

# Perfect Regulatory Storm

## Regulatory perspectives on suitability

### COMPLIANCE MATTERS BY REBECCA COWDERY AND PREMA THIELE

You can be excused from feeling overwhelmed at the amount of regulatory reading material coming at you this spring. Along with the voluminous registration reform proposals released by the Canadian securities regulators and the Investment Dealers Association (IDA) in February, the Mutual Fund Dealers Association (MFDA) recently released Member Regulation Notice 69 Suitability Guidelines. This brings to three the number of regulatory publications published in 2008 that focus on dealers' suitability requirements.

This much is clear – each of the securities regulators and the SROs have embarked on an effort to not only clarify, but also to ramp up the suitability requirements for dealers and advisors, given the continuing concerns that retail investors are being placed into inappropriate investments that do not fit their risk profile.

### REASONABLE STEPS

Suitability requirements refer to the long-standing requirements that a registrant take “reasonable steps” to ensure that before it makes a recommendation to, or accepts instructions from, a client, the proposed purchase or sale is suitable for the client with reference to the client's financial circumstances, risk tolerance, investment knowledge and investment

needs and objectives. Securities regulators also expect an advisor to inform a client that a particular security is inappropriate or unsuitable if the client asks to invest in a security that does not fit the client's risk profile. An advisor can only proceed with an unsuitable trade if the client insists.

Suitability requirements are intrinsically linked to the requirements that dealers and advisors “know their client.” It is only through understanding the client's specific circumstances that a dealer and advisor can make a suitable recommendation for any particular purchase or sale.

### Securities regulators propose to lessen the regulatory burden on registrants.

Curiously, the securities regulators propose to lessen the regulatory burden on registrants concerning ensuring suitability compliance. Proposed National Instrument 31-103 Registration Requirements, published for a second comment period in February 2008, contains the concept that a so-called “permitted client” [essentially a super-accredited investor] can waive the dealer's suitability obligations by doing so “in writing.” Notwithstanding the oddness of the notion that a registrant can make an unsuitable recommendation to a particular class of super-accredited investors, this provision appears to be designed

to excuse the registrant from the procedures built up to ensure compliance with the suitability requirements.

However, as drafted, the suitability requirements in proposed NI 31-103, including the ability for permitted clients to waive “suitability,” will not apply to a dealer that is a member of the IDA or the MFDA. Those dealers will be exempt from the rules in proposed NI 31-103, provided they comply with the applicable IDA and MFDA rules. This means that an SRO-member dealer will not be able to take advantage of the permitted client waiver exemption written into proposed NI 31-103.

The IDA suggests that advisors and dealers must undertake periodic suitability reviews – that is, review each account for overall suitability upon the occurrence of one or more specified triggering events. These triggering events include opening new client accounts, transferring in securities into a client account, changes in advisors for an account and material changes to a client's life circumstances or that could result in revisions to the client's KYC information.

IDA members must also disclose in the proposed relationship disclosure information whether or not the member conducts ongoing periodic monitoring of the suitability of investments that is in addition to the mandatory re-

views, and if so, the annual cost of such a service.

The MFDA's Notice 69 clarifies, but also expands on the basic suitability and KYC requirements that apply to MFDA members and their advisors. Similar to the IDA



Cowdery



Thiele

proposals, the MFDA suggests that advisors should conduct suitability analysis and confirm or amend KYC information within a reasonable period of time after the occurrence of stated triggering events – when a client transfers an account or a client transfers securities, when the dealer or the advisor becomes aware of a material change in the client's KYC information and when a client is reassigned from one advisor to another. The MFDA does not discuss the concept of IDA's ongoing suitability reviews.

### OBJECTIVE ASSESSMENT

The MFDA's recommendations for approaching suitability are detailed and cover new ground.

Suitability is always an “objective” assessment – by reviewing the investments against the KYC information, an advisor can assess whether the investment is suitable for the client. A conservative approach is recommended – for example, if a client's profile indicates that he or she has a medium risk tolerance, then no high-risk securities can be recommended for that client. Generally an exempt security (one that is distributed without a prospectus) should be considered to be a high-risk investment that will be unsuitable for a client that does not have a high-risk profile. Dealers must ensure they have appropri-

ate compliance systems in place whereby unsuitable trades will be identified and flagged for further follow-up. All trades in securities, whether mutual funds or exempt securities such as PPNs, must be subject to a suitability analysis. Advisors cannot consider other assets held by a client in doing a suitability analysis and must focus solely on the accounts the client holds with the MFDA dealer. The existence of a signed order or trade form will not lessen the suitability obligation and the MFDA considers that these documents will not constitute a valid defence to a claim that a particular trade or recommendation was unsuitable.

MFDA rules require amendment before the MFDA's approach is entirely legally enforceable but much in Notice 69 is simply the MFDA's interpretation of existing requirements. Given the perfect storm of regulatory focus on suitability, this is not the time to be guessing at regulatory responsibilities, so consider the notices and ask questions. **AER**

*Rebecca Cowdery and Prema Thiele are securities lawyers focusing on legal matters associated with the securities, investment management and insurance industries. They are partners in the Toronto office of Borden Ladner Gervais LLP. Their column appears regularly and deals with compliance and regulatory issues. The views expressed in their columns are their own and are not necessarily the view of other lawyers at BLG, the firm or its clients. No person should act or refrain from acting in reliance on any information found in these columns without first obtaining appropriate professional advice.  
rcowdery@blgcanada.com and pthiele@blgcanada.com*