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## **MEMBER REGULATION NOTICE**

### **KNOW-YOUR-PRODUCT**

This Notice is intended to clarify the obligations of Members and Approved Persons with respect to the approval and sale of investment products by MFDA Member firms.

#### **Introduction**

Members and Approved Persons are required to ensure that each order accepted or recommendation made for any account of a client is suitable for the client and in keeping with the client's investment objectives. Know-your-client requirements are a fundamental part of meeting basic suitability obligations. However, these obligations can only be properly discharged if Approved Persons and supervisory staff of the Member also fully understand the products that are being recommended to clients.

#### **Member Due Diligence / Product Approval**

Members must perform a reasonable level of due diligence on products prior to their approval for sale by Approved Persons. Members must have written policies and procedures in place that describe in detail the steps to be followed in the due diligence process.

A basic level of due diligence must be completed on all products being considered for sale by the Member before the products are approved. Member procedures should provide for different levels of analysis for different types of products. For example, an extensive formal review may not be required for many conventional mutual funds. However, a more comprehensive review should be performed on products that are novel or more complex in structure. In the event that products are presently being sold that have not been subjected to a reasonable due diligence review, such a review must be performed before continuing to sell the products.

In determining whether to approve a product for sale, Members should not merely rely on the representations of the issuer, or on the fact that the product appears to be similar to others, or that other firms are already offering the product. In all cases, the approval process must be independent and objective. Members are advised that simply making inquiries will not be sufficient to discharge their responsibility to conduct due diligence. Members must properly follow up on any questions they have raised until they have been satisfied that they have a complete understanding of the products they propose to sell.

To be effective, the due diligence review process should involve:

- a review of any offering documents;
- a review of any marketing materials related to the product;
- consideration of MFDA Rules and securities regulations that may apply in the sale of the product;
- an assessment of the risks associated with the product;
- an assessment of the costs associated with the product;
- an assessment of the commissions and other compensation to be paid to the Member and Approved Person for selling the product, and consideration of potential conflict issues that may arise under the compensation structure;
- consideration of competitive products that may be less costly or less risky;
- an assessment of the investment objectives and any projected returns for the product and the likelihood that the investment will meet these objectives and projections;
- a review of the issuer's financial position and history;
- an assessment of management qualifications and track records;
- an assessment of any custodian, investment manager or guarantor associated with the product;
- maintaining a thorough written record of the results of the Member's due diligence.

It is critical that the Member develops an understanding of all features of the product. Issues such as liquidity of the product and the nature of any underlying investments and their inherent risks must be examined before assigning a risk ranking to the product. The Member should develop guidelines or an investor profile for which the product would be generally suitable, including risk levels, time horizon, income and net worth. The Member should also clearly identify investors for whom the product is not suitable. Concentration limits should be assigned to products and/or general classes of products where appropriate.

As a reminder, the fact that a product is included on a Members approved product list does not in any way diminish the obligations of Members and Approved Persons to ensure that each recommendation made for any account of a client is suitable for the client and in keeping with the client's investment objectives.

As a best practice, a committee involving senior management of the Member should be empowered with ultimate authority in the product approval process, to ensure that all business units of the Member have signed off on the product prior to sale.

Where significant changes in market conditions have occurred which would affect the risks associated with certain products, it is appropriate for the Member to revisit the approval or risk ranking of such products. Approved Persons and supervisory staff should be aware of any such changes.

## Additional Considerations Regarding Exempt Securities

With respect to securities sold pursuant to exemptions under applicable securities legislation (“exempt securities”), the Member must, after due inquiry, satisfy itself that the conditions of any exemption claimed apply before trading in reliance on the exemption. Where there is uncertainty regarding the applicability of an exemption, the Member must take appropriate measures which may include consultation with the relevant securities regulatory authority or legal counsel. In addition, all local rules and applicable registration requirements of the relevant securities regulatory authorities must be satisfied prior to selling the securities. These conditions may vary significantly between jurisdictions and may include proficiency requirements, notice to or specific approval from regulators or amendment of the Member’s registration.

Members should be particularly careful when examining suitability issues in relation to exempt securities. It should be noted that the classification of an investor as a “sophisticated purchaser” or an “accredited investor” does not negate the obligations of the Member with respect to suitability review. Members may consider providing training for Approved Persons and supervisory staff on the particular characteristics and concerns relating to exempt securities, to ensure such products are recommended only in appropriate circumstances.

Members should also have policies and procedures in place with respect to the information to be provided to clients, to help ensure that clients fully understand the products being offered before entering into any transaction. The client should be clearly advised where a security is being sold under an exemption. It is important that the client also understands the implications of any restrictions that may apply with respect to liquidity and the potential absence of a secondary market for the securities. Finally, the client should be aware that an offering memorandum that may be provided prior to the sale of some exempt securities is not a prospectus, and that certain protections, rights and remedies that may exist under securities legislation in relation to prospectus offerings, including statutory rights of rescission and damages, may not be available to the client.