



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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Ms. Sherry Tabesh-Ndreka, Policy Counsel
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121 King Street West, Suite 1600
Toronto, Ontario
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DELIVERED VIA EMAIL

Dear Ms. Tabesh-Ndreka:

RE: Request for comments on draft guidance note: “Know-your-client and Suitability Guidelines” (the Guidance Note)

The Investment Industry Association of Canada (IIAC) appreciates the opportunity to comment on the Guidance Note, and commends the Investment Industry Regulatory Organization of Canada (IIROC) for undertaking the important task of outlining IIROC’s expectations concerning know-your-client (KYC) and suitability requirements.

The IIAC formed a KYC and Suitability Working Group (the Working Group) to assist in developing this submission. The Working Group was comprised of numerous members from across Canada, representing a broad cross-section of firms.

We appreciate that IIROC has attempted to present some best practices in the form of a notice rather than as a new rule, which is intended to allow members the flexibility to determine how to best and most appropriately adapt the practices into the business models of their respective firms. However, our Working Group is concerned that the Guidance Note does, in fact, introduce new obligations with respect to the applicable IIROC Dealer Member Rules relating to the KYC and suitability obligations, despite the statements made therein stating otherwise. Further, the Working Group is of the view that some areas of the Guidance Note require further clarification and guidance. We have outlined these concerns below. For greater clarity, we have set out in bold type the Working Group’s specific recommendations to improve this Guidance Note.

COMPLIANCE WITH KNOW YOUR CLIENT REQUIREMENTS

New account application requirements

The Working Group agrees with the elimination of the use of the word “form” as stated in the Guidance Note; however, we would like this to extend further by seeing the complete removal of the use of Form 2. A previous sub-committee at IIROC had undertaken extensive work to replace Form 2 with guidelines that would outline the type of information that should be obtained from clients when opening a new account. We hope to see a continuation of this work to put these guidelines into place.

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

The Guidance Note states that a single account application may be used for multiple accounts held by the same client provided certain conditions exist. One of the key conditions is that the client’s investment objectives and risk tolerance are identical for all of the accounts covered by the application. However, some participants of the Working Group have indicated that their firms have recently received IIROC approval for a revised Form 2 that covers multiple accounts with different objectives, and that they have been opening client accounts with this form. This approach is supported under section 13.3 of the Companion Policy to National Instrument 31-103 *Registration Requirements*. That section specifically states that:

If a client is opening more than one account, the registrant should indicate whether the client’s investment objectives and risk tolerance apply to a particular account or to the client’s whole portfolio of accounts.

The conditions outlined in this section of the Guidance Note also appear to contradict one another. The first bullet point seems to refer to individual accounts, whereas the third and fourth bullet points consider assessing suitability on a multiple account or portfolio basis. If suitability is to be examined from the perspective of the portfolio as a whole, it is impractical to require multiple account forms.

The Working Group believes that provided it is made clear to the client, a single account application should be able to encompass multiple accounts with differing objectives and risk tolerance. For example, if the account application can accurately reflect different information where necessary for different accounts, a client should not have to complete additional paper work when they are opening an RRSP account (with medium risk tolerance) along with an equity account (with high risk tolerance).

In addition, members often view a client’s risk tolerance from the perspective of the portfolio as a whole and not on an account-by-account basis. An example of this is where a client looking for a portfolio consisting of 10% high risk and 90% low risk. This could be achieved with an aggressive TFSA representing the 10% portion and the 90% portion coming from other accounts, such as holding 90% of the total portfolio in bonds within an RRSP. Together, they meet the client’s overall objective. Based on the proposed guidelines, however, these accounts would require separate applications.

Instead, it should be recognized that a client application can serve two functions. One, to gather the KYC information which applies to all accounts opened by the client and two, to deal with account specifics including the types of accounts and account objectives. The Guidance Note lacks flexibility by stating that a single account application cannot be used where a client's investment objectives differ as between accounts.

The account opening process should be as efficient as possible for clients. Severing accounts does not provide any meaningful benefit to clients. ***Consequently, the Working Group is of the view that requiring separate client account applications based on different objectives and risk tolerance is an artificial construct and we suggest that it be removed from the Guidance Note.***

We would also appreciate more clarification regarding the wording at the bottom of page two. The notice refers to "certain registered accounts" which may be included on the same account application for a client. This implies that some registered accounts will be excluded from the opportunity to aggregate. ***The Working Group suggests that this section be redrafted for greater clarity to specifically identify which types of registered accounts can or cannot be aggregated.***

Lastly, IIROC states that it is considering proposing these conditions as rule amendments. ***We question the order of issuing a Guidance Note in this area prior to rule changes. We would suggest that first, the proposed rule amendments are drafted with member consultation, and then followed up with a Guidance Note on those rules.***

Know your client information

The Working Group is unclear as to why the focus under this heading is on investment objectives and risk tolerance as we believe that these are just a few of the factors that need to be considered in knowing a client and determining his or her objectives.

Furthermore, many firms do not establish a risk tolerance for clients as a separate stand-alone factor, especially given the difficulty of defining "risk". Risk can be different for every client and no single standard can necessarily be applied. As well, each firm may establish and measure risk differently. As a result, this section in the Guidance Note does not accurately reflect how firms conduct the KYC process.

The Working Group suggests that this section be revised and clarified.

Time Horizon

The Working Group is unsure why time horizon was highlighted more than other equally important factors such as investment knowledge, financial situation, age, marital status and employment. We suggest that these other important considerations be discussed in the Guidance Note. Primarily focusing on time horizon gives the impression that this is an item that requires documentation in the account application, although it is not contained in the requirements of Form 2.

We would also like to point out that simply because an 80 year-old client likely has a short time horizon does not necessarily mean that he or she should only open a low risk account. That 80 year-old may choose to open an account with some “play money”. It should be left to the advisor to determine whether the orders within that account are suitable, although certainly it would make sense to ensure the client is made aware of the risks and that the investment objectives are reviewed with more frequency.

Periodic updates and review

This section states that “the account application information” must be updated any time there is a material change in a client’s circumstances. However, further down, the section states that “the account application”, without reference to “information”, must be updated any time there is a material change in a client’s circumstances. The Working Group would like these terms made consistent and confirm that it is not the actual account application which needs to be updated, but instead, the information contained therein.

Many firms use a material change form, an e-mail or a letter to ensure that proper updates are obtained from clients. However, requiring the actual account application to be amended would be far too onerous from a repapering perspective, especially in cases where firms require client signatures on the account application. Currently, firms experience significant challenges in tracking clients down in order to ensure they sign and return the account application. For this to occur when there is a material change in a client’s circumstances would be extremely time consuming for advisors and take them away from their primary responsibility of actually advising their clients and managing their investments.

As a result, we recommend that the language in these sections be amended and clarified to allow for the client’s information on file to be updated any time there is a material change in a client’s circumstances rather than having to update the actual account application.

This section also outlines that Registered Representatives (RRs) “periodically, or at a minimum annually, inquire with each client as to whether there are any material changes in the client’s circumstances.” The Working Group believes that rather than simply a best practice this provision introduces a new requirement. Neither IROC Dealer Member Rule 1300 nor Rule 2500 contains a requirement for the dealer or the RR to inquire annually as to whether the client’s circumstances have materially changed. Setting out a minimum expectation results in a new obligation, not a best practice.

Further, the Guidance Note does not provide any guidance or discussion concerning how this periodic update should be conducted nor how firms should monitor RRs to ensure it has been undertaken. New systems would need to be implemented to monitor and record the fact that a client has been asked whether there has been a material change in the information he or she provided, and to record that the RR has completed this inquiry. Systems would also be needed to provide reminders to supervisors and RRs when a review is required.

Advisors know that it is essential to remain up to date on their clients' circumstances in order to make appropriate decisions with respect to their investment objectives. ***Rather than an annual inquiry, the Guidance Note should simply discuss the obligation of RRs to be aware of material changes as communicated by the client and it should emphasize that clients also have an obligation to notify their advisors with respect to material changes.***

In addition to the above mentioned proposed new requirement, this section also states that RRs "conduct periodic suitability reviews, at a minimum annually". Neither IROC Dealer Member Rule 1300 nor Rule 2500 contains a requirement to conduct an annual suitability review. This section further suggests that this suitability review be used as an opportunity to conduct an inquiry regarding a client's material changes.

The Working Group notes that along with this new requirement, there is no clarity surrounding the meaning of the term "suitability review." This term can mean different things for different clients in many circumstances. For example, if a client has aggressive objectives, is it necessary to review every holding and discuss them with the client when the client may have hundreds of holdings in an account and possibility multiple accounts? ***The Working Group suggests some clarity surrounding expectations for suitability reviews.***

Furthermore, as the wording infers that this is to be done in conjunction with the client, this new requirement introduces an additional responsibility on the RR and one that can only be satisfied if the client chooses to cooperate in the annual review. Again, this annual suitability review is a new requirement and a change from the proposed Client Relationship Model, which included an optional suitability review but did not mandate the frequency of such review. ***The Working Group recommends that the provision in the Guidance Note be removed as it is inconsistent with current IROC Dealer Member Rules and the proposed Client Relationship Model.***

The Working Group also recommends that because this section requires account information to be updated any time there is a material change in a client's circumstances, that some guidance be provided as to what constitutes a material change. For example, if a client's income increased from \$60,000 to \$65,000, would this be defined as a material change?

We further suggest that references to requirements under the proposed Client Relationship Model be removed in this section and others throughout the Guidance Note. Until the Client Relationship Model is finalized, it is confusing to refer to it in this notice. Similar confusion resulted in 1997 and 1998 when the Investment Dealers Association, by way of notice, implemented pro group holding and client priority rules in anticipation of full implementation of rules resulting from recommendations of the Joint Securities Industry Committee on Conflict of Interest. At the time, IDA Bulletins encouraged members to proceed with early implementation of the Report's recommendations. Full implementation of those rules, including rules on pro group holding aggregation, never occurred.

To avoid a similar situation in this instance, it would be prudent to remove references to the proposed rule in this Guidance Note.

COMPLIANCE WITH THE SUITABILITY ASSESSMENT REQUIREMENTS

This section states that the member and RR should “ensure that the account type is suitable for the client”. This statement extends the suitability obligation beyond present suitability requirements for reviews when an order is accepted or when recommendations are made. It also goes beyond the proposed Client Relationship Model which would require suitability reviews when certain trigger events occur. ***Requiring a suitability review when the account is opened with respect to account type is more than a recommended best practice and should therefore be removed.*** In addition, stating that members and RRs “ensure” the suitability of the account type elevates this provision to a regulatory requirement rather than mere guidance.

Further, it is unclear how account type suitability reviews would occur. For example, if a client wishes to open a margin account, but never borrows money from the member to purchase securities, would this account type be deemed unsuitable? Such a determination in this example would also only be possible after the fact.

We believe the Guidance Note blurs the concepts of KYC and suitability. The determination of what type of account to open is based upon the KYC process where the advisor meets with his or her client to know the client and to determine what the client hopes to achieve, resulting in the establishment of an account with certain investment objectives. It is not associated with a suitability assessment, which is concerned with an analysis of what is contained in the portfolio. ***In general, we believe the Guidance Note mixes the concepts of KYC and suitability and ultimately causes more confusion rather than helpful commentary.***

With reference to the proposed Client Relationship Model and the suitability analysis required, it seems inappropriate that such an analysis would need to occur with the trigger event of a change in the “investment representative”. It makes sense for such a review to occur when the RR has changed, but IRs are registered solely to take/submit client orders for execution. They are not permitted to provide clients with investment advice. ***As a result, it seems somewhat excessive to require a suitability review when there is a change of investment representative in regard to a client account.***

Unsuitable investments

The Working Group questions how one defines an “unsuitable investment”. If one position in a client’s account decreases in value, but within the context of the entire portfolio nothing is specifically wrong with this investment, does this deem that one holding to be unsuitable? Singling out certain investments without considering the portfolio as a whole is not the appropriate way to ensure that a client’s investment objectives are achieved.

We are also unsure about the suggestion to rebalance the account by recommending changes to other investments within the account in order to ensure the suitability of the

overall portfolio. If the ultimate focus is the suitability of the overall portfolio and the other investments continue to remain suitable, what changes should occur? The Guidance Note appears contradictory when discussing a particular unsuitable security versus the suitability of the overall portfolio. If the portfolio is suitable as a whole, there should not be changes to the remainder of the portfolio. ***As a result, the Working Group recommends that this provision be removed.***

The Guidance Note recommends referring to the member's internal policies in handling unsuitable investments. ***The Working Group suggests that it would be beneficial if IIROC provided some explicit guidance on what should be contained in these internal policies.***

We also recommend some clarification regarding whether an RR has any further responsibility with respect to an investment that they have cautioned against. If the RR has advised against holding onto the investment, has recommended changes to other investments within the account (if this provision is not removed as suggested), and adhered to internal policies regarding the handling of unsuitable investments, does the RR continue to have some obligation? Are these actions sufficient to absolve the RR from any future liability? ***We request that the Guidance Note confirm that in such circumstances the RR does not have any further obligation or responsibility for the unsuitable investment.***

Unsolicited unsuitable orders

The Working Group agrees with the comment that an RR's obligation with respect to dealing with unsolicited unsuitable orders partially depends on his/her relationship with the client.

However, rather than simply refusing the order, it is ultimately better for the client to allow the RR to accept the order, so that the RR may provide cautionary advice, rather than forcing the client to go elsewhere with the order.

The Guidance Note is silent as to dealing with a situation where the client contacts a sales associate to place a potentially unsuitable unsolicited order. However, sales associates are not permitted to provide advice as to the unsuitability of the order. ***Some recommended best practices for this situation would be beneficial.***

Further, the notice again makes reference to internal procedures of the member for dealing with this issue, but some clear guidance as to what these internal policies should contain would be most helpful.

Inappropriate updates

The Working Group agrees that it is inappropriate to update or alter a client's KYC information in an effort to justify the suitability of an investment, order or recommendation that is otherwise unsuitable for the client.

However, we would again suggest it be made clear as to what is an unsuitable investment. ***Guidance would be appreciated as to whether the term “unsuitable” would include an underperforming investment.***

Best Practices

With respect to maintaining a suitable client portfolio, the reference in the first and second bullet points should be clarified to refer to a “suitability review of the portfolio” rather than simply a “suitability review”.

Further, as stated in the IIAC’s submission on the proposed Client Relationship Model, we believe there are difficulties with suggesting a suitability review be conducted when there are “significant market changes”. Simply because the value of a security goes down, does not automatically make the investment unsuitable.

In today’s current economic climate, such reviews would have to be conducted on a weekly basis. When the market goes up, a suitability review would be conducted, when the market goes down, a suitability review would be conducted. How much of a market fluctuation is considered significant? The definition is open to wide interpretation and will likely expose firms to undue risk. ***Given that, it is the Working Group’s position that this requirement should be removed.***

The second recommended best practice is for firms to conduct a suitability review where there is a material change of risk associated with an issuer. Monitoring an issuer in this manner would be extremely challenging and again, would take the RR’s focus away managing their clients’ investments. ***This review should instead be part of the next trade or other suitability review triggering event.***

The current obligations and responsibilities of advisors will ensure that advisors have a healthy, ongoing dialogue with their clients regarding their investments and will review the suitability of investments on a regular basis. However, focus on market changes and issuer risk does not properly capture the relationship that advisors have with their clients nor how they manage their clients’ portfolios.

GENERAL CONCERNS

Applicability to Discount Brokerage Firms

While the Guidance Note references IIROC Dealer Member Rule 2500, which pertains to retail accounts, there is no reference as to whether the notice is applicable to discount brokerage accounts. ***As these firms have different obligations with respect to KYC and suitability, we would suggest that a carve-out for discount brokerage firms be outlined in the Guidance Note.***

Under IIROC Rule 1300, discount brokerage firms are specifically exempted from the suitability obligation. Rule 3200 *Minimum Requirements for Dealer Members Seeking Approval under Rule 1300.1(T) for Suitability Relief for Trades not Recommended by the Member* requires firms that provide order-execution only services to disclose to clients

that the client alone is responsible for his or her own investment decisions and that the dealer member will not consider the customer's financial situation, investment knowledge, investment objectives and risk tolerance when accepting orders from the customer.

This exemption from conducting a suitability review therefore causes many of the provisions in the Guidance Note to be inapplicable to discount brokerage firms.

Applicability to Institutional Accounts

The Guidance Note generally illustrates aspects of retail suitability such as investment objectives, financial information and risk tolerance and does not address any of the exemptions available under IIROC Dealer Member Rule 2700 *Minimum Standards for Institutional Customer Account Opening, Operation and Supervision*.

The Guidance Note does not make reference to Institutional Customer accounts which have different obligations with respect to KYC and suitability.

The factors required by a member in determining institutional suitability under Rule 2700, section I (2) are clear. In addition, Rule 2700 does not require a member to determine the risk tolerance or investment objectives of an Institutional Customer. There is only a suitability obligation by the member when dealing with Institutional Customers to determine "...whether the customer is sufficiently sophisticated and capable of making its own investment decisions in order to determine the level of suitability owed to that Institutional Customer."

The Guidance Note is too generic. It does not mention the differing suitability determination factors for "retail" and "institutional" suitability. *The Working Group therefore recommends the use of a carve-out for Institutional Customers as there are different obligations with respect to suitability requirements for retail and institutional customers.*

Comment Process

The IIAC Working Group is extremely concerned that this Guidance Note is creating new standards and imposing regulatory requirements for members, rather than simply recommending best practices. *As such, we recommend the Guidance Note be subject to a further comment period once it has been amended based on industry input.*

The IIAC Working Group would welcome an opportunity to meet with IIROC staff to further discuss the Guidance Note and our suggestions for its improvement, as outlined in this comment letter.

Yours sincerely,

"Michelle Alexander"