

## Canadian Securities Administrators Staff Notice 33-315 Suitability Obligation and Know Your Product

September 2, 2009

This notice reminds registrants of their duty under securities law to satisfy their suitability obligations to clients, including the requirement to fully understand the products recommended to clients. It also provides guidance to registrants on how to meet their obligations.

### 1. Suitability Obligation

Securities law requires registrants to determine whether a proposed purchase or sale of a security<sup>1</sup> for a client is suitable.<sup>2</sup>

There are two key requirements for determining suitability. Registrants must understand:

1. the general investment needs and objectives of their client and any other factors necessary for them to be able to determine whether a proposed purchase or sale is suitable (know your client or KYC), and
2. the attributes and associated risks of the products they are recommending to clients (commonly referred to as know your product or KYP)

Registrants must meet the KYC and KYP requirements in order to make the suitability determination required by law. This notice focuses on the KYP requirement.

### 2. Know Your Product

Registrants must understand the structure and features of each investment product they recommend. This includes costs, risks and eligibility requirements. The KYP requirement applies to both the firm and the individual.

We expect firms to have a process for reviewing and approving new products and existing products whose structure or features have significantly changed. However, if a product is on the firm's "approved list", it does not mean that it will be suitable for all clients. Individual registrants must still determine suitability of each proposed transaction for each client.

KYP applies to all investment products whether or not they are sold under a prospectus. The extent of the product review process will depend on the structure and features of the product.

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<sup>1</sup> In Alberta, British Columbia, Saskatchewan and as of September 28, 2009, New Brunswick, a reference to "security" in this notice includes "exchange contract".

<sup>2</sup> The requirement to assess whether the purchase or sale of securities is suitable for a client is in section 13.3 of National Instrument 31-103 – *Registration Requirements and Exemptions* (NI 31-103). Before NI 31-103, provincial securities laws imposed similar suitability requirements.

For example, complex investment products (including those that are novel or not transparent in structure) may require a more extensive review than more straightforward products. Products that are sold under a prospectus exemption may require a more extensive review because of the limited disclosure available about them.

### **3. Individual Registrants**

The firm's approval of an investment product alone does not satisfy KYP. Individual registrants must thoroughly understand a product before they can determine whether it is suitable to recommend the product to a client. Firms may want to provide product training to ensure that their representatives can conduct their suitability review with an appropriate understanding of the products and their risks.

Although firms may set out general investor profiles describing the type of investor for whom a product may be suitable, individual registrants must still determine suitability on each transaction for a client. Individual registrants should also explain the risks of products they are recommending to their clients.

Unless a registrant can rely on a specific exemption from its suitability obligation, a registrant has a suitability obligation to all clients, including accredited investors and investors who buy a product under a prospectus exemption. Individual registrants may not delegate their suitability obligations to their client, another registrant or anyone else.

### **4. Product Review Process**

The firm's product review process should include procedures for identifying, reviewing and approving (or rejecting) new products and for monitoring existing products for significant changes to those products.

Registered firms must have the appropriate skills and experience to perform their own analysis of all products they recommend to clients. They cannot recommend a product based solely on:

- information from issuers or other third parties, including related parties, about the product's suitability or risk profile
- similarities with other products, or
- recommendations made by other market participants to their clients

Registrants should consider factors such as product features and structure, including risks, costs, management and financial strength of the issuer. They should also determine whether expected returns are realistic. Registrants will also need to re-evaluate an existing product if a change to a key feature causes significant changes to the risk and return profile of the product.

Listed below are some factors that registrants should consider when assessing investment products.

#### ***General Features and Structure***

- basis of security's return (e.g. minimum return, dividends, interest rate)
- use of leverage

- conflicts of interest arising from the compensation structure or other factors
- overall complexity, transparency and uniqueness of features of the product's structure

### ***Risks***

- the possibility that a client may lose some or all of the principal amount invested
- risks relating to the product, such as liquidity risk (including redemption rights and any features that lock in the principal and/or returns for a specified period), price volatility, default risk, and exposure to counterparty risk
- risks related to assets underlying derivatives or structured products

### ***Costs***

- fees paid to registrants or other parties, such as commissions, sales charges, trailer fees, management fees, incentive fees, referral fees and early redemption fees
- embedded costs, such as bid-ask spreads or other expenses

### ***Parties Involved***

- the issuer's financial position and history
- qualifications, reputation and track record of the parties involved in key aspects of the product, for example, the fund manager, portfolio manager, product manufacturer or sponsor, any guarantors and significant counterparties

### ***Legal and Regulatory Framework***

- any laws or rules of self-regulatory organizations that apply to the registrant
- if distributed under an exemption, whether the product meets the requirements of that exemption
- legal characteristics of derivatives and structured products (e.g. jurisdiction of special purpose vehicles, bankruptcy protection and RSP eligibility)
- frequency, completeness and quality of the issuer's disclosure

## **5. Policies and Procedures**

Registrants should establish and enforce written policies and procedures to ensure that they satisfy their KYC and suitability obligations, including KYP. These policies and procedures should include the steps the registered firm and registered individuals should follow to identify investment products requiring review, the process to review these products, and how to assess the suitability of a product for each client. All firms should have these written policies and procedures, regardless of the firm's size. Firms should monitor and assess compliance by the firm and its individual registrants.

## **6. Guidance from Self-Regulatory Organizations**

The Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association of Canada (MFDA) have issued the following notices addressing their members' know your product and suitability obligations:

- IIROC Notice 09-0087 Best practices for product due diligence dated March 23, 2009
- MFDA Member Regulation Notice MR-0048 *Know-Your-Product* dated October 31, 2005, and

- MFDA Member Regulation Notice MR-0069 *Suitability Guidelines* dated April 14, 2008

### Questions

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