

## Chapter 13

# SRO Notices and Disciplinary Proceedings

### 13.1.1 Notice of Commission Approval - Amendments to MFDA Rule 2.2.1 - "Know-Your-Client"

#### THE MUTUAL FUND DEALERS ASSOCIATION (MFDA) NOTICE OF COMMISSION APPROVAL AMENDMENTS TO MFDA RULE 2.2.1 "KNOW-YOUR-CLIENT"

The Ontario Securities Commission approved amendments to MFDA Rule 2.2.1, the "Know-Your-Client" rule. In addition, the Alberta Securities Commission, Nova Scotia Securities Commission and Saskatchewan Financial Services Commission approved; and the British Columbia Securities Commission did not object to the amendments. The amendments to MFDA Rule 2.2.1 clarify the Member's obligations when a transaction proposed by a client is not suitable for the client. A copy and description of these amendments were published on July 11, 2003 at (2003) 26 OSCB 5419. A summary of the public comments received is provided in Appendix "A". The final amendments to Rule 2.2.1 blacklined from the version published on July 11, 2003 are contained in Appendix "B".

### APPENDIX "A"

#### Summary of Public Comments Respecting Proposed Amendments to MFDA Rule 2.2.1 ("Know-Your-Client") And Response of the MFDA

On July 11, 2003, the Ontario Securities Commission published for public comment proposed amendments to MFDA Rule 2.2.1- "Know-Your-Client" (the "**Proposed Amendments**"). The MFDA proposal was published in Volume 28, Issue 26 of the Ontario Securities Commission Bulletin, dated July 11, 2003.

The public comment period expired on August 11, 2003.

Five submissions were received during the public comment period:

1. TWC Financial Corp.
2. Independent Planning Group Inc.
3. Manulife Securities International Ltd.
4. Berkshire Investment Group Inc.
5. Philip Anisman, Barrister and Solicitor

Copies of comment submissions may be viewed at the offices of the MFDA, 121 King Street West, Suite 1600, Toronto, Ontario by contacting Laurie Gillett, Corporate Secretary and Membership Services Manager, (416) 943-5827.

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

#### 1. **Responsibility to Advise Client that Proposed Transaction is Unsuitable**

One commentator suggested that a reference to Approved Person be added to the provision requiring Members to advise the client where the client proposes a transaction that is determined to be unsuitable for the client and in keeping with the client's investment objectives. Another commentator noted that it is unclear whether the responsibility to advise the client that the transaction is unsuitable can be fulfilled by the Approved Person on behalf of the Member or whether the Member must contact the client directly. Two commentators were of the view that it should be the responsibility of the Approved Person to advise the client before the execution of an unsuitable transaction rather than the Member. One of these commentators expressed concern that the Member will not be aware of proposed transactions, as it would be a result

of dialogue between the Approved Person and the client, and therefore it cannot be the Member's responsibility to advise a client before execution of an unsuitable transaction.

**MFDA Response**

The reference to Member in the Proposed Amendments is intended to include Approved Persons acting as employees and agents of the Member. Although in practice the Approved Person would be responsible for advising the client that a transaction proposed by the client is unsuitable, as a general principle the Member is responsible for establishing and implementing policies and procedures to ensure that the client is in fact advised in accordance with the Proposed Amendments.

**2. Transactions Proposed by Clients**

One commentator noted that investment decisions are often arrived at following lengthy discussions between the client and the salesperson, which makes it very difficult to determine to what extent a transaction was proposed by the client. The commentator stated that requiring that a transaction be proposed by the client does not enhance consumer protection given that the Member already has a duty to ensure that recommendations made by a salesperson are otherwise suitable.

**MFDA Response**

The fundamental principle underlying Rule 2.2.1 is that all recommendations made to a client should be suitable. The obligation imposed on the Member under the Proposed Amendments where an unsuitable transaction is proposed by a client is one of due diligence. Rule 5.1(b) requires a Member to keep an adequate record of each order, and of any other instruction, given or received for the purchase or sale of securities, whether executed or unexecuted. Where an unsolicited order is determined to be unsuitable for a client, the record of the order pursuant to Rule 5.1(b) should include evidence that:

- (i) the transaction was unsolicited;
- (ii) the Member performed a suitability review; and
- (iii) the Member advised the client that the proposed transaction was unsuitable.

**3. Obligation of Member to Make a Suitability Determination for Unsolicited Orders**

One commentator submitted that the Proposed Amendments as drafted renders unclear the obligation of Members and their Approved Persons to make a suitability analysis for unsolicited orders by removing the requirement that Members use due diligence to ensure that "each order accepted" for any client account be suitable for the client. The commentator stated that the obligation of a Member to make a suitability determination for unsolicited orders must instead be implied from the Member's obligation to advise

the client that a proposed transaction is not suitable. The commentator was of the view that the Proposed Amendments leave open an argument that a suitability determination is not required with respect to unsolicited orders and that Members and their Approved Persons need only use due diligence to advise the client where they recognize that the transaction in question is unsuitable for the client.

The commentator further submitted that the Proposed Amendments may soften a Member's existing obligation with respect to unsolicited orders that are unsuitable for a client. The commentator stated that in some circumstances a Member may be obligated to refuse to execute an order desired by a client on the basis that it is unsuitable for the client. The commentator submitted that the Proposed Amendments would arguably remove this existing obligation by specifying that a Member's only obligation with respect to an unsuitable order is to advise the client before executing it. The commentator suggested that Rule 2.2.1 be amended to state that in some circumstances it may be appropriate for a Member to refuse to execute an unsolicited order on the basis that it is unsuitable for the client. Alternatively, the commentator suggested that a statement to this effect could be included in the commentary to the Rule when it is adopted. The commentator submitted that the latter approach would be preferable because a decision to refuse an order will be based on the Member's judgment on the circumstances of each case. If this approach were adopted, the commentator suggested that the amended Rule should clarify that advising the client that a proposed transaction is unsuitable is a minimum requirement.

The commentator suggested that the reference to "each order accepted" be retained in paragraph (c) of Rule 2.2.1 and that the amended rule specify how, at a minimum, an unsolicited order that is found to be unsuitable for the client must be handled.

**MFDA Response**

The MFDA agrees with the commentator's submission with respect to clarifying the drafting of the Proposed Amendment with respect to the obligation of Members and their Approved Persons to make a suitability determination for unsolicited orders. Appendix "B" provides a blacklined version of the amendments to Rule 2.2.1 indicating the changes from the previously published version.

The MFDA will also issue a companion notice when the Proposed Amendments are adopted clarifying that a Member is not obligated to accept an order from a client that is determined by the Member to be unsuitable. The notice will state that the decision as to whether or not to refuse such a trade is an internal policy decision of the Member. Further, the notice will remind Members of their record-keeping requirements as set out in the MFDA response under heading 2 "Transactions Proposed by Clients" above with respect to unsuitable, unsolicited orders.

**APPENDIX "B"**

**The Final Amendments to Rule 2.2.1 Regarding  
"Know-Your-Client"**

- 2.2.1 "Know-Your-Client". Each Member shall use due diligence:
- (a) to learn the essential facts relative to each client and to each order or account accepted;
  - (b) to ensure that the acceptance of any order for any account is within the bounds of good business practice;
  - (c) to ensure that each order accepted or recommendation made for any account of a client is suitable for the client and in keeping with the client's investment objectives; and ~~in any event where a transaction proposed by a client is not suitable for the client and in keeping with the client's investment objectives, the Member shall so advise the client before execution thereof.~~
  - (d) to ensure that, notwithstanding the provisions of paragraph (c), where a transaction proposed by a client is not suitable for the client and in keeping with the client's investment objectives, the Member has so advised the client before execution thereof.