



Mutual Fund Dealers Association of Canada
Association canadienne des courtiers de fonds mutuels

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MFDA Bulletin

Compliance

For Distribution to Relevant Parties within your Firm

Common Sales Compliance Deficiencies and Appropriate Corrective Action

Third Round of Compliance Examinations

MFDA staff have commenced the third round of sales compliance examinations. These examinations include increased focus on high risk areas such as leveraging and the sale of exempt securities as well as the corrective action taken to address previously identified deficiencies.

The MFDA previously issued bulletins #0056-C and #0183-C which listed common deficiencies noted during on-site examinations. Members should refer to these bulletins, as many of the deficiencies listed continue to be identified during examinations. This bulletin focuses on a few of the most commonly identified deficiencies from the second round of examinations and provides guidance regarding best practices and MFDA staff expectations for corrective action. It is particularly important to implement best practices where a deficiency has been identified on a repeated or pervasive basis. Accordingly, Members should carefully review their prior examination reports to ensure that appropriate corrective action has been taken.

As noted in MFDA Member Regulation Notice MR-0057, the responsibility for compliance belongs to the Member generally. The boards of directors, management, supervisors and compliance staff all have a responsibility to take corrective action to address identified compliance deficiencies.

General Guidance on How to Address Compliance Deficiencies

Where a deficiency is identified in a compliance examination, a Member is required to submit a response to the MFDA describing the corrective action that will be taken. In all cases a Member's action plan to address an identified deficiency should be comprehensive and include an assessment of the root cause of the issue. An appropriate action plan includes specifically

detailing the actions to be taken, the individuals responsible and the specific timelines for completion. The action plan should also generally include the following:

- An assessment of the necessary resources to implement the plan including specifically reviewing the adequacy of existing staffing and technology;
- Development of appropriate preventive and detective internal controls;
- Drafting any necessary new written procedures;
- Training supervisory staff and Approved Persons on new procedures; and
- Regular reporting to senior management on progress;

The action plan should also include ongoing monitoring to assess compliance. Where deficiencies continue to be identified, further corrective action should be taken which may include additional training, resources, internal controls and disciplinary procedures.

Common Deficiencies

The following are some of the most common deficiencies identified to date during compliance examinations along with guidance on best practices to address these issues:

Inadequate Trade Supervision

Issue

This issue may include any of the following specific deficiencies identified at head office or branch locations:

- Insufficient evidence of trade supervision including an inadequate audit trail of the documents and reports reviewed, the trade inquiries generated and their follow-up and resolution;
- Failure to perform trade supervision in a timely manner;
- Inadequate or inappropriate trade review criteria;
- Incomplete trade supervision reports;
- Inadequate supervision of off-book trades;
- No independent supervision of trading activity for producing branch managers or compliance officers; and
- Inadequate procedures to identify churning.

Applicable Rules, Policies and Notices

MFDA Rules 2.2.1, 2.5.2, 2.5.3 and 2.5.4

MFDA Policy No. 2

Member Regulation Notice MR-0037

Member Regulation Notice MR-0069

Corrective Action

An action plan to address trade supervision issues should include:

- Ensuring adequate compliance staffing exists to fulfill trade supervision obligations;
- Ensuring procedures specify the reports and documents to be reviewed, the timing of the review and how review is to be evidenced (for both daily trade supervision and monthly or quarterly trend analysis);
- Detailed trade review criteria that adequately address the compliance risks at the Member;
- Procedures and guidance for supervisory staff on what types of trades should generate an inquiry including specifically addressing risk tolerance, investment objectives and time horizon suitability;
- Procedures and guidance for supervisory staff on trading activity that should generate an inquiry when reviewing trend reports including specifically addressing potential concerns with churning and outside business activities;
- Procedures to document trade inquiries, follow-up and resolution in a standardized, readily retrievable format;
- Procedures to ensure trade inquiries are issued and resolved in a timely manner including management reporting and escalation procedures;
- Reports and documents used for trade supervision that include all relevant information including transaction details, Know Your Client (“KYC”) information, product risk rankings, identification of leveraged accounts and account holdings; and
- Prioritizing branch examinations for any branches with identified supervisory deficiencies.

Incomplete KYC Information

Issue

This issue includes situations where KYC information is missing entirely for client accounts or specific KYC fields such as risk tolerance, investment objectives or time horizon are missing.

Applicable Rules, Policies and Notices

MFDA Rules 2.2.1 and 2.2.2

MFDA Policy No. 2

Member Regulation Notice MR-0069

Corrective Action

An action plan to address incomplete KYC information should include:

- Identifying all accounts with incomplete KYC information;

- Placing immediate trading restrictions on purchases and switches in accounts with incomplete KYC information;
- Making any necessary amendments to account opening forms to ensure adequate KYC information is captured;
- Implementation of internal controls including appropriate system restrictions and supervisory procedures to prevent the opening of accounts with incomplete or ambiguous KYC information. For example, controls to ensure that where multiple investment objectives are selected, percentage allocations are recorded;
- A plan, including specific deadlines, to obtain complete information for all accounts identified as deficient; and
- Procedures to track progress including regular reporting to senior management on the number of accounts outstanding and escalation procedures for Approved Persons or supervisory staff who are not meeting specified timelines.

Discrepancies between the KYC Information on the Back Office System and the KYC Information in the Client File

Issue

This issue directly affects the Member's ability to effectively supervise account activity where reliance is placed on KYC information in the back-office system that does not match the information documented in the client file. This issue is usually a result of one or more common root causes including:

- Inadequate controls surrounding access to the back-office system;
- Failure to have KYC amendments approved by supervisory staff; and
- The back-office system is unable to record information the same way it is recorded on the paper form. Examples include cases where the choices for investment objectives that can be selected on the form do not match the choices on the back-office system or percentages for risk tolerance and investment objectives recorded on the form can not be recorded on the back-office system.

Applicable Rules, Policies and Notices

MFDA Rule 2.2.1

MFDA Policy No. 2

Member Regulation Notice MR-0069

Corrective Action

An action plan to address this issue should include:

- Ensuring the information collected on the paper form is consistent with the information that can be recorded on the back-office system;

- A plan to reconcile all KYC information and update the back-office system to correct any discrepancies including specific timelines;
- Procedures to track progress including regular reporting to senior management on the number of accounts outstanding;
- Details on how trade supervision will be conducted in the interim given that reliance can not be placed on the information on the back-office system;
- Appropriate controls and restrictions over the ability to input and amend information in the back-office system; and
- Procedures requiring all KYC amendments to be approved by qualified supervisory staff.

Failure to Maintain Evidence of Client Instructions

Issue

This issue includes situations where client instructions are not documented at all or are documented inadequately. This issue is commonly identified in situations where verbal trade instructions are accepted and adequate notes of the discussions with the client are not maintained.

Applicable Rules, Policies and Notices

MFDA Rule 5.1(b)

Member Regulation Notice MR-0035

Member Regulation Notice MR-0038

Corrective Action

An action plan to address this issue should include:

- Developing a standardized format to record verbal trade instructions that includes documentation of the date and time of the discussion, particulars of the securities to be purchased, redeemed or switched, confirmation of any discussion on commissions to be earned and fees to be paid on the transactions, and in the case of redemptions details on where proceeds are to be sent or reinvested;
- Procedures to specifically test a sample of transactions for adequacy of documented client instructions and adherence to internal procedures during ongoing trade supervision and branch examinations; and
- Procedures to ensure that in situations where notes of client discussions are kept in Approved Persons' files, (either paper files or an electronic contact management system) the records are readily retrievable for supervisors and regulators and a copy is maintained by the Member even after an Approved Person resigns or is terminated.

Inadequate Product Due Diligence

Issue

This issue includes situations where Members have not implemented an adequate know-your-product process, or the know-your-product process has not been completed for all approved products. Specific concerns continue to be identified where exempt securities have not been subject to adequate due diligence.

Applicable Rules, Policies and Notices

MFDA Rule 2.2.1

Member Regulation Notice MR-0048

Corrective Action

An action plan to address this issue should include:

- Prohibiting further sales of exempt products until they have been subject to appropriate due diligence;
- Ensuring due diligence procedures include specifics on who is responsible for conducting the review, what approvals are required (e.x. compliance committee), and what specific information is to be obtained from the issuer;
- Procedures to document the analysis of all relevant factors identified in Member Regulation Notice MR-0048 including the risks, costs and commissions, any potential conflicts of interest and the financial position of the issuer; and
- Implementing a process to communicate product approvals to Approved Persons and supervisory staff including details of the client profile for which the product is suitable and any sales restrictions.

Inadequate Branch Review Process

Issue

A commonly identified issue is that Members have not developed an adequate branch review process. In many cases the branch review program does not include key procedures outlined in MFDA Policy No. 5 such as interviews with Approved Persons and supervisory staff, review of supervisory documentation and an assessment of the suitability of transactions. Other areas of concern include situations where there is insufficient documentation of the work performed, no written reporting on the results of the branch reviews and inadequate documentation of the corrective actions taken.

Applicable Rules, Policies and Notices

MFDA Policy No. 5

Corrective Action

A comprehensive action plan to address this issue should include:

- Ensuring an adequate number of qualified staff are in place to conduct reviews;
- Documented procedures for risk ranking and scheduling branch examinations;
- Procedures to perform a preliminary screening of the branch to identify issues requiring further investigation including reviewing complaint history, previously identified issues, the volume of leveraged trades, Approved Person websites and any outside business activities carried on by the branch's Approved Persons;
- A detailed branch review program including the test procedures referenced in MFDA Policy No. 5;
- Adequate instructions and training for staff executing the branch review program including clear documentation standards; and
- Procedures for issuing written reports and for resolving or escalating issues in a timely basis.

Suitability of Investments

Issue

Deficiencies are often identified where investments in client accounts are inconsistent with the documented KYC information. The most commonly identified inconsistency is client risk tolerance, followed by investment objectives and time horizon.

Applicable Rules, Policies and Notices

MFDA Rule 2.2.1

MFDA Member Regulation Notice MR-0069

Corrective Action

An action plan to address this issue should include:

- Advising any clients with unsuitable investments that the account is not consistent with the existing KYC information on file and discussing recommendations to rebalance the account;
 - If the client's KYC information is outdated and has materially changed, new KYC information needs to be obtained while keeping in mind that it is inappropriate to simply alter the KYC information in order to match the securities in the account;

- Where new KYC information is obtained, compliance staff should consider the reasonableness of the KYC update to ensure that the update is not being made to justify an unsuitable trade.
- A plan to review all affected accounts where the root cause of the issue impacts a large number of client accounts. For example, where suitability issues are due to improper risk rankings for certain products or large deviations from a client's stated risk tolerance were permitted in client accounts;
- An additional review of a sample of client accounts to determine the extent of the issue where suitability issues are specific to particular Approved Persons or branches;
- Ensuring KYC fields such as risk tolerance, investment objectives and time horizon are clearly defined to promote a consistent interpretation by Approved Persons, supervisory staff and clients;
- Written suitability guidelines for Approved Persons specifically addressing risk tolerance, investment objectives and time horizon suitability; and
- Appropriate amendments to the trade supervision procedures and criteria to identify, query and resolve future suitability issues (refer to the guidance provided under the heading Inadequate Trade Supervision in this bulletin).

Suitability of Leveraging

Issue

Deficiencies are often identified where leveraging recommendations appear inconsistent with the client's documented KYC information. Issues identified usually include a combination of several red flags including client age, net worth, income, risk tolerance, investment knowledge and time horizon.

Applicable Rules, Policies and Notices

MFDA Rule 2.2.1

MFDA Member Regulation Notice MR-0069

Corrective Action

A comprehensive action plan to address this issue should include the following:

- Suitability guidelines for leveraged accounts including both specifying red flags to be used in identifying recommendations that require further supervisory inquiry and specifying situations where leveraging recommendations would be clearly unsuitable for clients;
- Procedures for supervisory approval of leveraged transactions (pre-approval is recommended as a best practice);
- An additional review of a sample of client accounts to determine the extent of the issue where leveraging suitability issues are specific to particular Approved Persons or branches;

- Further review of existing client accounts with potential leveraging suitability issues to assess the reasonableness of the recommendation, including a review of relevant documents such as notes of discussions between the Approved Person and the client, any financial plan, and loan documents;
- Where leveraging suitability concerns remain after a review of all relevant documentation, supervisory staff should contact clients to assess the client's understanding of the risks inherent in the strategy; and
- A proposed course of action to resolve any specific cases of unsuitable leveraging.

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