

FAIR

Canadian Foundation *for*
Advancement *of* Investor Rights

December 1, 2009

Sherry Tabesh-Ndreka, Policy Counsel
Investment Industry Regulatory Organization of Canada
121 King Street West, Suite 1600
Toronto, Ontario
Canada M5H 3T9
Fax: (416) 943-6760
Email: stabesh@iiroc.ca

Re: Request for comments on draft Guidance Note: "Know your client and Suitability Guidelines"

We are pleased to provide you with the comments of the Canadian Foundation for Advancement of Investor Rights (FAIR Canada), in response to IIROC's request for comments on the proposed know your client (KYC) and suitability guidance notice.¹

FAIR Canada is a non-profit, independent national organization founded in 2008 to represent the interests of Canadian investors in securities regulation. Additional information about FAIR Canada, its governance, and priorities is available on our website at www.faircanada.ca.

Summary

FAIR Canada supports IIROC's initiative to provide more guidance on the KYC and suitability obligations of investment dealers. The suitability of investments is traditionally the largest source of client complaints filed with dealers, and suitability obligations are more important than ever with the increasing number and complexity of investment products available. We believe that many dealers would welcome more detailed guidance on how the regulators will administer and interpret the rules. However, the need for guidance applies to investors as well as dealers. Most retail clients do not understand the suitability obligation, or their rights and responsibilities under it.

It is FAIR Canada's submission that in addition to developing guidelines for IIROC's members, IIROC should develop educational materials for retail investors. Investors need to better understand the KYC and suitability requirements. Since investors are IIROC stakeholders, their needs should also be addressed.

FAIR Canada is of the view that the proposed guidelines for members are not comprehensive

¹ IIROC Notice 09-0293 issued on October 2, 2009

or clear enough. FAIR Canada proposes that IIROC should undertake an initiative to develop stronger and more extensive guidance to both its Dealer Members and investors on the KYC and suitability regime.

The Proposed Guidelines

The proposed guidelines include some useful guidance, particularly the importance of taking into account the client's personal circumstances including the time horizon. The requirements for compulsory updates and periodic suitability reviews, any time there is a material change and at least annually, are steps forward. Proposed standard procedures to handle inappropriate unsolicited orders are also clearly necessary.

However, the proposed guidelines do not provide a comprehensive and clear summary of Dealer Members' obligations under IIROC's rules, or of how IIROC interprets these obligations.² The guidelines also do not explain how members should implement the rules. Some useful best practices are set out, but to a large degree the guidelines focus on technical details such as account opening procedures. The proposed guidelines do not provide a thorough list of best practices. Instead, it appears that one of the main purposes of the guidelines is to recommend adoption of practices that would become mandatory under the proposed "client relationship model" rules, but that are not currently in effect.

Investors' and Dealers' Need for Guidance

It is FAIR Canada's submission that both investors and investment dealers have a significant need for more extensive guidance on the KYC and suitability rules, for a number of reasons. These include:

- Suitability issues are the top source of client complaints, and a major source of litigation and alternative dispute resolution claims against investment dealers. They are a major source of protection for clients, as well as a major risk for dealers. Therefore more guidance on these issues would be particularly useful.
- The increasing number and complexity of investment products makes the suitability rules more important than ever to safeguarding clients' interests particularly given the proliferation of firms' proprietary products and structured products that are more complicated than traditional "plain vanilla" securities. These trends also make administration of suitability obligations more complex for dealers. IIROC and other regulators have recognized this point in clarifying and providing guidance on "know your product" obligations, which are necessary to support suitability obligations.
- Most investors do not understand either the KYC process or what suitability entails. Many investors believe that investment dealers and their individual financial advisors

² FAIR Canada notes that the Mutual Fund Dealers Association of Canada (MFDA) issued more comprehensive guidelines on suitability to its members in 2008 (MFDA Notice MR-0069). These guidelines are very useful, but FAIR is not advocating that IIROC simply produce a similar set of guidelines. In addition to explaining an investment dealer's regulatory obligations in detail, we think it would be very useful for IIROC to support effective implementation of the rules by providing guidance to its members on how to implement the regulatory requirements through internal policies and procedures, and on industry best practices in the field.

have fiduciary obligations to clients. They often do not appreciate that they are entering into a legal contract when they complete a new client application form. In fact, many investors see (or are told) that KYC and account opening procedures are bureaucratic requirements imposed by regulators. There is a real need to explain to investors what KYC and suitability rules are, why they exist and why they are important to the investor. Investors need to understand the difference between fiduciary obligations and suitability requirements. Investors also need advice on what steps they should take to ensure that the KYC and suitability requirements are applied effectively in handling their investments.

- Dealers must maintain thorough policies and procedures to ensure compliance with KYC and suitability rules. These include detailed supervisory procedures to ensure that account activity is monitored, in large part for compliance with KYC and suitability rules. The industry would benefit from additional guidance on 1) how the regulators apply and interpret the rules, 2) how dealers should implement the rules, 3) firms' policies and procedures, and 4) industry best practices. Such guidance would promote better understanding of the requirements and support more effective compliance.

Legal commentators and other experts have written much about the nature of KYC and suitability rules, and how to address them. Many investment firms have internal policies that attempt to explain the rules, in addition to the necessary policies and procedures on complying with the rules. Compliance advisors and firms have a range of policies and interpretations about the nature of KYC and suitability obligations, and how to implement them. Both the industry and investors would benefit from a better understanding of the rules and more consistent industry standards in their application. IIROC is the appropriate organization to articulate best practice standards.

In summary, FAIR Canada is of the view that IIROC has an opportunity to meet a significant need in the marketplace by preparing authoritative and comprehensive guidance for its two core stakeholders: its regulated members and retail investors. Since these two audiences have different needs and levels of understanding of the regulatory system, we believe that two different sets of materials are needed.

Recommendation

FAIR Canada recommends that IIROC issue more comprehensive guidance on the know your client and suitability obligations of its Dealer Members in two forms:

- 1) For its Dealer Members: a detailed guidance note or manual that provides comprehensive guidelines on the application, implementation and administration of the KYC and suitability rules;
- 2) For retail investors: a manual written in plain language that explains the KYC and suitability obligations and the rights of investors, and provides related advice on dealing with investment firms and advisors.

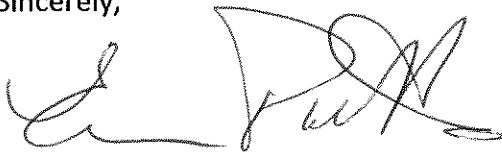
FAIR Canada suggests that the investors' manual cover:

- 1) Investors' Rights – Explain the KYC and suitability obligations of investment dealers, and the benefits of these requirements for clients;
- 2) Limitations of KYC and Suitability – Explain the difference between fiduciary duties and suitability requirements.
- 3) Advice for Investors – Outline the steps investors should take to ensure that those obligations are met, their KYC information stays up-to-date, and their investments remain suitable.

FAIR Canada also recommends that IIROC issue its draft guidance note and manual for public comment, so that investors, member firms and other interested parties have an opportunity to participate in the process.

We would be pleased to discuss our comments with you in more detail, including ideas about content for the suggested guidance note and manual.

Sincerely,

A handwritten signature in black ink, appearing to read 'E. Pascutto', written over a horizontal line.

Ermanno Pascutto, Executive Director
Canadian Foundation for Advancement of Investor Rights