

MUTUAL FUND DEALERS ASSOCIATION OF CANADA

MFDA POLICY NO. 2

MINIMUM STANDARDS FOR ACCOUNT SUPERVISION

**Version Showing Amendments from the Version Published for Comment
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Introduction

This Policy establishes minimum industry standards for account supervision. These standards represent the minimum requirements necessary to ensure that a Member has procedures in place to properly supervise account activity. This Policy does not:

- (a) relieve Members from complying with specific MFDA By-laws, Rules 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.

To ensure that a Member has met all applicable standards, Members are required to know and comply with MFDA By-laws, Rules and Policies as well as applicable securities legislation which may apply in any given circumstance. The following principles have been used to develop these minimum standards:

- (a) The term "review" in this Policy has been used to mean a preliminary screening designed to detect items for further investigation or an examination of unusual trading activity or both. It does not mean that every trade must be reviewed. The reviewer must use reasonable judgement in selecting the items for further investigation.
- (b) It has been assumed that Members have or will provide the necessary resources and qualified supervisors to meet these standards.
- (c) The initial compliance with the know-your-client ("KYC") rule and suitability of investment requirements is primarily the responsibility of the registered salesperson. The supervisory standards in this Policy relating to KYC and suitability are intended to provide supervisors with a checklist against which to monitor the handling of these responsibilities by the registered salesperson.

Members that seek to adopt policies and procedures relating to branch and head office supervision or the allocation of supervisory activities that differ from those contained in this Policy must demonstrate that all of the principles and objectives of the minimum standards set out in this Policy have been properly satisfied. Further, any such alternative policies and procedures must adequately address the risk management issues of the Member and must be

pre-approved by MFDA staff before implementation.

Supervisory staff has a duty to ensure compliance with Member policies and procedures and MFDA regulatory requirements, which includes the general duty to effectively supervise and to ensure that appropriate action is taken when a concern is identified. Such action would depend on the circumstances of each case and may include following up with the registered salesperson and/or the client. Supervisory staff must also maintain records of the issues identified, action taken and resolution achieved.

I. ESTABLISHING AND MAINTAINING PROCEDURES

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 individuals who have the necessary knowledge of industry regulations and Member policies 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

1. Evidence of supervisory reviews must be maintained. Evidence of the review, such as inquiries made, replies received, date of completion etc. must be maintained for seven years and on-site for one year.
2. An on-going review of sales compliance procedures and practices must be undertaken both at head office and at branch offices.

Delegation of Procedures

1. Tasks and procedures may be delegated to a knowledgeable and qualified individual but not responsibility.
2. The Member must advise supervisors of those specific functions which cannot be delegated, such as approval of new accounts.

3. The supervisor delegating the task must ensure that these tasks are being performed adequately and that exceptions are brought to his/her attention.
4. Those who are delegated tasks must have the qualifications and required proficiency to perform the tasks and should be advised in writing of their duties. The general expectation is that tasks be delegated only to individuals with the same proficiency as the delegating supervisor. In certain limited circumstances, it may be acceptable to delegate specialized tasks to an individual that has not satisfied the proficiency requirements provided that the individual has equivalent training, education or experience related to the function being performed. The Member must consider the responsibilities and functions to be performed in relation to the delegated tasks and make a determination as to appropriate equivalent qualifications and proficiency. The Member must be able to demonstrate to MFDA staff that the equivalency standard has been met. Tasks related to trade supervision can only be delegated to individuals that possess the proficiency of a branch manager or compliance officer.

Education

1. The Member's current policies and procedures manual must be made available to all sales and supervisory staff.
2. Introductory training and continuing education should be provided for all registered salespersons. For training and enhanced supervisory requirements for newly registered salespersons, please refer to the MFDA Policy No. 1 entitled "New Registrant Training and Supervision Policy."
3. Relevant information contained in compliance-related MFDA Member Regulation Notices and Bulletins and compliance-related notices from other applicable regulatory bodies must be communicated to registered salespersons and employees. Procedures relating to the method and timing of distribution of compliance-related information must be clearly detailed in the Member's written procedures. Members should ensure that they maintain evidence of compliance with such procedures.

II. OPENING NEW ACCOUNTS

To comply with the KYC and suitability requirements set out in MFDA Rule 2, 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 salesperson and the supervisory staff to conduct the necessary reviews to ensure that recommendations made for any account are appropriate for the client and in keeping with investment objectives. Maintaining accurate and current documentation will allow the registered salesperson and the supervisory staff to ensure that all recommendations made for any account are and continue to be appropriate for a client's investment objectives.

Documentation of Client Account Information

1. A New Account Application Form (“NAAF”) must be completed for each new account.
2. A complete set of documentation relating to each client’s account must be maintained by the Member. Registered salespersons must have access to information and documentation relating to the client’s account as required to service the account. In the case of a Level 1 Introducing Dealer and corresponding Carrying Dealer, both Members must maintain a copy of each client's NAAF.
3. For each account of a client that is a natural person, the Member must obtain information sufficient to allow for the operation of the account and sufficient to determine the essential facts relative to each client, which would include, at a minimum, the following information:
 - (a) name;
 - (b) type of account;
 - (c) residential address and contact information;
 - (d) date of birth;
 - (e) employment information;
 - (f) number of dependants;
 - (g) other persons with trading authorization on the account;
 - (h) other persons with a financial interest in the account;
 - (i) investment knowledge;
 - (j) risk tolerance;
 - (k) investment objectives;
 - (l) time horizon;
 - (m) income;
 - (n) net worth;
 - (o) for non-registered leveraged accounts, details of the net worth calculation, specifying liquid assets plus any other additional assets less total liabilities;
 - (p) information required by other laws and regulations applicable to the Member’s business as amended from time to time including information required for relevant tax reporting; information required for compliance with the *Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations* and any authorization necessary to provide information to the MFDA under applicable privacy legislation.

The preceding provides a list of minimum requirements. The Member may require clients to provide any additional information that it considers relevant. In the case of

accounts jointly owned by two or more persons, information required under subparagraphs (a), (c), (d), (e), (f) and (i) must be collected with respect to each owner. Income and net worth may be collected for each owner or on a combined basis as long as it is clear which method has been used.

4. For each account of a client that is a corporation, trust or other type of legal entity, the Member must obtain information sufficient to allow for the operation of the account and sufficient to determine the essential facts relative to the client, which would include, at a minimum, the following information:
 - (a) legal name;
 - (b) head office address and contact information;
 - (c) type of legal entity (i.e. corporation, trust, etc.);
 - (d) form and details regarding the organization of the legal entity (i.e. articles of incorporation, trust deed, or other constating documents);
 - (e) nature of business;
 - (f) persons authorized to provide instructions on the account and details of any restrictions on their authority;
 - (g) investment knowledge of the persons to provide instructions on the account;
 - (h) risk tolerance;
 - (i) investment objectives;
 - (j) time horizon;
 - (k) income;
 - (l) net worth;
 - (m) information required by other laws and regulations applicable to the Member's business as amended from time to time including information required for relevant tax reporting; information required for compliance with the *Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations* and any authorization necessary to provide information to the MFDA under applicable privacy legislation.

The preceding provides a list of minimum requirements. The Member may require clients to provide any additional information that it considers relevant.

5. For supervisory purposes, registered accounts, leveraged accounts and accounts of any registered salesperson's family member operating under a limited trading authorization or operating under a power of attorney in favour of the registered salesperson must be readily identifiable.
6. If the NAAF does not include KYC information, this must be documented on a separate KYC form(s). Such form(s) must be signed by the client and dated. A copy of the completed NAAF and KYC form, if separate from the NAAF, must be provided to the client.

7. The Member must have internal controls and policies and procedures in place with respect to the entry of KYC information on their back office systems. Such controls should provide an effective means to detect and prevent inconsistencies between the KYC information used for account supervision with that provided by the client.
8. Except as noted in the following paragraph, NAAFs must be prepared and completed for all new clients prior to the opening of new client accounts. The new account or KYC information must be approved by the individual designated as responsible for the opening of new accounts under Rule 2.2.3 no later than one business day after the initial transaction date. Records of all such approvals must be maintained in accordance with Rule 5.
9. Notwithstanding the preceding paragraph, NAAFs for clients of a registered salesperson transferring to the Member must be prepared and completed within a reasonable time (but in any event no later than the time of the first trade). The new accounts or KYC information for clients of the transferring salesperson must be approved by the individual designated as responsible for the opening of new accounts under Rule 2.2.3 no later than one business day after the date that the NAAF is completed. Records of all such approvals must be maintained in accordance with Rule 5.
10. In the event that a NAAF is not completed prior to or within a reasonable time after opening an account, as required by this Policy, the Member must have policies and procedures to restrict transactions on such accounts to liquidating trades until a fully completed NAAF is received.

Changes to KYC Information

1. The registered salesperson or Member must update the KYC information whenever they become aware of a material change in client information as defined in Rule 2.2.4(a).
2. On account opening, the Member should advise the client to promptly notify the Member of any material changes in the client information, as defined in Rule 2.2.4(a), previously provided to the Member and provide examples of the types of information that should be regularly updated.
3. In accordance with Rule 2.2.4(e), Members must also, on an annual basis, request in writing that clients notify them if there has been any material change in client information, as defined in Rule 2.2.4(a), previously provided, or if the client's circumstances have materially changed.
4. Access to amend KYC information must be controlled and instructions to make any such amendments must be properly documented.
5. A client signature, which may include an electronic signature, or other internal controls sufficient to authenticate the client's identity and verify the client's

authorization must be used to evidence any change in client name, client address or client banking information.

6. Material changes to client information, as defined in Rule 2.2.4(a), may be evidenced by a client signature, which may include an electronic signature or, alternatively, such changes may be evidenced by maintaining notes in the client file detailing the client's instructions to change the information and verified by providing written confirmation to the client with details of the instructions and providing an opportunity for the client to make corrections to any changes that have been made.
7. All material changes in client information, as defined in Rule 2.2.4(a), must be approved by the individual designated as responsible for the opening of new accounts under Rule 2.2.3 no later than one business day after the date on which notice of the change in information is received from the client. When approving material changes, branch managers should be reviewing the previous KYC information to assess whether the change appears reasonable. Branch managers should be aware of situations where material changes may have been made to justify unsuitable trades or leveraging. For example, branch managers should investigate further material changes that accompany trades in higher risk investments or leveraging or changes made within a short period of time (for example 6 months). Records of all such approvals must be maintained in accordance with Rule 5.
8. Where any material changes have been made to the information contained in the NAAF or KYC form(s), the client must promptly be provided with a document or documents specifying the current risk tolerance, investment objectives, time horizon, income and net worth that applies to the client's account.
9. The last date upon which the KYC information has been updated or confirmed by the client must be indicated in the client's file and on the Member's back office system.

Pending/Supporting Documents

1. Members must have procedures in place to ensure supporting documents are received within a reasonable period of time of opening the account.
2. Supporting documentation that is not received or is incomplete must be noted, filed in a pending documentation file and reviewed on a periodic basis.
3. Failure to obtain required documentation within 25 days of the opening of the account must result in positive actions being taken.

Client Communications

1. 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. Hold mail should

never be permitted to occur over a prolonged period of time (i.e. in excess of 6 months).

2. Returned mail is to be promptly investigated and controlled.

III. ASSESSING SUITABILITY OF INVESTMENTS AND BORROWING TO INVEST (“LEVERAGING”) STRATEGIES

General

1. Members must establish and maintain policies and procedures with respect to their suitability obligations. The policies and procedures must include guidance and criteria for registered salespersons to ensure that recommendations made and orders accepted (with the exception of unsolicited orders accepted pursuant to Rule 2.2.1(d)) are suitable for the client. The policies and procedures must also include criteria for supervisory staff at the branch and head office to review the suitability of the investments in each client’s account and the client’s use of borrowing to invest (“leverage”).
2. The criteria for selecting trades and leverage strategies for review, the inquiry and resolution process, supervisory documentation requirements and the escalation and disciplinary process must be documented and clearly communicated to all registered salespersons and all relevant employees. Registered salespersons must be advised of the criteria used in assessing suitability, actions the Member will take when a trade or leverage strategy has been flagged for review and appropriate options for resolution.

Leverage Suitability

1. ~~The suitability of leverage must be assessed having regard to the client’s investment knowledge, risk tolerance, age, time horizon, income, net worth and investment objectives.~~ The minimum criteria listed below are intended to prompt a supervisory review and investigation by the Member of a leverage strategy. While Members must consider all the criteria in assessing the suitability of the leverage strategy, the triggering of one or more of the criteria may not necessarily mean that the leverage strategy is unsuitable.

The review and investigation of leverage suitability must be conducted in a fair and objective manner having regard only to the best interest of the client in accordance with Rule 2.1.4 and the general standard of conduct required by Rule 2.1.1. Where the leverage strategy is approved, the analysis and rationale must be documented.

Minimum criteria that require ~~further~~ supervisory review and investigation include the following:

- (a) investment knowledge of low or poor (or similar categories);
- (b) risk tolerance of less than medium (or similar categories);
- (c) age of 60 and above;
- (d) time horizon of less than 5 years;
- (e) total leverage amount that exceeds 30% of the client's total net worth; and
- (f) total debt and lease payments that exceed 35% of the client's gross income, not including income generated from leveraged investments. Total debt payments would include all loans of any kind whether or not obtained for purpose of investment. Total lease payments would include all significant ongoing lease and rental payments such as automobile leases and rental payments on residential property.

~~2. The objective of the supervisory review is to assess the suitability of the leveraging strategy. The supervisory review and investigation of leverage suitability must be conducted in a fair and objective manner having regard only to the best interest of the client in accordance with Rule 2.1.4 and the general standard of conduct required by Rule 2.1.1. Where the leverage strategy is approved, the analysis and rationale must be documented.~~

32. With respect to a recommendation for a client to use a leveraging strategy, Members and registered salespersons may not obtain a waiver from the client to exempt the Member and the registered salesperson from their obligations to ensure the suitability of such a recommendation.

43. The Member must review and maintain documents to facilitate proper supervision. This would include:

- (a) Lending documents and details of lending arrangements – The Member or registered salesperson must either maintain copies of the lending documents or make sufficient inquiries to obtain details of the loan, including interest rate, terms for repayment, and the outstanding loan value. Where the Member or registered salesperson assists the client in completing the loan application, the Member must maintain copies of lending documents in the file, including copies of the loan application.

Where the client arranges their own financing, it may be difficult in some cases for the Member or registered salesperson to obtain details of the lending arrangement from the client. Where a client is unwilling to provide details of the lending arrangement, the Member and registered salesperson ~~should~~ **must** advise the client that they cannot assess the suitability of the leverage strategy without additional information and maintain evidence of such advice.

- (b) NAAF and updates to KYC information – Supervisory staff must compare the client's KYC information with all other information received in respect of the

loan and follow up on any material inconsistencies, which may require obtaining additional supporting documentation from the client.

- (c) Numerical ~~D~~ details in support of income and net worth calculations required by sections 1(e) and 1(f) ~~—This would include information on all existing debt payments, as well as the investment loan payments.~~
- (d) Trade documents, notes supporting client instructions or authorizations and notes supporting the rationale for recommending a leverage strategy to the client.

Registered Salespersons

1. All recommendations made and orders accepted by registered salespersons (with the exception of unsolicited orders accepted pursuant to Rule 2.2.1(d)) must be suitable in accordance with Rule 2.2.1(c). Where the registered salesperson recommends a leverage strategy to a client or where the registered salesperson is aware that a transaction proposed by the client involves the use of borrowed funds, the registered salesperson must ensure that the client's account is identified as "leveraged" on the Member's system in accordance with the Member's policies and procedures.
2. Registered salespersons must assess the suitability of investments in each client account whenever:
 - the client transfers to the Member or transfers assets into an account at the Member;
 - the Member or registered salesperson becomes aware of a material change in the client's KYC information; or
 - the client account has been re-assigned to the registered salesperson from another registrant at the Member.

Where there is a transfer of assets into an account at the Member or where the client account is re-assigned to the registered salesperson from another registrant at the Member, the suitability assessment must be performed within a reasonable time, but in any event no later than the time of the next trade. The determination of "reasonable time" in a particular instance will depend on the circumstances surrounding the event that gives rise to the requirement to perform the suitability assessment. For example, with respect to client transfers, the volume of accounts to be reviewed may be a relevant factor in determining reasonable time.

Where the Member or registered salesperson becomes aware of a material change in the client's KYC information, the suitability assessment must be performed no later than one business day after the date on which the notice of change in information is received from the client.

3. Registered salespersons must also assess the suitability of a leverage strategy having regard to the client's investment knowledge, risk tolerance, age, time horizon, income, net worth and investment objectives whenever:

- the client transfers assets purchased using borrowed funds into an account at the Member;
- the Member or registered salesperson becomes aware of a material change in the client’s KYC information; or
- the client account has been re-assigned to the registered salesperson from another registrant at the Member.

Where there is a transfer of assets purchased using borrowed funds into an account at the Member or where the client account is re-assigned to the registered salesperson from another registrant at the Member, the suitability assessment must be performed in a timely manner as soon as possible after the transfer in accordance with the circumstances, but in any event no later than the time of the next trade.

Where the Member or registered salesperson becomes aware of a material change in the client’s KYC information, the suitability assessment must be performed no later than one business day after the date on which the notice of change in information is received from the client.

4. Should a registered salesperson identify unsuitable investments in a client’s account or an unsuitable leverage strategy, the registered salesperson must advise the client and take appropriate steps to determine if there has been any change to client circumstances that would warrant altering the KYC information. Where there has not been a change in client circumstances, it is inappropriate to alter the KYC information in order to match the investments in the client’s account or the leverage strategy. If there is no change to the KYC information, or if investments in the account or the leverage strategy continue to be unsuitable after the KYC information has been amended, the registered salesperson should discuss any inconsistencies with the client and provide recommendations as to rebalancing investments in the account. Transactions in the account must only be made in accordance with client instructions and any recommendations made with respect to the rebalancing of the account must be properly recorded.

Where an existing leverage strategy is determined to be unsuitable, the client must be advised of his/her options.

5. Registered salespersons must maintain evidence of completion of all suitability assessments performed and any follow up action taken with respect to such assessments.

IV. BRANCH OFFICE SUPERVISION

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

account activity.

Daily Reviews

1. All new account applications and updates to client information must be reviewed and approved in accordance with this Policy.
2. The branch manager (or alternate) must review the previous day's trading for unsuitable trades, leveraging and any other unusual trading activity using any convenient means. This review must include, at a minimum, all:
 - initial trades;
 - trades in exempt securities (excluding guaranteed investment certificates);
 - ~~leveraged trades/leverage recommendations~~leveraging for accounts other than registered retirement savings plans or registered education savings plans;
 - trades in accounts of family members of registered salespersons operating under a power of attorney in favour of the registered salesperson;
 - redemptions over \$10,000;
 - trades over \$2,500 in moderate-high or high risk investments;
 - trades over \$5,000 in moderate or medium risk investments; and
 - trades over \$10,000 in all other investments.

For the purposes of this section, “trades” does not include redemptions except where specifically referenced.

3. When reviewing redemptions, branch managers should seek to identify and assess:
 - the suitability of the redemption with regard to the composition of the remaining portfolio;
 - the impact and appropriateness of any redemption charges;
 - possible outside business activity where money may be leaving the Member for reinvestment into other potentially inappropriate or unauthorized investments; and
 - potential churning, including situations where redemption proceeds are being held on a temporary basis pending reinvestment.
4. The branch manager (or alternate) is responsible for following up on unusual trades identified by head office.

Other Reviews

1. The branch manager must review-assess the suitability of investments in each client account and the suitability of the client’s use of leverage, if any, where the Member becomes aware of a material change in the client’s KYC information that results in a significant decrease in the client’s risk tolerance, time horizon, income or net worth

or more conservative investment objectives. The suitability assessment must be performed no later than one business day after the date on which notice of the change in information is received from the client.

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

V. HEAD OFFICE SUPERVISION

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 the same elements. Head office review should be focused on unusual activity or reviews that cannot be carried out at the branch level. Head office reviews must include procedures to effectively detect unsuitable investments and excessive trading in client accounts.

Daily Reviews

1. In addition to the trading review criteria for branch managers, head office must conduct daily reviews of account activity which must include, at a minimum, all:
 - redemptions over \$50,000;
 - trades over \$5,000 in exempt securities (excluding guaranteed investment certificates), moderate-high or high risk investments, or ~~leveraged trades/recommendations~~ **leveraging** for accounts other than registered retirement savings plans or registered education savings plans;
 - trades over \$10,000 in moderate or medium risk mutual funds; and
 - trades over \$50,000 in all other investments (excluding money market funds).

For the purposes of this section, “trades” does not include redemptions except where specifically referenced.

2. There must be closer supervision of trading by registered salespersons who have had a history of questionable conduct. Questionable conduct may include trading activity that frequently raises questions in account reviews, frequent or serious complaints, regulatory investigations or failure to take remedial action on account problems identified.
3. Daily reviews should be completed within one business day unless precluded by unusual circumstances.
4. Daily reviews should be conducted of client accounts of producing branch managers.

Other Reviews

1. On a sample basis, the Member must review the suitability of investments in accounts where clients have transferred assets into an account in accordance with Rule 2.2.1(e)(i). The Member must have policies and procedures regarding sample size and selection, which should be based on the risk level associated with the account, focusing on accounts that hold higher risk investments, exempt securities or products not sold by the Member, accounts that are operated under a power of attorney in favour of a registered salesperson and accounts employing a leverage strategy other than registered retirement savings plans and registered education savings plans. The Member's reviews must be completed within a reasonable time, but in any event no later than the time of the next trade.
2. Members must also review the suitability of the use of leverage in all cases where the client transfers assets purchased using borrowed funds into an account at the Member. Given the high risk nature of leveraging strategies, the Member's reviews must be completed in a timely manner as soon as possible after the transfer in accordance with the circumstances, but in any event no later than the time of the next trade.

VI. IDENTIFICATION OF TRENDS IN TRADING ACTIVITY

1. Members must establish policies and procedures to identify trends or patterns that may be of concern including:
 - excessive trading or switching between funds indicating possible unauthorized trading, lack of suitability or possible issues of churning (for example, redemptions made within 3 months of a purchase, DSC purchases made within 3 months of a DSC redemption or accounts where there are more than 5 trades per month);
 - excessive switches between no load funds and deferred sales charge or front load funds;
 - excessive switches between deferred sales charge funds and front load funds; and
 - excessive switches where a switch fee is charged.
2. Head office supervisory review procedures must include, at a minimum, the following criteria:
 - a review of all accounts generating commissions greater than \$1,500 within the month;
 - a quarterly review of reports on assets under administration (“AUA”) comparing current AUA to AUA at the same time the prior year;

- a quarterly review of commission reports for the previous 12 month period comparing commissions received in the current year to commissions received for the same period in the prior year.

Significant increases in commissions or AUA beyond those caused by market fluctuations may indicate issues with churning or leveraging strategies. Significant decreases may indicate potential inappropriate outside business activity.

3. Reviews should be completed within 30 days of the last day of the period being reviewed unless precluded by unusual circumstances.

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