



PRIVATE CAPITAL MARKETS ASSOCIATION
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THE NATIONAL VOICE OF EXEMPT MARKET DEALERS, ISSUERS AND INDUSTRY PROFESSIONALS

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Compliance Corner

Client Suitability

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Agenda

- ▣ Background
- ▣ The Philosophy of Suitability
- ▣ Building a Suitability Culture in Your Firm
- ▣ Best Practices Around KYP
- ▣ Know-Your-Client
- ▣ Client Directed Trades
- ▣ Recent Cases
- ▣ Resources



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Suitability is not a new Requirement



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- ❑ KYC and Suitability were previously combined – a single requirement
- ❑ The working group responsible for NI 31-103 separated the components
- ❑ Increased focus on the Know Your Product aspect, especially for private securities
- ❑ There was always acknowledgement by the securities commissions and the courts of the three prongs of suitability



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Three Components

- ▣ Client due diligence
- ▣ Product due diligence
- ▣ Application of sound professional judgement



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“KYC information forms the basis for determining whether trades in securities are suitable for investors.”

- Companion Policy 31-103CPI



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“To meet this suitability obligation, registrants should have in-depth knowledge of all securities that they buy and sell for, or recommend to, their clients.”

- Companion Policy 31-103CPi



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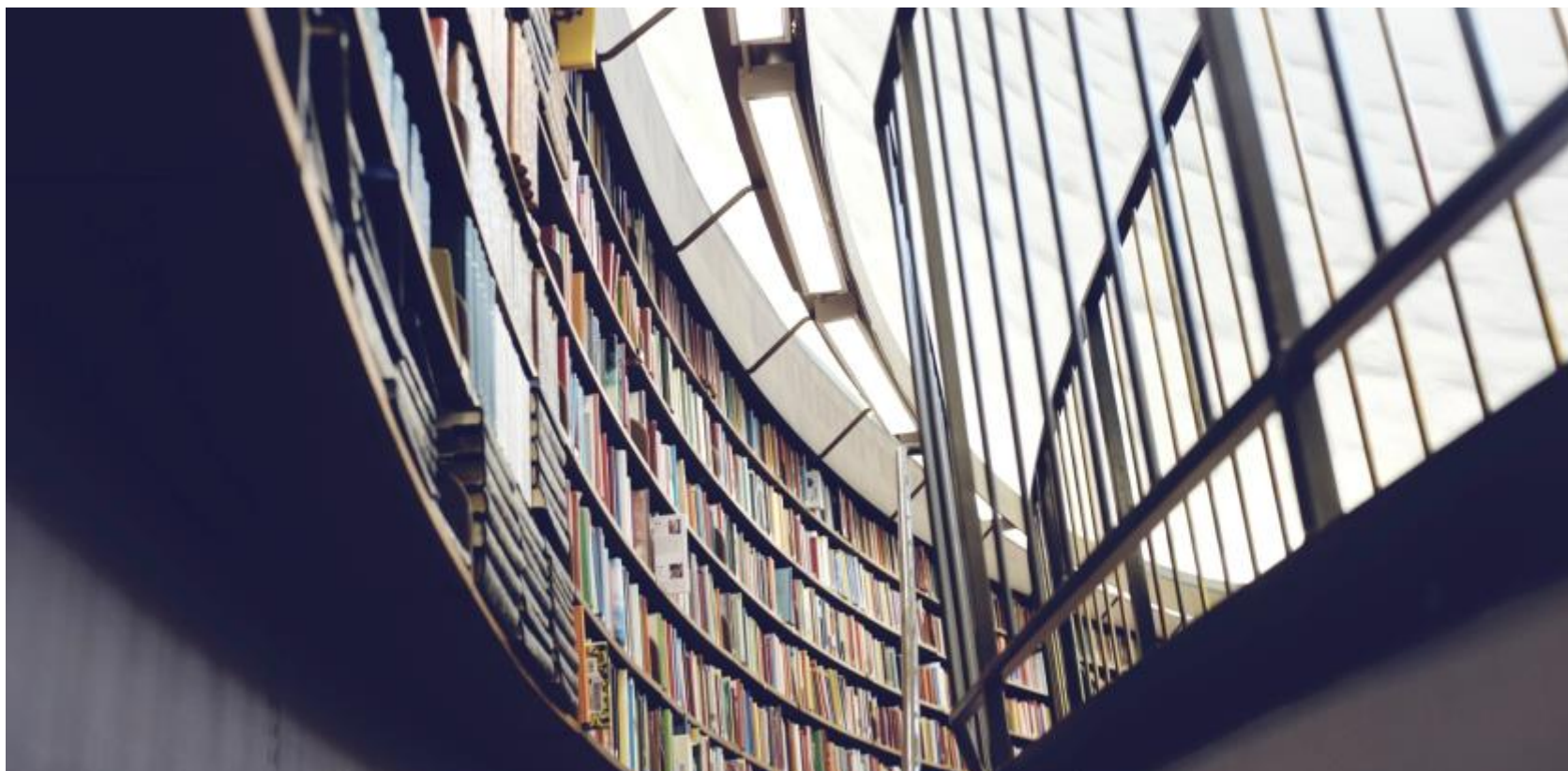
“The know-your-client (KYC), know-your-product (KYP) and suitability obligations are among the most fundamental obligations owed by registrants to their clients and are cornerstones of our investment protection regime.”

- CSA Staff Notice 31-336



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The Philosophy of Suitability

Building a Strong Suitability Culture

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There has been, and will continue to be, constant change to the law.

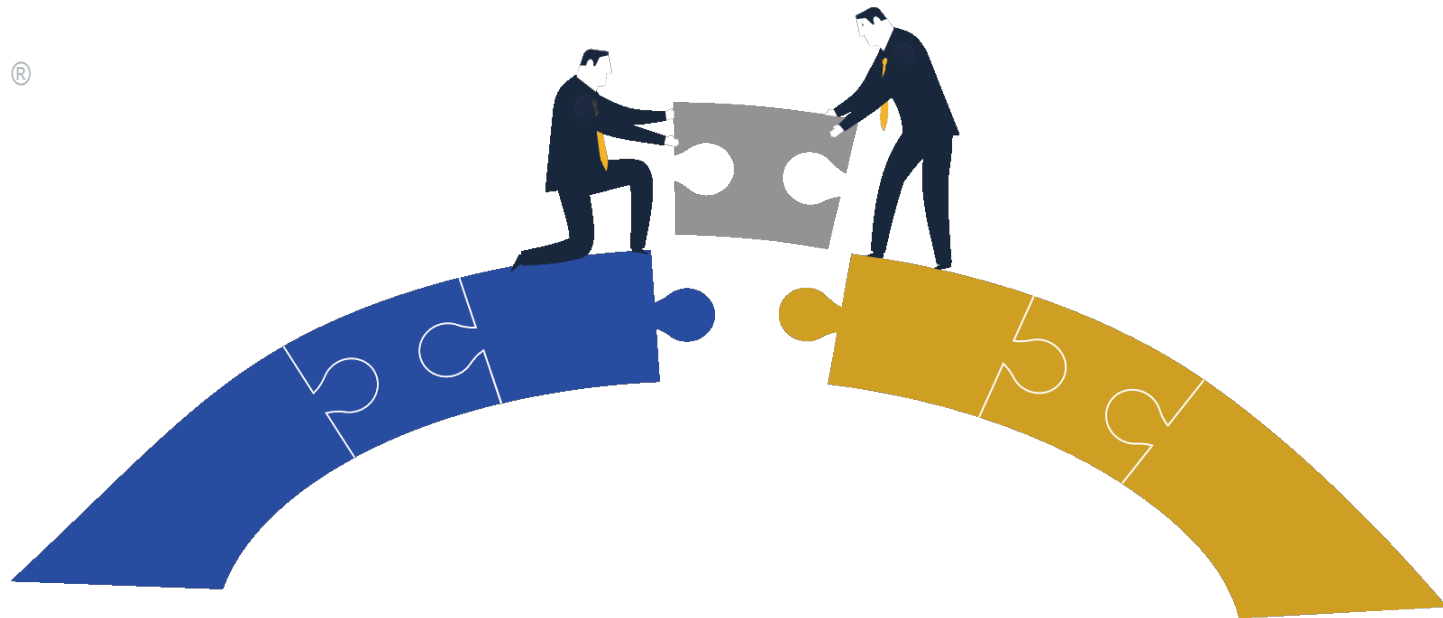
The only way for the firm to have seamless adaptation to these changes at the front line of deal flow is to:

- **understand the philosophy of suitability**
- **develop skills to execute on that philosophy**
- **embed that philosophy and those skills into your firm's culture.**

... so what is that philosophy?

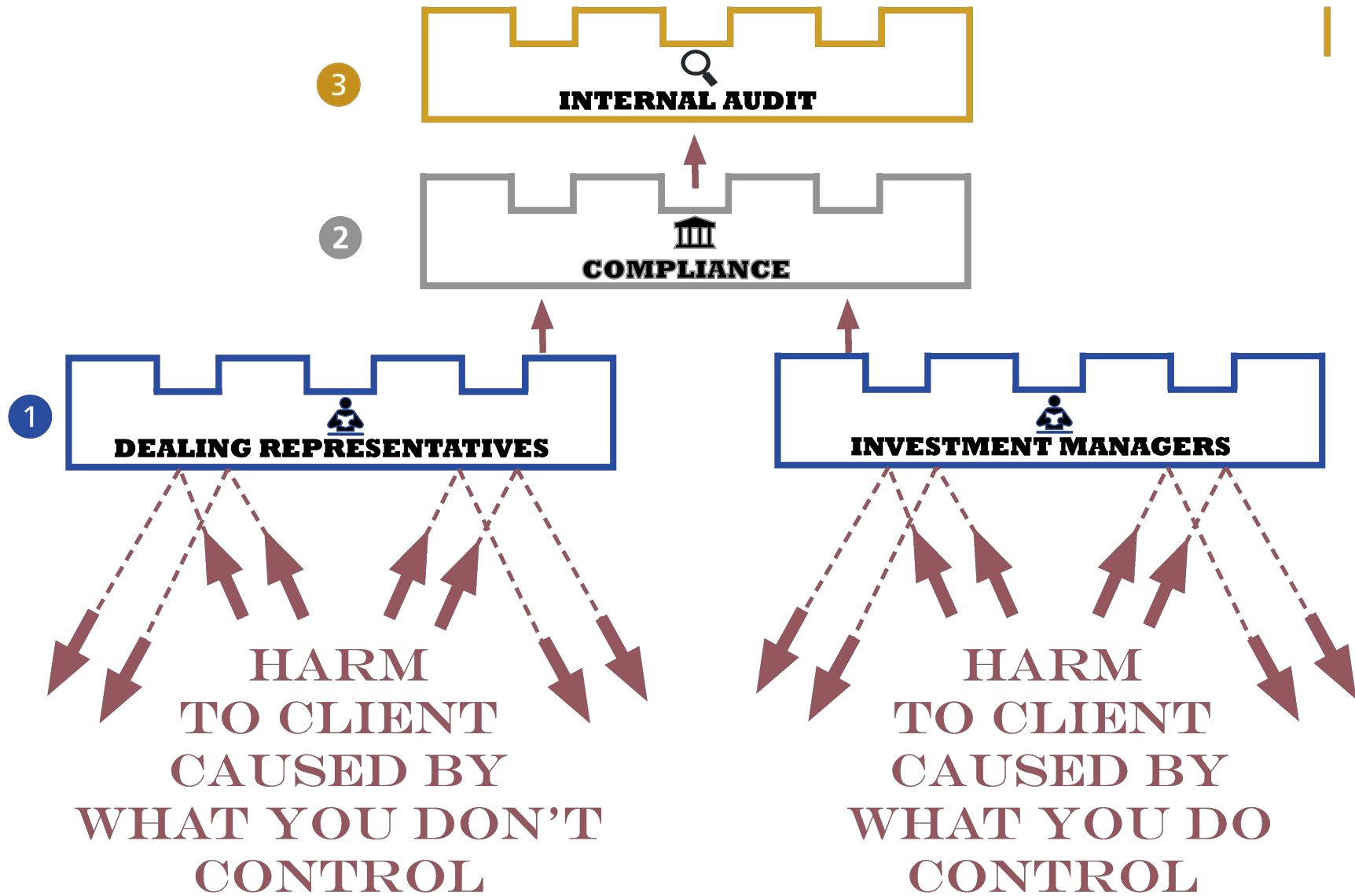


YOUR GOAL



THE RIGHT
PERSON

THE RIGHT
INVESTMENT



YOUR
INVESTMENT
SELECTION
CULTURE LIVES
HERE



3

INTERNAL AUDIT

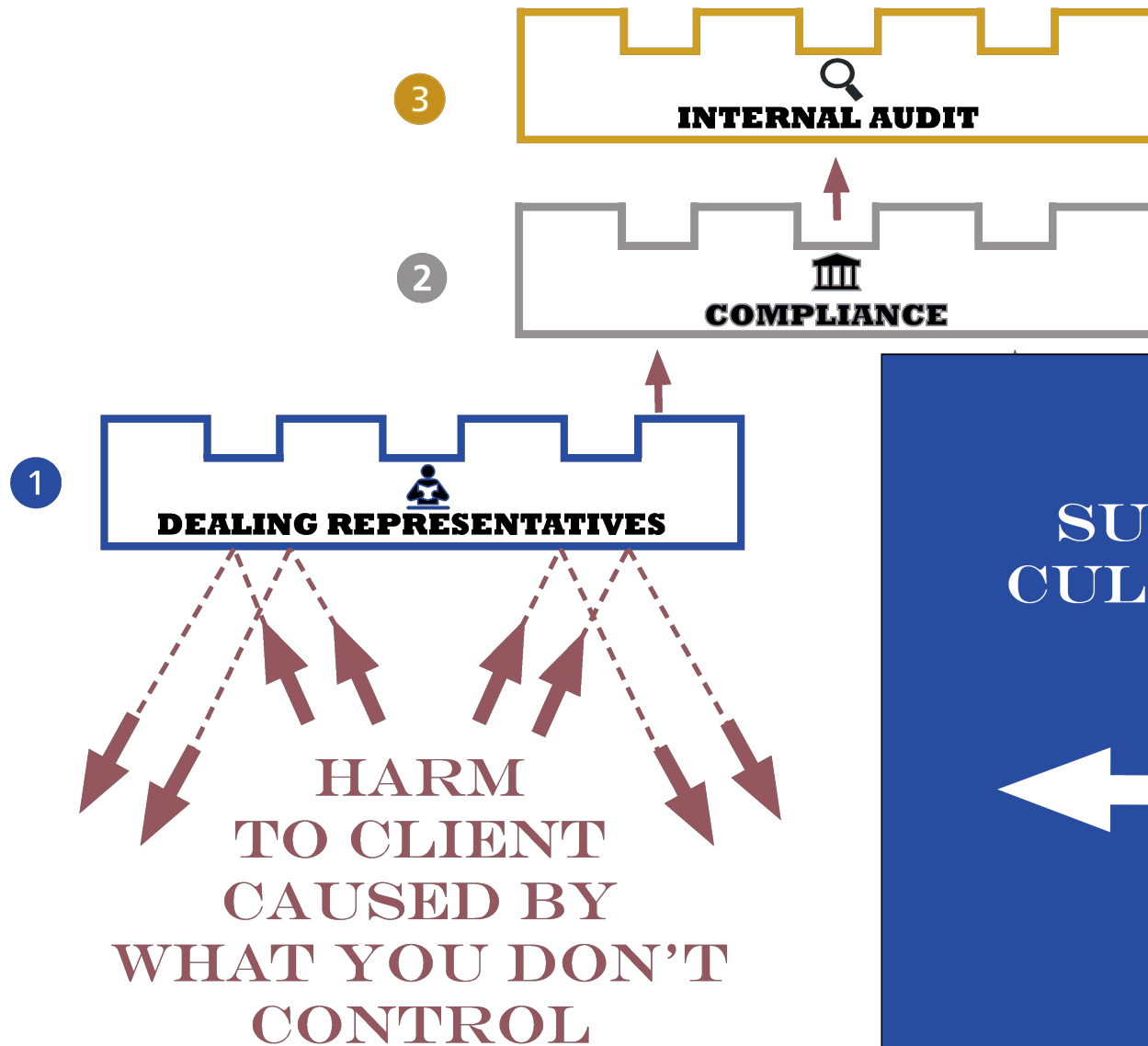
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COMPLIANCE

1

INVESTMENT MANAGERS

HARM
TO CLIENT
CAUSED BY
WHAT YOU DO
CONTROL



**YOUR
SUITABILITY
CULTURE LIVES
HERE**





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What Harms do Client's Need Protection From?

- ❑ Lack of liquidity
- ❑ Asymmetric or missing information
- ❑ No ongoing reporting obligations

SYSTEMIC RISKS

-
- ❑ Market risk
 - ❑ Time delays
 - ❑ Risky ventures
 - ❑ Management risk
 - ❑ ... etc.

SPECIFIC RISKS



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KYC (and Suitability) is a Responsibility Not a Form

“...ensure that [you] have sufficient information... to meet [your suitability] obligations under s. 13.3”

- NI 31-103, s. 13.2(2)(c)

- Don't forget to focus on “why” you collect information
- KYC is just a means to an end.



SUITABILITY IS UNIQUE TO EACH CLIENT!



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Why You Take Notes (Internal Compliance Requirement)

Three Obligations:

1. Becoming highly skilled at asking the questions and learning all about the client and then advising them on investing, is **your primary obligation**.
3. Creating an account of the meeting, and providing the details of the assessment so that your **Compliance or Internal Audit Team can verify the assessment is your secondary obligation**.
4. Someone should be independently verifying the reasonable completion of step #1 by examining the notes in step #2 and comparing to regulatory and policy frameworks. Sometimes this is a regulator!



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How You Take Notes

❑ Create statements that are supported by facts:

“The client is protected from the liquidity risk, because of... [personal circumstances of client]”

❑ Address the policy guidelines:

“This investment represents > 10% of the client’s NFA, but that does not create undue risk to them, because...”

❑ Address any negatives of investing to confirm your client understood the decision they made:

“The client and I discussed that this investment cannot be sold and may have redemption restrictions, which creates liquidity risk.”



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“a financial advisor must be taken to assume duties similar to those of any other professional advisor... to take reasonable steps to ensure that customers or clients are aware of the available options, and of the main potential benefits and risks associated with them.... the advisor is not, of course, answerable as "guarantor", "custodian" or "insurer" ... but only to show that he or she reasonably applied the skill and care appropriate to the task undertaken and the circumstances of the case.”

- *Rhoads v. Prudential-Bache Securities Canada Ltd.* (1992) 63 B.C.L.R. (2d) 256i



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“To put the duty in a different way, brokers are under no duty to offer only successful financial advice. Brokers will inevitably make wrong predictions and it is difficult, in hindsight, to question honest investment advice.”

- *Mills v. Merrill Lynch Canada Inc.*, 2005 BCSC 1511



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Best Practices in Suitability

Best Practices for KYP, KYC and Client Directed Trades

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Best Practices for KYP

- Approved product list – you don't have to approve everything!
- Product Due Diligence Committee
 - representatives from operations, compliance, legal and investment management
 - responsible for reviewing and approving each product that is eligible for distribution to clients
 - review the fund manager or issuer in addition to the product
 - ongoing monitoring after initial approval



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Best Practices for KYP

- ▣ Third party due diligence reports – they can be *one* tool to assess a product.
- ▣ Don't be afraid to call the issuer or ask colleagues at other firms about their experience with a product or issuer.
- ▣ Provide dealing reps with a summary of an approved product along with a recommendation as to who the product may be suitable for (time horizon, investment objectives, type of account, risk tolerance, liquidity requirements).



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Best Practices for KYP

- For related products, have training sessions to ensure the dealing rep thoroughly understands the product and ensure disclosure is provided to the client that this is not arms length investment.
- Trust your instincts, if there is a high concentration in one product or issuer, discuss with the dealing rep to ensure they thoroughly understand the product.
- Consider whether a disclaimer should be provided to a client to ensure they understand the main features of a product.



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Know-Your-Client

- ▣ KYC form – what do you need to collect?
 - ▣ Financial circumstances
 - ▣ Risk tolerance
 - ▣ Investment knowledge
 - ▣ Investment needs and objectives
 - ▣ Anything else required to determine suitability of trading activity
- ▣ Comparing against other client documents.
- ▣ How frequently should KYC be updated?



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SUITABILITY = KYC + KYP



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Client Directed Trades

- ❑ To accept or not to accept??
- ❑ Is it suitable?
- ❑ Is it *really* a client directed?
- ❑ NI 31-103 Section 13.3(2) Form



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RECENT CASE LAW

The Law's Approach to Suitability

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Questions??



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Resources

- ▣ Companion Policy 31-103CP Part 13
- ▣ CSA Staff Notice 33-315: Suitability Obligation and Know Your Product
- ▣ IIROC Notice 09-0087: Best practices for product due diligence
- ▣ IIROC Notice 10-0234: New product due diligence regulatory review
- ▣ MFDA Notice MR-0048: Know-Your-Product
- ▣ MFDA Notice MR-0069: Suitability Guidelines



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- CSA Staff Notice 31-336 – Know Your Client, Know Your Product, and Suitability Obligations
- OSC Staff Notice 33-740 – Know Your Client, Know Your Product and Suitability Obligations
- IIROC Notice 12-0109 – Know Your Client and Suitability
- NASD Notice 05-26 – New Products
- FINRA Regulatory Notice 10-22 – Regulation D Offerings