



Canadian Foundation *for*  
Advancement *of* Investor Rights

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Dear Sir and Madam,

**RE: Request for Comment Plain language rule re-write project - Dealing with clients, Proposed Rules 3400-3900**

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## 1. Background

- 1.1. We are pleased to provide you with the comments of the Canadian Foundation for Advancement of Investor Rights (“**FAIR Canada**”), in response to the Request for Comments (the “**RFC**”) by the Investment Industry Regulatory Organization of Canada (“**IIROC**”) on the Plain Language Rule Re-write project Dealing with Clients, Proposed Rules 3400-3900 (the “**Proposed Rules**”).
- 1.2. FAIR Canada is a national, non-profit organization that advocates for stronger investor protections in securities regulation. Visit [www.faircanada.ca](http://www.faircanada.ca) for more information.

## 2. General Comments on the Proposed Revisions

- 2.1. Broadly, we agree with the Proposed Rules. Our comments will focus on the rewritten Proposed Rule 3400, *Suitability* as well as its relevant Guidance Note 3400-1 *Recommendations* (the “**Suitability Rules**”). This letter will begin with our comments on this rule, first with general comments and then will provide specific comments on the drafting of certain sections. Following this, we make specific comments regarding certain other sections of the Proposed Rules.
- 2.2. National Instrument 31-103 is the statutory basis on which proposed Rule 3400 is founded. Section 13.3 of NI 31-103 provides that:

### *Suitability*

- (1) *A registrant must take reasonable steps to ensure that, before it makes a recommendation to or accepts an instruction from a client to buy or sell a security, or makes a purchase or sale of a security for a client’s managed account, the purchase or sale is suitable for the client.*
- (2) *If a client instructs a registrant to buy, sell or hold a security and in the registrant’s reasonable opinion following the instruction would not be suitable for the client, the registrant must inform the client of the registrant’s opinion and must not buy or sell the security unless the client instructs the registrant to proceed nonetheless.*
- 2.3. FAIR Canada supports IIROC’s initiative, in combination with the plain language rule re-write project, to be clearer about the precise nature of a “suitable” order or recommendation, and to provide more guidance regarding both policy and best practices for making and executing suitable orders and recommendations. However, FAIR Canada does not consider the current Proposed Rule 3400 to be: (1) sufficiently strong or comprehensive to properly guide either investors or dealers as to the nature of a suitable order or recommendation; or (2) sufficiently precise in defining both suitability itself and the best practices to be taken to ensure suitable orders and recommendations. We also suggest that the suitability obligation should apply on an ongoing basis to client accounts (such as through regular reviews).
- 2.4. The requirement for registrants to make suitable recommendations and counsel investors regarding suitable orders is one of the bedrock principles of Canadian securities regulation. However, this requirement and the allied requirement that registrants know their clients (the “**KYC requirements**”) are very poorly understood by investors and indeed by the industry. Half of the investment cases opened by the Ombudsman for Banking Services and Investment (“**OBSI**”)

in 2009 were related to the suitability of investments<sup>1</sup> and such cases formed a majority of OBSI's investigations. Failing to meet KYC and suitability requirements (and thereby failing to understand and meet clients' needs) and failing to properly explain investment characteristics and risks were identified by OBSI as the principal causes of these complaints.

- 2.5. The proposed Suitability Rules do not provide a clear, comprehensive summary of the obligations of Dealer Members to ensure suitability and do not provide a clear roadmap to ensuring compliance with the Suitability Rules. Instead, Rule 3400 has been drafted in a way that is overly vague. Terms such as "due diligence" are not adequately explained. Specific guidelines as to additional factors that need to be considered in determining suitability are lacking (we will discuss some specific ones in detail in the second part of our letter).
- 2.6. **Scope of Suitability.** Furthermore, we consider it important that the Suitability Rules should make clear that any and all factors that may make an investment unsuitable for a client must be considered by the Dealer Member and the Registered Representative in determining suitability. This is the case whether or not the factors are enumerated within the Suitability Rules and whether or not they form an enumerated part of the Dealer Member's KYC obligations.
- 2.7. **Need for Greater Guidance.** FAIR Canada considers there to be an urgent need for guidance for both Dealer Members and investors on the Suitability Rules, which is not provided by the proposed draft. We do not have a particular preference about the form of this guidance, whether it takes the form of a Rule, a Guidance Note or some other published guidance. However, there are three principal reasons why additional detailed written guidance is needed for all stakeholders:
- Complex investment products, especially complex tax-motivated investment structures, complex leveraging arrangements and an increasing appetite for worldwide exposure among investors, have made it increasingly difficult for investors themselves (as well as Dealer Members) to determine whether certain products are suitable.
  - The Suitability Rules themselves are not understood by investors and investors are unable to assess a Dealer Member's compliance without further guidance as to the precise nature of the Rules and how they are to be applied in particular cases. The general provision that an investment must be "suitable" and the short enumerated list of factors do not provide investors with the tools they need to knowledgeably assess whether a Dealer Member has effectively followed the Suitability Rules. We consider this particularly important because most retail clients of Dealer Members will have little knowledge of, or sophistication about,

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<sup>1</sup> OBSI 2009 Annual Report, available at [http://www.obsi.ca/UI/ar2009-eng/downloads/obsi\\_ar09\\_rev\\_overview.pdf](http://www.obsi.ca/UI/ar2009-eng/downloads/obsi_ar09_rev_overview.pdf).

the Suitability Rules. Ensuring that the Suitability Rules (and their interpretation) are clear and comprehensible to investors must be an IIROC priority.

- Compliance is easier to establish and easier to monitor when rules are precise and detailed rather than vague and subject to many interpretations. Compliance in such matters is almost universally arrived at through careful establishment of and adherence to internal policies and procedures by Dealer Members and their Registered Representatives.

2.8. FAIR Canada is concerned that the redrafted Suitability Rules do not make the precise nature of the Suitability Rules adequately clear. Ensuring that the Suitability Rules are drafted in plain English, while helpful, is not enough. Through industry practice and through IIROC guidance and decision-making (as well as Securities Commission decisions and other sources of jurisprudence) a great deal of experience goes into practical compliance with the Suitability Rules. Yet the average retail investor will know nothing of this, certainly not unless she or he retains counsel – an event that presupposes that retail investors will suspect or know that their investment is unsuitable.

2.9. **Guidance to Investors and Industry.** FAIR Canada would therefore like to see IIROC provide more comprehensive guidance, either through a revision to the proposed Suitability Rules, or through Guidance Notes or other published guidance. We reiterate our submissions from December 2009 on the draft “Know your client and Suitability Guidelines” Guidance Note:

- IIROC should draft a detailed Guidance Note geared toward Dealer Members, to provide comprehensive guidelines on the application, implementation and administration of the KYC and suitability rules, incorporating detailed descriptions of best practices and best policies to apply and implement these rules; and
- IIROC should provide a manual for retail investors (either published as a Guidance Note or as other written guidance, but available to investors in readable, plain language) that explains the rights of investors and the obligations of dealers regarding KYC and suitability; that explains the difference between these obligations and a fiduciary or “best-interest” obligation; and explains to investors how they can safeguard and enforce their rights regarding KYC and suitability obligations.

2.10. FAIR Canada would also like to take this opportunity to point out a more general problem with the framework of “suitability” as the fundamental responsibility of Dealer Members. We believe that the current definition of “suitability” is inappropriate as a basis for the regulation of the activities of Dealer Members. Under the current definition of suitability, an investment may be “suitable” but not in the client’s best interests. We believe that the fundamental framework

upon which Dealer Members' activities should be regulated is one where a Dealer Member is required to put the client's best interests first. This may be achieved through the definition of suitability or through a separate rule.

- 2.11. This would require Dealer Members and Registered Representatives to provide advice that prioritizes a client's best interests over all other interests (unless by clear mutual agreement, advice is not to be provided), and that puts the client's best interests first in determining when and how that advice is provided.
- 2.12. Dealer Members and Registered Representatives are already required, in certain aspects of their relationships with clients, to prioritize the best interests of their clients. In section 13.4 of the Companion Policy to NI 31-103, there is a directive to Dealer Members to consider whether any of their particular benefits, compensation or remuneration practices are inconsistent with their obligations to clients, and particularly where the firm relies heavily on commission-based remuneration. Similarly, section 13.5 of the Companion Policy provides guidance on referral arrangements that specifically directs Dealer Members to consider whether an unreasonably high fee may create a conflict that "could motivate its representatives to act contrary to their duties toward their clients."
- 2.13. FAIR Canada considers that such a standard is an appropriate one for an industry that holds itself out as a profession which provides advice to clients and which is fundamental to the economic well-being of Canadians. Dealer Members, through their role in modern life and the modern economy, are placed in a position of enormous trust, yet their advice is not held to high standards by the current regulatory system.
- 2.14. FAIR Canada also has specific recommendations to be made regarding the drafting of the current Suitability Rules, which we explore in the next section of our letter.

### **3. Specific Comments on the Suitability Rules**

- 3.1. We now turn our attention to certain specific aspects of the Suitability Rules as drafted.
- 3.2. Proposed subsection 3402(2) has been revised to take into account IIROC expectations of Dealer Members regarding suitability, by specifically stating that suitability of account type, trading strategy, order type and financing be considered in determining whether an order or recommendation is suitable. Proposed subsection 3403(1) enumerates several other factors: the client's financial situation, investment knowledge, investment objectives and risk tolerance.
- 3.3. We recommend that IIROC add a reference to the cost to the client of the product as compared

to comparable products and the value of the service or advice being provided relative to the fees charged.

- 3.4. We consider proposed subsection 3402(2) to be a worthwhile addition to the Suitability Rules as drafted. However, although the specific injunction to consider such factors is important and appropriate, we would reiterate our concern expressed above that the enumeration of such factors is not sufficient in order to properly identify to both investors and Dealer Members the elements to be considered in determining whether an order or recommendation is suitable. Furthermore, we consider the addition of these particular enumerated factors to create the dangerous appearance of completeness, when in fact there are many additional factors that may determine suitability. FAIR Canada would therefore propose additional language (which we have bolded) in the preamble to proposed subsection 3402(2), so that it would read “In order to comply with the requirements set out in 3402(1), **following due diligence and in addition to all the client’s other relevant characteristics**, each Dealer Member must consider:”
- 3.5. FAIR Canada would also propose additional language (which we have bolded) in proposed subsection 3403(1), so that it would read:
- In order to comply with the requirements set out in section 3402, the suitability of an order for a retail client or a recommendation made to a retail client must be assessed based on **all relevant** factors including **(but not limited to)** the client’s financial situation, investment knowledge, investment objectives and risk tolerance and cost to the client.*
- 3.6. **Firm Responsibility for Compliance.** FAIR Canada would also like to offer a proposed amendment to subsection 3403(2) regarding the responsibility for ensuring compliance with KYC and suitability requirements. Proposed subsection 3403(2) makes this “primarily the responsibility of the Registered Representative”. We believe this is a mistake of emphasis. It is certainly not borne out by National Instrument 31-103 or its Companion Policy, both of which make clear that the obligation to ensure suitability of orders and of recommendations is an obligation of each registrant. Section 13.3 of NI 31-103 is particularly clear on this point. Force of law should, we feel, encourage IIROC to allocate responsibility for compliance with Suitability Rules equally between Dealer Members and Registered Representatives.
- 3.7. In addition to NI 31-103, we feel strongly that Dealer Members, who will set policy and procedures for Registered Representatives to follow, are best placed to enforce and ensure compliance. The Dealer Members are in the best position to assess whether the procedures and policies that ensure suitable recommendations and orders are working. We think this is consistent with the position implicit in Proposed Rule 3948 *Suitability of client orders and recommendations* which provides that Dealer Members must supervise suitability compliance by

its registered representatives.

- 3.8. We therefore would like to offer a proposed revision to subsection 3403(2) so that it reads “equally the responsibility of the Registered Representative and of the Dealer Member.”
- 3.9. **Execution-Only Services.** FAIR Canada would also like to offer a proposed revision to proposed section 3406 *Order execution-only services*. Currently, a Dealer Member allowing order-execution only trades inside an advisory account must ensure that procedure terminology is properly updated, that record-keeping take into account labelling of trades as recommended or non-recommended, and disclose in reporting to the client whether trades were recommended or non-recommended. However, although Dealer Members must “maintain records of complaints or requests from customers to change the designation of a trade as recommended or non-recommended” there is no corresponding requirement for Dealer Members to notify clients of their right to request such a change of designation. There is also no requirement to explain to clients the purpose of labelling trades as recommended or non-recommended and the purpose for which such distinctions are maintained (and the loss of customer rights that may occur as a result).
- 3.10. We would propose, therefore, that subsection 3406(2) be changed to incorporate a requirement that where a Dealer Member allows order-execution only trades in an advisory account, it must:
- (v) Disclose on the monthly activity portion of the monthly statements that labelling of trades as “non-recommended” may result in a significant impairment to the customer’s rights regarding such trade, and that if such a trade has been mislabelled that the customer may contact the Dealer Member in a specific, appropriate manner to request that the designation be changed.*
- 3.11. **Permitted Clients.** We question the logical basis for retail investors’ being able to waive the suitability obligation based on a test that focuses on net worth rather than on the investor’s knowledge and experience and the need for a suitability obligation. We recommend that the ability of a “permitted client” to waive the suitability obligation be eliminated or, at the very least, that the test for a “permitted client” be revised to focus on the needs of the client rather than on the dollar value of the client’s net worth. In this regard, we refer to the “sufficient sophistication and capability” test for institutional clients described in the next paragraph.
- 3.12. **Institutional Clients.** We would also like to offer one final minor proposed revision to the Suitability Rules. In subsection 3404(2), dealing with determining suitability for institutional clients, the proposed Suitability Rules state that a Dealer Member’s suitability obligation is fulfilled when it has “concluded, on reasonable grounds, that the Institutional Client has sufficient sophistication and capability to make its own investment decisions....” We would like to

suggest that the phrase “and after reasonable due diligence” be added after the phrase “on reasonable grounds,”.

#### **4. Specific Comment on Other Proposed Rules**

- 4.1. Although the bulk of our comments concern the new Suitability Rules, we have one comment related to other Proposed Rules.
- 4.2. We discussed above, in section 3.7, Proposed Rule 3948 *Suitability of client orders and recommendations* which provides that Dealer Members must supervise suitability compliance by its Registered Representatives. In keeping with the changes suggested above in section 3.8, that Registered Representatives and Dealer Members be equally responsible for ensuring suitable orders and recommendations, we suggest a change to Proposed Rule 3948 to include “, and those of the dealer,” after the word “responsibilities”.

We welcome the publication of these comments by IROC either as is or in summary form, and we would also be happy to speak to you further about these comments or to provide further information. Please do not hesitate to contact Ermanno Pascutto at 416-572-2282/[ermanno.pascutto@faircanada.ca](mailto:ermanno.pascutto@faircanada.ca) or Ilana Singer at 416-572-2215/[ilana.singer@faircanada.ca](mailto:ilana.singer@faircanada.ca).

With thanks and regards,



FAIR Canada (Canadian Foundation for Advancement of Investor Rights)