have been used for the purpose of investment in an open account and we note that this is already addressed under the Policy.

In circumstances where a client is using a small investment loan (to top up a tax-free savings account for example), a Member would consider the client's KYC information on file. Based on this review, if the minimum criteria set out in Policy 2 for supervisory review of leverage is unlikely to be triggered, a full assessment of the leverage strategy may not be necessary.

Other Recommendations/Suggestions

FAIR indicated that marketing materials should not be permitted to play down the associated risks of leverage and recommended a requirement for full disclosure to the client of commissions and other remuneration that would be paid to the Approved Person as a result of the use of leverage by the client.

FAIR also recommended the adoption of a Clients First Model that would require that all client recommendations be in the best interests of the investor, rather than requiring only suitability.

FAIR proposed that MR-0074 (long form leverage risk disclosure) be amended (with corresponding amendments to MFDA Rule 2.6) to include a certification (and client acknowledgement) requirement that would oblige Approved Persons to certify, at the time of a leverage recommendation, that they have explained the risks associated with leverage to the client and their belief that the client understands the associated risks.

MFDA Response

MFDA Rule 2.7.2 (Advertising and Sales Communications – General Restrictions), notes, in addition to other restrictions, that Members may not issue to the public,

participate in or knowingly allow their name to be used in respect of any advertisement or sales communication in connection with their business that: contains any untrue statement, or omission of a material fact, or is otherwise false or misleading; fails to fairly present the potential risks to the client; or does not comply with any applicable legislation or the guidelines, policies or directives of any regulatory authority having jurisdiction over the Member. We note that there are similar requirements under securities legislation. In addition, guidance in respect of this issue has been provided under MR-0070 *Misleading Communications Regarding Leverage*, issued in 2008, and the Leverage Supervision Guide, issued in 2010.

The recommendation regarding adoption of a Clients First Model is beyond the scope of the Proposed Amendments. We note that an initiative addressing this matter is currently under consideration by the securities regulatory authorities.

With respect to recommended amendments to MR-0074, as noted above, it is the Member and Approved Person that are responsible for ensuring that each order accepted or recommendation made, including recommendations to borrow to invest, are suitable for the client. Staff is concerned that the suggestion for a certification and client acknowledgement requirement could, in certain circumstances, operate to shift responsibility away from the Member and Approved Person to the investor in a manner that takes away from existing levels of investor protection. Staff is of the view that the potential for such a shift in responsibility is inconsistent with the regulatory objectives of the Proposed Amendments and the current obligations of Members and Approved Persons under Rule 2.2.1, MFDA Rules generally and securities legislation.

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