

## MUTUAL FUND DEALERS ASSOCIATION OF CANADA

### PROPOSED AMENDMENTS TO MFDA RULE 2.3 (POWER OF ATTORNEY/LIMITED TRADING AUTHORIZATION/DISCRETIONARY TRADING)

#### I. OVERVIEW

##### A. Current Framework

MFDA Rule 2.3.1(a) currently provides that no Member or Approved Person shall accept or act upon a general power of attorney or other similar authorization from a client in favor of the Member or Approved Person or engage in any discretionary trading.

MFDA Rule 2.3.1(b) currently allows for an exception to the prohibition in Rule 2.3.1(a) by providing that an Approved Person may accept or act upon a general power of attorney or similar authorization from a client in favor of the Approved Person where such client is a spouse, parent or child of the Approved Person.

To rely on the exception under Rule 2.3.1(b), the following conditions, as currently set out in the Rule, must be met: (i) the Approved Person must notify the Member of the acceptance of the general power of attorney or similar authorization; (ii) an Approved Person other than the Approved Person holding the general power of attorney must be the Approved Person of record on the account; and (iii) compliance with any other conditions prescribed by the Corporation. In accordance with current requirements under MFDA Policy No. 2 *Minimum Standards for Account Supervision* (“Policy No. 2”), Members must also ensure that accounts subject to a power of attorney or similar authorization are readily identifiable for supervisory purposes and that trading in such accounts meets the trade review requirements prescribed under the Policy.

##### B. Reasons for Amendments

As noted above, the exception currently set out under Rule 2.3.1(b) requires that the account be transferred to another Approved Person. MFDA staff has received comments that this requirement is unnecessarily onerous and not justified from a risk perspective in the case of accounts of family members. In addition, Members have sought clarification as to what is meant by “other similar authorization”, as currently set out under the Rule.

##### C. Objectives

The objectives of the proposed amendments are to address concerns that have been raised respecting certain requirements under Rule 2.3.1 while maintaining investor protection and to clarify the regulatory intent of the Rule.

## D. Effect of Proposed Amendments

The effect of the proposed amendments will be to achieve greater clarity with respect to the regulatory intent of requirements under the Rule while preserving investor protection and effective risk controls.

## II. DETAILED ANALYSIS

### A. Proposed Amendments

#### Description of the Proposed Amendments

The following is a summary of proposed amendments to Rule 2.3. Attached as Schedule “A” to this Notice is a blacklined version of the proposed amendments that indicates the changes from the current version of the Rule.

- **Rule 2.3.1(a):** The words “or other similar authorization” have been deleted. Rule 2.3.1(a), as revised, more clearly sets out the types of control or authority to which reference is being made. Under the Rule, as revised, *No Member or Approved Person shall have full or partial control or authority over the financial affairs of a client including: (i) accepting or acting upon a power of attorney from a client; (ii) accepting an appointment to act as a trustee or executor of a client; or (iii) acting as a trustee or executor in respect of the estate of a client;*
- **Rule 2.3.1(c) (i)-(iii):** The exception set out under Rule 2.3.1(c) has been amended to require that: the client be a Related Person of the Approved Person, as defined by the *Income Tax Act (Canada)*; the Approved Person notify the Member of the appointment; and that the Approved Person obtain written Member approval prior to accepting or acting upon the control or authority. As noted above, the requirement to transfer the account to another Approved Person has been deleted. “Related Person”, as defined under the *Income Tax Act (Canada)*, includes individuals connected by blood relationship, marriage, common law partnership or adoption.

#### Consequential changes to Policy No. 2, Policy No. 5

To reflect the amendments noted above, consequential changes will be made to the wording in Policy No. 2 respecting certain supervisory and trade review requirements. Appropriate conforming changes will also be made to Policy No. 5 *Branch Review Requirements*. In addition, revisions will be made to the guidance set out under MFDA Staff Notice MSN- 0031 *Powers of Attorney – Rule 2.3.1 Exception for Related Persons of Approved Persons*.

Attached as Schedules “B” and “C” to this Notice are blacklined versions of the consequential amendments to Policy No. 2 and Policy No. 5 that indicate the changes from the current version of the Policies.

## **B. Comparison with Similar Provisions**

During the development of the proposed amendments, consideration was given to similar requirements under Investment Industry Regulatory Organization of Canada (“IIROC”) rules that came into effect in December 2013 and additional IIROC rule amendments that were proposed in April 2014.

### IIROC Requirements effective December (2013)

IIROC rule amendments that became effective in December 2013 prohibit employees and Approved Persons from engaging in personal financial dealings with clients (e.g. acting on a power of attorney from a client, or acting as a client’s trustee or executor), unless the client is a Related Person of the Approved Person, as defined by the *Income Tax Act (Canada)*, and the arrangement is disclosed to and approved by the IIROC dealer member prior to its taking effect. The proposed amendments to MFDA Rule 2.3 are consistent with these requirements.

### Additional Proposed IIROC Rule Amendments (2014)

In April 2014, IIROC published for comment additional proposed amendments to its personal financial dealings rule. Included among these proposed amendments are changes that provide an exemption that would allow IIROC Registered Representatives (“RRs”) and Investment Representatives (“IRs”) to act as trustees or executors in respect of any client, subject to certain conditions set out under the rule. The April 2014 rule amendments proposed by IIROC are still under consideration and have not yet received approval from the Canadian Securities Administrators (“CSA”).

During the public comment period for the April 2014 IIROC amendments, concerns were expressed with respect to the breadth of the proposed changes. MFDA staff agrees with many of these concerns. The MFDA has disciplined Approved Persons that have acted as executors or trustees for clients, many of whom are vulnerable, in violation of MFDA Rules. In such cases, significant trust and reliance is placed on Approved Persons which has given rise to irreconcilable conflicts of interest and resulted in significant client harm. Having regard to these considerations, MFDA staff is of the view that the proposed MFDA Rule amendments are appropriately limited in scope and maintain investor protection.

## **C. Issues and Alternatives Considered**

No other alternatives were considered.

## **D. Systems Impact of Amendments**

It is not anticipated that the proposed amendments will have any additional material impact upon Members’ systems, impose any material burden or constraint on competition or innovation, impose any material costs or restrictions on the activities of market participants, or result in any material increased costs of compliance.

#### **E. Best Interests of the Capital Markets**

The proposed amendments to Rule 2.3 were approved by the MFDA Board of Directors at their March 2, 2016 meeting. The Board has determined that the proposed amendments are consistent with the best interests of the capital markets.

#### **F. Public Interest Objective**

The proposed amendments will achieve greater clarity with respect to the regulatory intent of requirements under the Rule, while preserving investor protection and effective risk controls. The proposed amendments are consistent with the public interest.

#### **G. Classification**

The proposed amendments have been classified as Public Comment Rule proposals.

### **III. COMMENTARY**

#### **A. Filing in Other Jurisdictions**

The proposed amendments will be filed for approval with the Alberta, British Columbia, Manitoba, Nova Scotia and Ontario Securities Commissions, the New Brunswick Financial and Consumer Services Commission, the Superintendent of Securities of Prince Edward Island, and the Saskatchewan Financial and Consumer Affairs Authority.

#### **B. Effectiveness**

The proposed amendments are simple and effective.

#### **C. Process**

The proposed amendments have been developed in consultation with the relevant departments within the MFDA and have been reviewed by the MFDA Policy Advisory Committee, the Regulatory Issues Committee of the MFDA Board of Directors and, subsequently, approved by the full MFDA Board of Directors. The MFDA Board of Directors approved the proposed amendments on March 2, 2016. In approving the proposed amendments, the MFDA has followed its established internal governance practices and has considered the need for consequential amendments.

#### **D. Effective Date**

The proposed amendments will be effective on a date to be subsequently determined by the MFDA.

#### **E. Exemption from Requirements under Securities Legislation**

The proposed amendments do not involve a Rule that the MFDA, its Members or Approved Persons must comply with in order to be exempted from a securities legislation requirement.

## F. Conflict with Applicable Laws or Terms and Conditions of Recognition Order

The proposed amendments do not conflict with applicable laws or the Terms and Conditions of a Recognizing Regulator's Recognition Order.

## IV. SOURCES

- MFDA Rule 2.3 (Power of Attorney/Limited Trading Authorization/Discretionary Trading);
- MFDA Rule 2.1.4 (Conflicts of Interest);
- Proposed amendments to IIROC Rule 42 (Conflicts of Interest);
- Proposed amendments to IIROC Rule 43 (Personal Financial Dealings with Clients);
- IIROC Notice 13-0162;
- IIROC Notice 14-0103;
- IIROC Notice 15-0096;
- IIROC Notice 15-0256.

## V. REQUIREMENT TO PUBLISH FOR COMMENT

The MFDA is required to publish for comment the proposed amendments so that the issues referred to above may be considered by the Recognizing Regulators.

**The MFDA has determined that the entry into force of the proposed amendments would be in the public interest and is not detrimental to the capital markets. Comments are sought on the proposed amendments.** Comments should be made in writing. One copy of each comment letter should be delivered within 90 days of the publication of this notice, addressed to the attention of:

Paige Ward  
General Counsel, Corporate Secretary and Vice-President, Policy  
Mutual Fund Dealers Association of Canada  
121 King St. West, Suite 1000  
Toronto, Ontario M5H 3T9  
[pward@mfd.ca](mailto:pward@mfd.ca)

and one copy addressed to the attention of:

Anne Hamilton  
Senior Legal Counsel  
British Columbia Securities Commission  
701 West Georgia Street  
P.O. Box 10142, Pacific Centre  
Vancouver, British Columbia, V7Y 1L2  
[ahamilton@bcsc.bc.ca](mailto:ahamilton@bcsc.bc.ca)

Those submitting comment letters should be aware that a copy of their comment letter will be made publicly available on the MFDA website at [www.mfda.ca](http://www.mfda.ca).

Questions may be referred to:

Paige Ward  
General Counsel, Corporate Secretary and  
Vice-President, Policy  
Mutual Fund Dealers Association of Canada  
(416) 943-5838

**DM#467497**

**2.3 CONTROL OR AUTHORITY POWER OF ATTORNEY/LIMITED TRADING  
AUTHORIZATION/DISCRETIONARY TRADING**

2.3.1

- (a) **Control or Authority. Prohibition.** No Member or Approved Person shall have full or partial control or authority over the financial affairs of a client, including:
- (i) accepting or acting upon a general power of attorney or other similar authorization from a client in favour of the Member or Approved Person;
  - (ii) accepting an appointment to act as a trustee or executor of a client; or
  - (iii) acting as a trustee or executor in respect of the estate of a client.
- (b) **Discretionary Trading.** No Member or Approved Person shall ~~or~~ engage in any discretionary trading.
- (c) **Exception.** Notwithstanding the provisions of paragraph (a), an Approved Person may have full or partial control or authority over the financial affairs of a client provided that:
- (i) the client is a Related Person of the Approved Person, as defined by the Income Tax Act (Canada);
  - (ii) the Approved Person notifies the Member of the appointment; and
  - (iii) the Approved Person obtains written Member approval prior to accepting or acting upon the control or authority.
- ~~.. accept or act upon a general power of attorney or similar authorization from a client in favour of the Approved Person where such client is a spouse, parent or child of the Approved Person and provided that:~~
- ~~the Approved Person notifies the Member of the acceptance of the general power of attorney or similar authorization; (paragraph (c))~~
- ~~(ii) an Approved Person other than the Approved Person holding the general power of attorney must be the Approved Person of record on the account; and~~
  - ~~(iii) such other conditions as prescribed by the Corporation are met.~~

## MFDA Policy No. 2

### Minimum Standards for Account Supervision

#### **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, the following account types must be readily identifiable: registered accounts; leveraged accounts; and accounts where the client is a Related Person of the registered salesperson, as defined by the Income Tax Act (Canada), and the registered salesperson has full or partial control or authority over the financial affairs of the client. ~~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 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 interests 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 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. 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.
3. 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 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 details in support of income and net worth calculations required by sections 1(e) and 1(f).
- (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 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**

1. An on-site branch manager is in the best position to know the registered salespersons in the office, know or meet many of the clients, understand local conditions and needs, facilitate business through the timely approval of new accounts and respond immediately to questions or problems. In accordance with Rule 2.5.5(c), a Member may designate a branch manager for a branch office who is not normally on-site. In determining whether an on-site branch manager is necessary at a branch, a number of factors, including the following, should be considered:
  - the specific activities at the branch;
  - complaint history;
  - number of Approved Persons at the branch;
  - experience of Approved Persons at the branch;
  - trade volume/commissions earned;
  - results of previous Policy No. 5 branch reviews;
  - MFDA compliance examination findings;
  - daily trade supervision issues;
  - supervisory tools used at the branch (manual or automated);
  - the nature of dual occupations or outside business activities carried on at the branch; and
  - the availability of a branch manager or branch managers in nearby locations.
2. Where a branch or sub-branch does not have an on-site branch manager, the Member must assign an off-site branch manager to the location. The Member's policies and procedures must include provision for periodic visits to the branch and sub-branch by the branch manager, or other Approved Persons at the Member who are delegated supervisory responsibility, as necessary to ensure that business is being conducted properly at the location. Members must maintain records of the visits as well as issues

identified and follow-up action taken.

3. Members must maintain an internal record of branch managers and the branches and sub-branches they are responsible for supervising.

## 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);
  - leveraging for accounts other than registered retirement savings plans or registered education savings plans;
  - trades in accounts where the client is a Related Person of the registered salesperson, as defined by the Income Tax Act (Canada), and the registered salesperson has full or partial control or authority over the financial affairs of the client; ~~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 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 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 where the client is a Related Person of the registered salesperson, as defined by the Income Tax Act (Canada), and the registered salesperson has full or partial control or authority over the financial affairs of the client 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.

**DM#463745**



July 24, 2006

## **MFDA POLICY NO. 5**

### **BRANCH REVIEW REQUIREMENTS**

#### **Introduction**

This Policy establishes minimum standards for the development and implementation of branch and sub-branch review procedures. All references to “branch” in this Policy include sub-branches as defined in MFDA By-law No.1.

Members are responsible for establishing, implementing and maintaining policies and procedures to ensure that business is conducted and managed in accordance with MFDA By-laws, Rules and Policies and with applicable securities legislation. Under MFDA Policy 2, the Member is required to conduct an on-going review of sales compliance procedures and practices at both head office and at branch offices to confirm that these procedures are adequately fulfilling the purposes for which they have been designed. The requirement to complete regular branch reviews is consistent with these obligations and will serve to enhance the Member’s ability to meet the fundamental supervision requirements under MFDA By-laws, Rules and Policies.

The intent of this Policy is to establish minimum standards for internal branch review programs (“Branch Review Program”), while allowing Members sufficient flexibility to develop procedures that are appropriate to the Member’s size and business model. Accordingly, strict adherence to the minimum standards as set out in this Policy will not necessarily ensure that a Member’s Branch Review Program is effective to ensure proper supervision and compliance with MFDA Rules. The objective is for Members to create and effectively implement processes that maximize their ability to detect potential compliance issues, so that corrective action may be taken before serious problems occur. MFDA staff will assess the effectiveness of the Member’s Branch Review Program in the course of conducting compliance examinations and may impose additional requirements to ensure compliance with MFDA By-laws, Rules and Policies.

#### **Branch Review Procedures**

Each Member must establish a Branch Review Program to effectively assess and monitor compliance with regulatory requirements at all branch locations.

##### ***a) General Requirements***

- The Branch Review Program must include an assessment of the supervisory procedures and practices in place at the branch, as well as the quality of execution of those procedures.
- The Branch Review Program must address all significant aspects of the Member’s policies and procedures manual and MFDA By-laws, Rules and Policies.

- The Branch Review Program must include interviews with branch supervisors and a selection of other Approved Persons along with substantive testing to verify the accuracy of information that is provided in the interviews. Substantive testing should involve reviewing client files, trade blotters, trust account records, advertising and marketing material and other relevant records.

***b) Branch Interviews***

- The purpose of the interviews is to confirm that the branch manager and Approved Persons are aware of requirements under MFDA By-laws, Rules and Policies and applicable securities regulation. It is particularly important that the reviewer confirm that the branch manager has a good understanding of the fundamental supervisory requirements. The interview process also serves as a forum for the branch manager and Approved Persons to raise and discuss issues and areas of regulatory concern.
- The interviews must also include discussion about branch policies and procedures relating to:
  - products and services offered to clients;
  - complaints;
  - advertising and sales communications;
  - referral arrangements;
  - outside business activities;
  - account opening procedures; and
  - other branch and sub-branch supervision issues.

***c) Review of Trade Blotters and Other Supervisory Review Documentation***

- Documentation must be reviewed to confirm that trade reviews have been performed adequately and in a timely manner covering the minimum requirements of MFDA Policy 2. This includes a review to confirm that all trades in exempt securities and a sample of initial trades, leveraged transactions, trades made in accounts where the client is a Related Person of the registered salesperson, as defined by the Income Tax Act (Canada), and the registered salesperson has full or partial control or authority over the financial affairs of the client~~under a limited trading authorization or power of attorney~~, and trades in speculative funds have been reviewed. Samples of different types of transactions, including purchases, switches and redemptions must be reviewed. Trade blotters must be reviewed to assess:
  - trading patterns;
  - evidence of supervision; and
  - timeliness of review.
- The suitability of individual trades must be assessed to confirm that the quality of trade supervision is consistent with the Member's standards and regulatory expectations.
- Trade supervision records must also be reviewed to confirm the recording of issues noted by supervisory staff, inquiries made, responses received and resolutions achieved.

***d) Review of Client Files***

- Client files must be examined to verify that there is proper account opening documentation on file and that branch client files are appropriately safeguarded. Know-your-client information must be reviewed to:
  - assess completeness;
  - confirm that back up for any changes has been maintained on file; and
  - confirm that KYC information on the back office system matches with that recorded in the files.
- The branch review process must confirm that account opening approval procedures have been properly followed, where these are the responsibility of branch staff.
- Client files must be examined to verify that proper evidence of client instructions and any relevant trading authorizations have been maintained on file. Files should be reviewed to assess the adequacy of notes regarding advice or recommendations provided to the client, as well as notes regarding discussions relating to fees and services, if any.
- Trade orders must be reviewed to:
  - assess suitability;
  - detect unlicensed / out-of-province trading;
  - confirm proper identification of leveraged trades; and
  - confirm timeliness of trade processing.

***e) Review of Sales Communications, Advertising and Client Communications***

- The Branch Review Program must include a review of sales communications, advertising and client communications, including business cards, letterhead and websites to confirm that any required approvals have been obtained.
- The branch review process must also involve, where appropriate, discussions and testing to detect:
  - misleading communications;
  - trade names of Approved Persons that have not been approved by the Member;
  - undisclosed outside business activities or personal financial dealings with clients;
  - securities related business conducted outside of the Member; and
  - undisclosed referral arrangements.
- Where the reviewer detects a potential material deficiency with respect to the conduct of outside business or personal financial dealings under MFDA By-laws, Rules or Policies, the Branch Review Program must provide for the review of files of Approved Persons relating to non-Member business.

***f) Complaints***

- The branch review process must confirm that any complaints that may have been made involving individuals at the branch have been recorded and handled in accordance with Member procedures and MFDA By-laws, Rules and Policies.

- The nature of any complaints, as well as the timeliness and fairness of resolution must be assessed.
- The branch review process must confirm that all complaints and pending legal actions are made known to the compliance officer at head office (or another person at head office designated to receive such information) within two business days in accordance with MFDA Policy No.3. (“Handling Client Complaints”).

## Scope of Review

Sample size and the extent of the review are matters of discretion for the Member. However, at a minimum, the review should involve a preliminary screening of the branch that is sufficient to provide a reasonable indication of items or issues for further investigation. Sample size and the extent of review must be reasonable based on a number of factors such as:

- the specific activities at the branch;
- complaint history;
- number of Approved Persons at the branch;
- trade volume/commissions earned;
- results of previous reviews;
- MFDA compliance examination findings;
- daily trade supervision issues;
- experience of supervisory staff at the branch;
- supervisory tools used at the branch (manual or automated);
- the nature of dual occupations or outside business activities carried on at the branch;
- the volume of leveraged trades; and
- the date of the last review.

## Branch Review Cycle and Schedule

The Member must be able to justify its branch review schedule and cycle by developing a risk-based methodology to rank branch locations as high, medium or low risk using appropriate criteria. Such criteria would include the factors set out above under “Scope of Review”. Members are generally expected to perform an on-site review of their branches no less than once every three years. However, Members must review certain branches more frequently than once every three years if justified based on risk. Where, under unusual circumstances, a Member exceeds a three year branch review cycle, the Member must be able to justify the longer review cycle by demonstrating that the branches that have not been subject to an on-site review are low risk and have been subject to alternative compliance review procedures performed by head office, such as an off-site desk review. Under no circumstances however, should a Member never perform an on-site review of a branch.

The branch review cycle and the status of completion of the branch review cycle against benchmarks should be included as part of the annual compliance report to the board of directors or partners of the Member required by MFDA Rule 2.5.2(b).

## Qualifications for Reviewers

The individuals responsible for performing the branch reviews must have the training, skills and proficiency necessary to accomplish the objectives of the review program. The individuals must possess sufficient knowledge not only to be able to follow prescribed procedures, but to be able to know where follow up review should be pursued. In addition, Members should ensure that individuals delegated the responsibility to perform branch reviews have adequate existing time or whether workloads can be rescheduled in order to provide the time necessary for proper performance.

Individuals that have successfully completed the courses required for designation as a branch manager as set out under MFDA Rule 1.2.2(a) or that have equivalent experience, training or education would generally be considered sufficiently qualified to perform branch reviews. The Member must consider the responsibilities and functions that are performed as part of a branch review and make the determination of what constitutes equivalent experience, training or education sufficient to qualify an individual as a branch reviewer. The Member will be required to satisfy the MFDA that the equivalency standard has been met.

Equivalent experience, training or education may include: audit experience, legal training in the area of securities or mutual fund regulation, or experience in a regulatory supervisory or compliance role. Members may also have an internal training program for branch reviewers, which may satisfy the equivalency test.

The branch reviewer must be independent of the branch and the branch manager, so as to ensure that the reviewer can act objectively without preconceived opinions and is not subject to inappropriate influence when performing the review.

## Reporting of Results

All serious issues detected in the branch reviews must be made known to the compliance officer at head office (or another person at head office designated to receive such information) within a reasonable period of time.

Each Member must also ensure that branch managers are made aware of all issues that are identified in the branch review in a timely manner. In addition, Approved Persons at the branch should be made aware of issues identified in the report relevant to them.

The report to the branch manager on the results of the branch review must include the following information:

- the date of the review;
- basic branch information, including the Approved Persons and staff at the branch location;
- details of any compliance deficiencies noted in completing the branch review including missing documentation or any gaps in supervision;

- the date of the report; and
- the date by which a response is required.

## Follow Up of Branch Review Findings

The Member must have procedures in place to ensure that the issues identified in the course of the branch review are followed up and resolved. Therefore, the Branch Review Program must provide for:

- consistent and timely reporting of results;
- a means of tracking responses to the reports; and
- a means of ensuring that the branch implements all required changes in a reasonable amount of time.

## Branch Review Files

Members must maintain orderly, up-to-date files for each branch that has been reviewed. The files must include details of the procedures performed at the branch and all working papers to support the work done and provide evidence of any deficiencies noted. All follow-up documentation, including the report to the branch manager, must also be included in the file. Records must be maintained for a period of seven years and must be made available for review by the MFDA, if requested.

Branch review records should be used to identify significant deficiencies that may disclose a need for further education and training of branch supervisors, Approved Persons, or other staff. When systemic issues are detected through the branch review process, a review of internal procedures and practices may be warranted.