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MR-0069

April 14, 2008

(This Notice was [updated on February 22, 2013](#))

MEMBER REGULATION NOTICE

SUITABILITY GUIDELINES

This Notice is intended to provide guidance to Members on how to establish a suitability framework to comply with their obligation to ensure each order accepted or recommendation made is in keeping with clients' know-your-client ("KYC") information. It provides further guidance on assessing suitability where borrowed funds have been used to invest and advises of MFDA staff's view when assessing suitability as part of a compliance examination or enforcement case.

Specifically, these guidelines are intended to assist in the establishment of consistent and objective industry standards for assessing investment suitability for the benefit of Members and investors. MFDA staff receives numerous requests from Members for guidance in this area. In addition, issues identified in compliance reviews as well as the number of complaints received by the MFDA related to suitability concerns have indicated that guidance and clarification for Members in this area should be a regulatory priority for the MFDA. Certain aspects of this Notice will be the subject of future Rule and Policy proposals, however, given the importance of this issue and in response to Member requests for guidance, MFDA staff is issuing this Notice in the interim.

The information that follows reflects both existing regulatory obligations as well as new guidelines in certain areas, such as material changes to KYC information, suitability triggers and criteria for account and trade supervision, which will result in future corresponding Rule and Policy amendments. Such Rule or Policy amendments will be subject to the normal course review and approval process and be subject to a public comment period. To the extent public comments received result in changes that necessitate amendments to the draft Rule or Policies that are inconsistent with the guidelines contained herein, this Notice will be updated accordingly.

Given the broad scope of the following guidelines, if Members have questions about how the guidelines specifically relate to their operations, they should contact the Compliance Manager assigned to their firm or Ken Woodard, Director, Communications and Membership Services.

MUTUAL FUND DEALERS ASSOCIATION OF CANADA SUITABILITY GUIDELINES

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SUITABILITY GUIDELINES

1. KNOW YOUR CLIENT (“KYC”)

A. Maintaining Accurate and Complete KYC Information

MFDA Rule 2.2.1 requires Members and their Approved Persons (“APs”) to use due diligence 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”. In order to meet this obligation, Members and APs must obtain and maintain complete, timely and accurate KYC information. Without this information, a determination cannot be made as to whether a recommendation is suitable for a client. Accordingly, Members are required to obtain complete KYC information when opening an account and before trading on behalf of clients.

A Member’s New Account Application Form (“NAAF”) or KYC form should be developed considering the products the Member distributes, investment strategies offered to clients and trade supervision policies and procedures of the Member in order to adequately capture sufficient information to assess whether recommendations made or orders accepted are suitable. Where changes to products, investment strategies or internal policies are made, the form should be flexible enough to reflect new information required or a new form should be created. Where a form does not provide enough specific detailed information to assess whether a recommendation or order is suitable, the Member should take the most conservative approach in assessing suitability.

Members are required to have policies and procedures relating to obtaining, approving and updating KYC information. Policies and procedures should include a description of the process to:

- Open and approve new accounts, including timeframes for submission of the information and subsequent approval;
- Update KYC information, including recommended timeframes to update the information and a description of the approval process for updates;
- Ensure completeness of KYC information prior to opening or trading in an account; and
- Detect or prevent inconsistent KYC information in use by APs and by supervisors.

Where an account has been opened without first obtaining complete KYC information, the account should be restricted from trading, except to allow for redemptions. The Member should also investigate why the account was opened without KYC information on file.

Members are also required to have internal controls over the entry of KYC information into their back office system when opening a new account or updating KYC for an existing account.

B. Approval of KYC Information

Members must have policies and procedures for both branch and head office staff relating to the opening of new accounts and updating of KYC information. The approval process should not be viewed solely as an administrative function. Rather, KYC information submitted for approval should be reviewed for completeness as well as reasonableness and consistency.

Completeness

Members must have controls in place to ensure accounts are only opened if complete KYC information is obtained. In cases where a Member has accounts that have already been opened and KYC information is not complete, the accounts should be restricted from trading, except to allow for redemptions.

Reasonableness

The approval of new accounts and KYC updates should include the objective review of the KYC information submitted. For example, a 70 year-old client with a long term time horizon and high risk tolerance should be flagged for follow-up to assess whether the KYC information is accurate or whether there are other objectives of the client that have not been identified or recorded on the KYC form.

Consistency

Members should have controls in place to prevent or detect inconsistencies in KYC information. For example, a client with a “speculative” investment objective should not also have a “low” risk tolerance. In some instances, Members have incorporated edit checks into their trading systems that prohibit inconsistent KYC information from being entered or accepted.

Evidence of inquiries made, responses received and approvals given must be maintained as verification of the Member’s supervisory activities. When issuing an inquiry, the reason for the inquiry as well as timelines to respond and additional information required should be documented and the progress monitored to ensure a timely resolution.

When approving new accounts, KYC amendments or performing branch examinations, Member supervisory staff should be alert to situations where APs have a significant number of client accounts with the same or very similar KYC information. MFDA staff has found, in examinations and investigations, APs who use the same KYC information for a number of their clients in order to match their trade recommendations or investment strategies. APs are expected to make suitable recommendations based upon specific client KYC information and should not document KYC information solely to support their recommendations.

C. Material Changes to KYC Information

Members should have policies and procedures for updating KYC information as a result of material changes that would include:

- The requirement to obtain supervisory approval;

- Internal controls to ensure accuracy of client information in use by APs and supervisory staff; and
- Compliance with record keeping requirements.

Material changes would include any information that would reasonably be expected to result in changes to the stated risk tolerance, time horizon and investment objectives as well as any situation that would have significant impact on net worth or income of the client (for example a job loss, long term illness, or new debt financing).

MFDA Rule 2.2.1(a) requires KYC information to be up-to-date at the time of a trade and MFDA Rule 2.2.4(b) requires Members annually to ask clients in writing if KYC information has changed. As a best practice, some Members have also instituted a policy that requires APs to directly contact clients annually to confirm or update KYC information.

Some Members are also able to flag stale-dated KYC information within their back office system. Typically, the system flags KYC information that has not been updated in the past twelve months.

When performing branch examinations, MFDA staff frequently finds KYC information in a client file which is different from the KYC information on a Member's back office system. In some cases this occurs because updates are not processed in the same manner that is used when a new account is opened. Staff has found that updated KYC information is generally not subject to an approval process and there are few, if any, controls or procedures to ensure head office records have been amended to reflect the new information. In other instances, Members have made changes to their NAAF without a corresponding change to their back office system or have made changes to their back office system without corresponding changes to their NAAF. The result is inaccurate information being used by the Member's head office supervisory staff to assess suitability. It is important for Members to develop policies and controls with respect to the update process. Further, when a Member performs its branch reviews in accordance with MFDA Policy No. 5 *Branch Review Requirements*, the Member should also test to ensure consistency between the information on its system and the information within the client file, including KYC information contained in financial plans or lending documents where available.

D. New Account Application or KYC Form

KYC information must be defined in a clear and concise way to assist clients in understanding what the terms mean and how the criteria will relate to the specific investments recommended or accepted by the Member.

An illustration of how to define KYC information is attached in Appendix 1 to provide further information on how to apply the concepts discussed below.

KYC Information

KYC information includes:

- Age
- Investment Knowledge
- Annual Income
- Net worth
- Investment Objectives
- Time horizon
- Risk Tolerance

a) Age

The client's date of birth must be recorded.

b) Investment Knowledge

Investment knowledge should reflect the client's understanding of investing, investment products and their associated risks.

c) Annual Income

This should represent annual income from all relevant sources. It should be collected as a number or by using reasonable ranges.

d) Net Worth

The details of the net worth calculations should be recorded. Net worth should be calculated as estimated liquid assets plus fixed assets less estimated liabilities. Net worth should only include assets of the account holder and his or her spouse. Liquid assets would include those that are not subject to restrictions and are readily converted into cash without penalties. For example, generally investments would be considered liquid assets unless they are locked-in or held in a registered plan where there would be taxes owing on withdrawal.

It is important to identify both liquid and fixed assets, especially in assessing the suitability of borrowing to invest ("leverage"). Further guidance on assessing the suitability of leverage is in section 4 of this Notice.

e) Investment Objectives

Investment objectives are the result desired by the client from investing and should relate to the type of investments that will be purchased by the client. To the extent a client has multiple objectives, the Member must have a way of identifying the relative importance of each objective within the account. This can be done by using percentages or descriptions of the recommended account holdings as further described under the model portfolio approach explained in section E that follows. MFDA staff has observed Members that use tick boxes and may tick multiple

objectives for an account without indicating what percentage of the account should be allocated to each objective.

MFDA staff has also observed KYC forms with investment objectives that are too broad or vague to relate to any specific trade or investment but that relate more to the overall objectives of the account (such as “retirement savings” or “tax planning”).

If a Member wants to also record these types of overall goals, they can be separately documented on the KYC form. However, the investment objectives used for trade supervision and the suitability assessment should clearly relate to the type of investments that will be purchased by the client.

Definitions of “growth”, “income” and “balanced” are provided in Appendix 1. Where Members use the term “balanced”, it should be defined in terms of a reasonable allocation between income and growth investments. Staff has observed the use of other terms including “capital preservation” and “speculative”. Where these terms are used, they must be appropriately defined in a manner to allow the client to understand what types of investments they relate to.

f) *Time Horizon*

Time horizon is the period from now to when the client will need to access a significant portion of the money invested. It can be defined in absolute terms or in ranges that provide for a sufficient number of categories to assess the suitability of the products sold or investment strategies used.

g) *Risk Tolerance*

Members and Approved Persons should consider risk tolerance to be the lower of the investor's willingness to accept risk and the investor's ability to withstand declines in the value of his or her portfolio. It is not just the client's comfort level or attitude towards risk, but also his or her actual ability to withstand financial losses. Risk tolerance therefore should be determined as the lesser of both criteria.

Incorrectly assessing client risk tolerance is one of the most common allegations made in client complaints to the MFDA. Clients allege that the risk tolerance indicated on the KYC form was higher than what the client asserts was his or her actual risk tolerance.

In some cases, there is a difference between the risk a client is willing or is able to take and the return the client expects, which can result in an AP assessing risk tolerance higher than it should be in an attempt to meet client expectations.

There are also instances where APs and Members may be determining client risk tolerance as the result of a combination of other KYC criteria. While other KYC criteria, such as income, net worth and time horizon, should be considered and discussed with clients when assisting them in understanding risk tolerance and how they factor in to risk and return, these criteria should not override the client's ultimate

assessment of their actual willingness and ability to accept risk. APs and Members cannot substitute their own judgment for that of the client. For example, a client with a long term time horizon, significant net worth and income level may be able to withstand fluctuations in the market over the long term which could lead to the conclusion that the client is high risk or should invest a significant portion of his or her portfolio in high risk investments. However, if the client is not willing to accept that level of risk or is not comfortable with investing in high risk investments, the KYC form should reflect the client's decision and not the AP's view of what the client's risk tolerance should be.

KYC for Joint Accounts

For joint accounts, certain KYC information such as age and investment knowledge should be collected for each individual account holder. Annual income and net worth can be collected for each individual or on a combined basis as long as it is clear which method has been used. Investment objectives, time horizon and risk tolerance should relate to the account and should not be collected separately for each individual account holder.

E. Methods of Recording or Depicting Risk Tolerance

MFDA staff has observed three methods of depicting risk on KYC forms:

a) Tick Boxes

This method typically uses three boxes (high, medium and low risk) or a numerical ranking of client risk where the risk rankings are grouped into high, medium and low risk categories (i.e. 1-3 is low risk, 4-6 is medium risk, 7-9 is high risk). Where this method is used, securities with risk higher than the risk tolerance indicated on the form would be unsuitable as there is no indication that the client has agreed to hold any securities with a risk rating higher than indicated on the form. For example, a "medium" risk client should not invest in a "high" risk mutual fund. If a Member does not want to be limited to accepting securities with a risk tolerance equal to or less than that indicated by the tick box and wants to be able to construct portfolios that include higher risk securities, then the Member must explain to the client the composition of high, medium and low risk investments that will be held in the account and use either the percentage or model portfolio approaches discussed later.

Staff has observed some Members that use a tick box and disclose that the account may hold a portion of higher risk investments.

For example, the medium risk tick box would be defined as "a portfolio that holds no more than 20% of high risk investments". Staff would consider any approach that describes the account composition in this manner to be the "model portfolio approach" discussed below.

Members that want to use the model portfolio approach must be able to demonstrate using statistical analysis and in consideration of all investments offered for sale, that their

definitions are appropriate and that they are able to monitor the portfolio compositions on an ongoing basis.

b) Percentages

Some Members use a percentage basis to identify the risk composition of the securities to be purchased for the account which is agreed to by a client (for example 10% high risk, 60% medium risk, 30% low risk). To the extent a trade will result in the risk composition exceeding the stated risk thresholds on the KYC form, it is flagged for a suitability assessment and resolved in the normal course.

c) Model Portfolios

A few Members have developed a model portfolio approach that categorizes clients based upon their KYC information and matches them to pre-established portfolios. The portfolios are broken down into their various risk levels and by type of investment (i.e. equity or income). Clear disclosure must be given to the client regarding the composition of the portfolios and how the KYC information provided results in the particular portfolio being selected.

To date, MFDA staff has only seen this approach used in an acceptable form by Members that sell a limited number of products and have access to a portfolio manager, as it requires regular monitoring of the securities within the portfolios to ensure that any account constructed under the model is in fact appropriate for a client with a particular set of KYC information. Any Member using this model has to be able to demonstrate, using valid statistical analysis, that the pre-established portfolios are suitable for clients within each category, considering all the investments the Member sells and that it has the ability to monitor the established portfolio compositions for suitability on an ongoing basis.

MFDA Compliance Trade Review Criteria

In routine compliance examinations where MFDA staff performs sample testing of trades, staff will inquire about the suitability of any trade that results in the account containing securities in excess of 10% of a client's stated risk tolerance. Staff's threshold to flag trades for inquiry does not in any way detract from a Member's obligation to supervise suitability of trades or handle complaints fairly.

F. Use of Questionnaire to Collect KYC Information

Questionnaires can be a useful tool in assessing client KYC criteria if used properly. A questionnaire should be designed so that the risk tolerance generated is the lesser of the client's ability to withstand losses or willingness to accept risk. However, MFDA staff has seen instances where the questionnaire does not accomplish this result. In these cases, the questionnaires assign a greater relative weight or score to questions that solicit information regarding the client's ability to withstand losses than questions regarding the client's willingness to accept risk and then averages the scores together. This results in a higher risk tolerance for the client than is appropriate.

Staff has also seen questions that are too vague to provide reliable information and questions that do not correspond to the Member's KYC criteria. Members that use questionnaires, or who allow APs to use their own questionnaires, are expected to review and test them to assess whether they provide appropriate and consistent results.

G. Additional Concerns with the Quality of KYC Information

MFDA staff has also identified the following concerns with respect to KYC information being collected by Members:

- Where ranges are used, at times they are too broad. For example, long term time horizons defined as greater than 3 years and the top category for net worth is greater than \$100,000;
- The NAAF does not collect sufficient information to assess suitability of particular products or investment strategies of the Member. For example, if selling exempt securities under the accredited investor exemption, the NAAF should include income and net worth information specific enough to demonstrate compliance with the exemption conditions. Another example, where a minimum time horizon has been established as a guideline for recommending leveraging, the time horizon on the NAAF should be able to support that this criteria has been met. Staff has also observed Members that define long term time horizon as greater than 3 years, which would not be adequate to determine whether the sale of a mutual fund with a deferred sales charge is suitable;
- KYC choices on the NAAF are ambiguous. For example, time horizon of "none" was interpreted differently by staff at a Member to mean either extremely long term or very short term;
- For joint accounts, Members have collected KYC information for each account holder rather than for the account itself. In some cases, the KYC information collected for each account holder conflicts and it is not clear what KYC information relates to the account;
- KYC information that is inconsistent. For example, a client with a speculative investment objective and a low risk tolerance. A Member should either have controls to prevent such inconsistencies or have detective controls to identify and follow-up where inconsistencies are identified;
- Use of calculators or other formula that focus on ability to withstand losses rather than the lesser of the client's willingness and ability to accept risk;
- Little or no explanation of terms used on the NAAF, including risk tolerance, investment objectives and time horizon;
- Where the model portfolio approach is used, little or no disclosure to the client regarding the composition of the portfolio, how the portfolio was selected and no statistical analysis to support its reasonableness;

- Where questionnaires are used to assess risk tolerance, the end determination of the client's risk tolerance is greater than what the responses from the questionnaire suggest;
- KYC information may either be missing or incomplete;
- NAAFs are not reviewed for consistency and reasonableness;
- NAAFs are either not approved or not approved in a timely fashion;
- Updates to KYC information are not reviewed or approved or the Member's back office systems are not updated;
- Supervisors do not question situations where an AP has a significant portion of clients with the same or similar KYC information. In these cases, it appears the KYC information is being determined based upon trading practices used by the AP rather than on clients' actual circumstances;
- Staff assigned to approve new accounts or KYC updates only reviews them for completeness and not consistency or reasonableness; and
- Members may record risk tolerance either as a number or range of numbers without providing explanation of what the number means or how it was derived. For example, a NAAF may indicate medium risk means a value of "4 to 6" and a client may be given a numerical value of "4". There may be no information or documentation provided to the client as to how the number "4" was derived, no explanation on the NAAF regarding the difference between a medium risk client that rates a "4" versus a "5" and no explanation of what medium risk means in terms of how it will relate to the types of investments that will be purchased.

H. Account vs. Client KYC

A Member should collect KYC Information separately for each account. A client may have different risk tolerance, time horizons and investment objectives for various accounts. However, other factors, such as income, age and investment knowledge, must remain the same across accounts for the same client.

Where a Member wants to use one set of risk tolerance, time horizon and investment objectives for multiple accounts within the firm and assess suitability on a consolidated basis, the Member would have to demonstrate that:

- a) The client has agreed that the KYC information relates to all the accounts specifically listed on the KYC form and the combined portfolio in these accounts will be reviewed when assessing suitability;
- b) The beneficial owners are the same for all the accounts;
- c) The Member's back office system is able to effectively consolidate accounts to allow for a suitability assessment. For example, if a Member uses a percentage method for identifying risk tolerance, the Member would have to demonstrate that it's back office

system can consolidate assets in all of the client's accounts into their respective risk categories to flag trades that would result in the risk tolerance of the combined accounts being exceeded; and

- d) The Member's back office system is able to separate accounts previously aggregated if one of the account's KYC information changes. For example, if the investment objectives for one of the accounts changes, the Member's back office system would have to be able to separately identify that account from the others as part of the trade supervision process.

2. KNOW YOUR PRODUCT

Members and APs must understand the salient facts about the products they offer to their clients in order to fulfill their suitability obligation. MFDA Member Regulation Notice MR-0048-“Know-Your-Product” provides further guidance to Members on their due diligence obligations when approving and offering a product for sale.

A. Assessing Risk of Prospectus Qualified Mutual Funds

The risk ranking of a mutual fund should be determined with reference to the mutual fund's prospectus. Each mutual fund is assigned a risk ranking in the prospectus, which can change over time.

Comparing a client's risk tolerance to a mutual fund's risk ranking will not raise significant difficulty when the risk categories used on the KYC information and in the prospectus are the same.

However, when either the KYC information or the prospectus uses split-risk categories such as “medium-high”, it may be more difficult to match up the risk categories between the KYC information and the prospectus. In this instance, Members and APs should adopt the most conservative approach to assessing risk.

For example, if a mutual fund uses a risk category of medium-high and the Member uses only high, medium and low risk tolerances on its KYC form, the fund should be considered high risk for suitability purposes. Additionally, if a Member uses a “tick box” approach and has a number of risk tolerance categories (low, low-medium, medium, medium-high, high), a mutual fund with a risk ranking of high would not be appropriate for a client with a medium-high risk tolerance. Members should also not attempt to divide a split-risk ranked mutual fund into individual risk components (for example, medium-high risk means 50% medium risk and 50% high risk).

B. Exempt Securities

A Member may distribute certain exempt securities such as hedge funds, limited partnerships or private notes or debentures for which there is no prospectus. In these circumstances these securities should be considered to be high risk. It should be noted that these securities are not

regulated to the same extent as mutual funds, may have significant liquidity restrictions and, in the case of hedge funds, may employ riskier strategies than conventional mutual funds such as leveraging and short selling. These facts alone often justify a high risk ranking.

Members should also consider the concentration of investments in exempt securities when performing a suitability assessment. Staff has observed situations where some Members open a new account to trade only in an exempt security. In assessing suitability in these cases, Members should consider whether the KYC information for the new account is reasonable given existing information on file for the client and also whether the amount invested in the exempt security is suitable given the client's other investments.

C. Principal Protected Notes

Principal Protected Notes ("PPNs") that are guaranteed by a chartered bank or the Government of Canada usually guarantee 100% return of principal. However, they generally require clients to invest their funds for long periods of time and take a risk that their investment may not generate any returns at all during this period.

PPNs may be subject to liquidity restrictions and may not have a guaranteed secondary market created by the issuer. Even where a buyer is found, the client may be forced to sell the investment in the note at a loss when disposing of it before the maturity date. Furthermore, some PPNs contain early redemption charges over the first 2 or 3 years of the investment, which further penalizes investors who sell the investment in this time period. Accordingly, PPNs are generally not suitable investments for clients with a time horizon shorter than the maturity period of the note.

Most PPNs do not offer an income stream but provide a return to clients at the maturity date provided certain conditions are met. This makes these investments generally unsuitable for clients with an investment objective of "income".

While they share some common characteristics, PPNs can vary greatly in how their returns are calculated and the term of the investment. When analyzing these products for suitability, Members and APs should always conduct proper due diligence to gain an appropriate understanding of the note in question.

The MFDA is aware that in some cases, APs have recommended that clients purchase a PPN with the intent of selling the product before it matures. Where a recommendation is made with the intent of selling these products before maturity, this should be clearly noted in the client file together with a discussion of the risks associated with this strategy. At a minimum, clients should be informed that:

- A secondary market may not exist for the PPN at which point, the PPN must be held to maturity;
- If a secondary market does exist, you may not be able to sell the PPN for a profit; and

- If the issuer allows early redemptions, the issuer may charge early redemption fees.

The Member's due diligence and risk ranking should reflect the liquidity restrictions noted above and the fact that the principal is not guaranteed if the product is not held to maturity. A recommendation to purchase a PPN with the intent of selling before maturity is not generally suitable for a low risk investor.

3. SUITABILITY PROCESS

A. When is Suitability Assessment Required?

MFDA Rule 2.2.1 requires that a suitability review be performed for each order accepted or recommendation made for any account of a client. This means that the suitability assessment must be performed for trades that are recommended by the AP as well as for orders proposed by the client. For more guidance with respect to suitability obligations for unsolicited orders, please refer to MFDA Member Regulation Notice MR-0025 "Suitability Obligations for Unsolicited Orders".

Members and APs should conduct a suitability analysis and confirm or amend KYC information, as appropriate, within a reasonable time but no later than the time of the first trade in the following circumstances:

- a)* Where a client transfers in or a client transfers securities into an existing account at a Member;
- b)* Where a Member or AP becomes aware of a material change in a client's KYC information; and
- c)* With respect only to APs, where a client of the Member is reassigned from one AP to another (note that this applies only to Members that assign accounts to APs).

The determination of "reasonable time" in a particular instance will depend on the circumstances surrounding the event that gives rise to the requirement to perform the suitability assessment. For example, on client transfers, the volume of accounts to be reviewed may be a relevant factor in determining reasonable time.

When assets are transferred in to a Member, the Member should become familiar with all the investments being transferred in order to perform an appropriate suitability assessment.

Should a Member or an AP identify an account that contains unsuitable investments, they must bring this fact to the client's attention and discuss whether there has been any change to client circumstances that would warrant altering the KYC information. It is inappropriate to simply alter the KYC information in order to match the securities in the account without discussing the situation with the client. If, even after obtaining a justifiable KYC update, the account continues to be unsuitable, the AP should discuss this situation with the client and

recommend rebalancing the account to correspond to the client's new KYC information. In following this process, the AP must act in accordance with the client's instructions. Trades must be placed only in accordance with client instructions and any advice given should be properly recorded, particularly if the client declines to follow the recommendation.

B. Suitability in General

An investment suitability analysis is mostly an objective analysis. To the extent that there is subjectivity in the analysis, the expectation of MFDA staff is that the Member and AP take the most conservative approach and act in the best interests of the client. The analysis generally involves matching the characteristics of an investment with the overall assets in the account to the investor's stated investment needs as set out in the KYC information. Where there is a discrepancy between the KYC information and the investments, the investments will generally be considered unsuitable or the KYC information may need to be updated. In any event, such a situation should result in a supervisory inquiry.

Client risk tolerance, investment objectives and time horizon noted in the KYC information give direct information regarding what is suitable for a client. These three elements must be directly compared against the assets in the client's account to ensure that the trades are suitable. The other categories (investment knowledge, annual income, net worth and age) serve two main functions. Firstly, they are used in assessing the suitability of any leveraged loans and secondly, they can be used as a check against the three categories that give direct information regarding whether the investments are suitable for a client. For example, if a 70 year-old client is shown as having a high risk tolerance and little or no investment knowledge, it is indicative of a situation which would require follow up.

Regardless of the methodology used by the dealer to record KYC information, the Member should be able to demonstrate, using appropriate and accepted methodologies, that its suitability process is sufficient to reasonably ensure that recommendations or orders accepted are suitable for clients considering their particular KYC information. Further, Members are responsible for assessing suitability of recommendations made with respect to all business of the Member. This would include investment advice or recommendations for investment products which may not meet the definition of a "security" under securities legislation (for example, PPNs or charitable donations schemes with investment characteristics).

When assessing suitability, only assets distributed or held by the Member can be considered in the analysis.

C. Risk Tolerance Suitability

A Member's system for identifying trades that exceed a client's stated risk tolerance depends on the Member's approach to recording risk tolerance. Where a Member uses a "tick the box" approach to recording risk tolerance, a trade in an investment with risk greater than the client's stated risk tolerance, should be flagged for review and resolution.

Where a Member is using the percentage method for recording risk tolerance, a trade that results in an account with a greater percentage of low, medium to high risk investments than

indicated on the KYC form should be flagged for a suitability review. While generally in an examination the MFDA will not query trades where the account has a greater percentage of lower risk investments, these situations may indicate that the KYC information on file requires an update or the client's objectives are not being met. Where a Member uses the model portfolio approach, an account that exceeds the pre-established thresholds should be flagged for review.

D. Use of Weighted Average of Fund Risk Ratings

Staff is aware of some Members using a simple weighted averaging process to assess suitability that involves:

- a) Recording client risk tolerance on a scale of 0 to 9, either in absolute terms or as a range;
- b) Risk rating mutual funds on a scale of 0 to 9 which may not specifically correspond to their prospectus risk ranking; and
- c) Taking a weighted average of the risk ranking of each fund and comparing it to the client's score.

The weighted average of fund risk scores is not an appropriate method for assessing suitability. To illustrate an actual example, assume a Member categorizes clients as follows:

Low risk	0 to 3
Medium risk	4 to 6
High risk	7 to 9

A client is considered medium risk and is given a risk ranking of between 4 and 6. Assume the client has 50% high risk investments with a risk rating of 8, 30% medium risk investments with a risk rating of 5 and 20% low risk investments with a risk rating of 1. The overall risk of the portfolio would be calculated as follows:

High risk investments	50% x 8 =	4.0
Medium risk investments	30% x 5 =	1.5
Low risk investments	20% x 1 =	<u>0.2</u>
Weighted Average Risk of the Portfolio		<u>5.7</u>

The above portfolio would appear to be suitable using the weighted averaging methodology. However, mutual funds with an 8 ranking have included speculative and volatile funds and mutual funds with a 5 risk ranking have included growth funds. Such a portfolio could result in a significantly higher standard deviation than the industry average or industry guidelines in respect of a medium risk mutual fund.

It appears that the general concept being relied upon is that high and low risk investments always counteract each other, which is not necessarily true in all cases. Modern Portfolio Theory calculates the standard deviation of a portfolio as the weighted average of the standard deviations of each security in addition to components that account for the co-

movement of returns of the individual securities. The weighted average of fund ratings, while simple to use and easy to implement, is not an appropriate or effective method to prevent and detect unsuitable transactions.

E. Investment Objective Suitability

Investment objectives can be stated as a whole or as percentages. For example, a client can state an investment objective as “income” or 50% income and 30% growth and 20% aggressive growth. When assessing investment objective suitability, it is necessary to determine whether the particular investment or trade meets the objectives of the account.

F. Time Horizon Suitability

The characteristics of a particular investment should be suitable given the client’s stated time horizon. Mutual funds are generally considered medium to long term investments.

A client’s stated time horizon is most important when considering the fee structure of a mutual fund. Generally, it is considered unsuitable for a client to be put into a DSC fee fund and have a time horizon that is shorter than the DSC schedule and, at a minimum, a client’s time horizon should never be 3 years or less if DSC fee funds are purchased. A time horizon suitability analysis of investments with liquidity restrictions should also be performed. If the stated time horizon is less than the liquidity restriction, the investment is not suitable for the client.

G. Trade and Account Supervision, Inquiry Resolution

Members should have systems or processes to identify trades inconsistent with the client’s risk tolerance, investment objectives and time horizon.

A Member’s criteria for selecting trades for review at both the branch and head office, inquiry and escalation process, supervisory documentation requirements and resolution options should be documented and clearly communicated to all levels within the Member. APs should know the criteria the Member uses in assessing suitability, actions the Member will take when a trade has been flagged for review and appropriate options for resolution. Branch Managers should also be trained on their obligations to maintain evidence of their supervisory review, including what information must be kept (signature, date, explanation of how the inquiry was resolved and supporting documents when necessary). Head office staff responsible for performing trade supervision and branch reviews must also be trained on the head office trade supervision criteria, documentation standards, timelines for inquiry and resolution and the escalation and disciplinary process.

Outlined below are guidelines for trade review for branch and head office supervision.

a) Branch Office Supervision

A branch manager (or alternate) must review the previous day's trading for unusual trading activity. This review should include, at a minimum, all:

- Initial trades;
- Trades in exempt securities;
- Leveraged trades in open accounts;
- Trades over \$1,000 in moderate-high or high risk investments;
- Trades in accounts operating under a Power of Attorney for family members of APs; and
- Other trades and redemptions over \$5,000.

When reviewing trades, including redemptions, it would also be advisable to determine whether the AP has maintained adequate notes and instructions on a sample basis.

b) Head Office

In addition to the trading review criteria for branch managers, head office must conduct daily reviews of account activity based upon appropriate criteria. This review should include, at a minimum, all:

- Trades greater than \$5,000 for exempt securities, moderate-high or high risk investments or leveraged trades in open accounts;
- Trades greater than \$10,000 for other investments (excluding money market mutual funds); and
- Redemptions greater than \$10,000.

Redemptions should be reviewed to identify possible outside business activity where money may be leaving the Member for potentially inappropriate or unauthorized purposes, potential churning where the money is being parked or held pending reinvestment, to assess the impact and appropriateness of redemption charges, where applicable and to assess suitability in terms of the redemption's impact on the composition of the remaining portfolio. For example, a client may have a balanced objective and hold a combination of fixed income and equity mutual funds. If the client redeemed out the entire fixed income component of his or her portfolio, the remaining portfolio of equity mutual funds would be inconsistent with the client's balanced investment objective.

For the purposes of Sections a) and b) above, "trades" does not include redemptions except where specifically referenced.

c) Trend Analysis

In addition to performing day-to-day trade reviews, Members should establish a process to identify trends or patterns that may be of concern.

The reviews conducted should include criteria to detect excessive trading or switching between funds indicating possible unauthorized trading, lack of suitability

or churning. Branch and head office supervisors should be alert to transactions that indicate trends or patterns of concern, including:

- Redemptions made within 3 months of a purchase;
- Redemptions with redemption charges;
- Switches with switch fees; and
- DSC redemptions followed by DSC purchases within 3 months.

Head office should also implement procedures to identify or detect trends or patterns of concern which would include, at a minimum, reviewing:

- Accounts generating commissions greater than \$1,500 within the month;
- Frequent trading reports where there are greater than 5 trades per month in any one client account;
- AUA reports on a quarterly basis and comparing current AUA to AUA at the same time the prior year; and
- Commission reports on a quarterly basis for the previous twelve-month period and comparing them to the same period the prior year.

After taking into consideration market fluctuations, a significant increase in commissions or AUA may indicate concerns with churning or leveraging strategies and a significant decrease may indicate potential inappropriate outside business activity.

d) *Inquiry and Resolution*

Members must have policies and procedures with respect to the trade inquiry process. The policy should include timelines for APs to respond to inquiries and methods to resolve the inquiry. Appropriate resolution may include:

- Cancelling or reversing the trade or rebalancing the account, without cost to the client, to make it consistent with the client's KYC information; or
- Obtaining a new KYC form where the trade was suitable but the KYC information was outdated.

Where a new KYC form is obtained, it is important that the supervisor who queried the trade consider the reasonableness of the KYC update. For example, if there has been a short time frame since the last update or the KYC information has changed drastically, it is possible that the update is only being made to justify an unsuitable trade.

Members should also include an escalation procedure in their trade inquiry process. If an AP does not respond to an inquiry or does not provide sufficient justification for the trade within a reasonable period of time, the Member must take steps to resolve the query. The escalation procedure should include timelines to respond and the

process that will be taken by the Member if the AP does not take steps to resolve the query. Members should also consider imposing increased supervision over trade activity of an AP where he or she has an inordinate number of trades being queried or queries which raise concerns regarding the APs competency or understanding of the Member's internal policies.

An appropriate audit trail of all trade supervision must be maintained. This includes not only initials of the supervisor and a date but also documentation evidencing what trades were queried, the response received and resolution made.

H. Unsolicited Unsuitable Trades and Unsuitable Portfolios

MFDA Rule 2.2.1(d) requires that where a client has requested a trade on an unsolicited basis that, in the view of the AP or Member, is unsuitable, the Member or AP must advise the client of this fact before executing such a transaction. The Member must maintain a record of the advice given and the client's authorization to proceed.

In some instances, accounts may be inconsistent with client KYC information that is not a result of any action taken by an AP or Member. For example, a client transferring into a Member may have employed a leveraging strategy that, in the view of the Member, is not suitable or consistent with their leveraging guidelines. In this case, staff recommends that a Member follow the same process that is in place for unsolicited unsuitable trades.

I. Additional Concerns Regarding Trade Supervision and Suitability Assessments

MFDA staff has also identified the following concerns with respect to the suitability process of trade reviews conducted by Members:

- Exempt products are not given a risk assessment and are not considered in the suitability analysis;
- Suitability is assessed without considering all the KYC information. For example, a Member may only focus on risk tolerance and ignore time horizon or investment objectives;
- Members are only performing trade reviews and are not performing trend analysis to identify trends of concern including significant redemptions;
- Members are employing an unreasonable materiality threshold for assessing suitability;
- Members do not have policies regarding their suitability process and, as a result, there are inconsistencies in how trades are selected and reviewed for suitability;
- Members are not classifying hedge funds and exempt securities as high risk;
- Lack of due diligence on exempt products which results in a misunderstanding of key attributes of the offering;

- Little or no guidance given to APs or supervisors as to attributes of exempt products offered to clients and the type of client that such products would be suitable for;
- Trades of branch managers are not reviewed by head office;
- Trade supervision is not performed within one business day;
- Inadequate trade selection criteria;
- Minimal or no policy on trade supervision at branch and head office;
- Little or no training of supervisory staff on suitability criteria and supervisory process;
- Branches are not performing trade supervision or documenting supervisory activity;
- Inadequate documentation of trade inquiries made, follow up and resolution;
- Trade blotters used for supervision do not include KYC information or identify leveraged trades;
- Supervisors accept AP explanations without objectively considering their reasonableness; and
- Members do not have an escalation or discipline policy dealing with unsuitable trading practices (e.g. heightened supervision, fines, termination, etc).

4. LEVERAGING

A number of previous MFDA Member Regulation Notices have reminded Members that using borrowed funds to invest (or leveraging) is not suitable for all investors and have highlighted the Member's responsibility to ensure that all leveraging recommendations are suitable for the client and in keeping with the client's KYC information, in accordance with MFDA Rule 2.2.1 However, MFDA staff continues to identify issues regarding the suitability of leveraging.

A. Informing the Client

Clients must be provided with a balanced presentation of available options and the risks associated with the use of leverage must be clearly disclosed. Many issues arise because of the client's failure to fully understand certain key considerations before borrowing money to invest such as:

- The strategy should only be used by individuals that are comfortable with the general risks associated with leveraging;
- The value of the leveraged portfolio may fall below the value of the loan;
- There is a magnification of the investment risk where a leverage strategy is used;
- Even where returns on leveraged investments are positive, interest costs may exceed the returns received;

- Whether investment returns are positive or negative, clients must still pay back the loan plus the agreed interest, which may cause client hardship;
- The clients may be forced to realize losses as a result of the terms of secured loans;
- Any loans secured against a client's home can put the client's equity interest in the home at risk;
- If a client is relying on investment returns to cover borrowing costs and the investment falls in value, the client could default on the loan;
- A lender's assessment of a client's ability to repay an RRSP loan may be based on the presumption that the client will use the tax refund to pay back the loan; and
- A leverage strategy is not necessarily suitable simply because it is being used as a means to take advantage of tax deductions; there is specific tax legislation governing the deductibility of interest and, if the conditions are not complied with, it may lead to a reassessment.

Members should ensure that APs provide this information to any clients to whom leveraging recommendations are made, and to clients who the AP otherwise knows are investing with borrowed funds.

B. Member and AP Responsibilities Regarding Leveraged Transactions

As noted in MFDA Member Regulation Notice MR-0008 "Policies and Procedures Manual", each Member's policies and procedures manual should address issues related to borrowing for the purchase of securities. The manual should:

- Outline the requirement to deliver the risk disclosure documents to clients in accordance with MFDA Rule 2.6;
- Describe appropriate client circumstances for recommending the purchase of securities with borrowed funds (guidance is provided under "Assessing Suitability of Leveraging Recommendations" below);
- Describe the information required to be maintained in the client file to facilitate proper Member supervision, including lending documents which should be consistent with KYC information on file for the client;
- Describe procedures for identifying and reviewing leveraged trades, as required by MFDA Policy No. 2 *Minimum Standards for Account Supervision*; and
- Describe procedures for Member approval of AP arrangements with lenders to ensure the proper recording and supervision of leveraging recommendations.

The responsibility of the Member and AP in a given instance will depend on their level of involvement in the client's decision to employ a leverage strategy. Where the Member or AP has made a specific recommendation to borrow money for the purpose of investing, lending documents should be maintained in the client's file. In the event that a Member or AP only

becomes aware of a client's use of leverage after the investment loan has been made, details of the loan should be requested or suitable inquiries should be made, so that the client information maintained on file is as complete as possible.

The Member's policies and procedures should also address situations where APs have arrangements with lending institutions to finance leveraging strategies. Arrangements in which compensation is paid are referral arrangements pursuant to MFDA Rule 2.4.2 and must be documented and entered into between the Member and the financial institution. Even where there is no compensation paid, Members are expected to have policies and procedures in place to require APs to inform them of any arrangement or agreement with a lender to comply with the Members general supervisory obligation to address any actual or potential conflict of interest. This would not include situations where clients arrange their own financing without the recommendation or advice of the AP. Where clients do arrange their own financing and it comes to the attention of the Member or AP, the Member should have policies and procedures to flag the account and review such situations in accordance with its leveraging guidelines.

The Member should ensure that all APs are fully aware of the negative, as well as the positive aspects of leveraged investing so that full disclosure can be made to their clients. APs must understand and observe the requirement to provide balanced, objective information to the client. In particular, where projections are provided to clients, any assumptions on which a projection is based must be clearly stated, with examples of positive and negative results.

C. Assessing the Suitability of Leveraging Strategies

The following guidelines are not intended to apply to loans obtained for the purpose of investing in a registered retirement savings plan.

Leverage is not suitable for all investors and the appropriateness of a recommendation to use leverage must be assessed on a client-by-client basis, having regard to the client's age, financial circumstances, investment objectives, risk tolerance, time horizon, the manner in which they intend to secure and repay their loan and any other factors that are known at the time or reasonably ascertainable and may be relevant in the circumstances. Members must have policies and procedures with respect to leveraging, including criteria that would indicate when it is an unsuitable strategy and the approval process. MFDA staff also recommends preapproval of leverage recommendations by supervisory staff.

None of the criteria below, on their own, are necessarily indicative of an unsuitable leveraging recommendation but should be considered a "red flag" prompting a suitability assessment. Each factor must be considered in context with all other factors in order to determine whether a leveraging strategy is suitable. For example, as is noted below, a leveraging strategy is generally not suitable for a client who is 60 years or older. The fact that a 60-year-old client is leveraged is not in, and of itself, determinative of unsuitable leveraging, but rather a red flag for further review and analysis. However, if the 60-year-old

client is leveraged and has a minimal income stream and liquid assets, then the leveraging strategy is most likely unsuitable.

Where an inconsistency with one of the criteria is identified, further due diligence is required to assess the suitability of the leverage recommendation which may include obtaining detailed information on client cash flows, monthly expenses and other debt or lending obligations.

Criteria that should be considered when assessing leveraging suitability include:

a) *Investment Knowledge*

A leveraging strategy is not recommended for clients who have indicated that their investment knowledge is low or poor.

b) *Risk Tolerance*

A leveraging strategy should only be recommended where a client has a medium risk tolerance or higher. A leveraging strategy is generally not suitable for investing in low risk investments as the cost of borrowing may be greater than the returns from the investment. Where a Member uses the percentage method for recording risk tolerance, leveraging would be suitable where the client has indicated that the majority of the account will be invested in medium and high risk investments.

c) *Age*

A leveraging strategy is used mostly for long term growth investments. Most clients who are 60 years or older have a portfolio that is maximized for income generation and capital preservation as opposed to long term growth. Further, when clients are at or nearing retirement, their earning potential and ability to withstand investment losses decreases. As such, leveraging is generally not considered suitable for these clients and a red flag should be raised and an objective assessment of the KYC information should be provided.

d) *Time Horizon*

A leveraging strategy is generally more appropriate for clients with a long term time horizon. This is because investing for the long term alleviates to some extent the risks of short and medium term market volatility. If a client is leveraged and has a time horizon of less than 5 years, this issue should be flagged for review.

e) *Net worth*

A general guideline is that an investment loan should not exceed 30% of a client's net worth and 50% of a client's liquid net worth. For example, a client with a liquid net worth of \$200,000 should not have a loan that is more than \$100,000.

In some instances it may be acceptable to exceed these thresholds and this will require judgment. For example, it may be appropriate in some circumstances for a young client with very little liquid net worth but with a high income to be leveraged. As always this factor must be considered in conjunction with all others.

f) Client's Income

A client's income must be sufficient to service the debt payments on all of the client's loans. A general guideline is that the debt payments should not exceed 35% of the client's gross income, not including income generated from the leveraged investments. For example, a client with a gross income of \$2,000 a month should not have a loan that requires monthly payments in excess of \$700 a month.

Other Issues Regarding the Suitability of Leveraging

Clients should not be relying on the growth of mutual funds in the account to make payments on the leveraged loan, nor should the client have to make withdrawals from registered investments to make payments.

A Member and AP cannot rely on the approval by the lending institution of the loan as an indication of suitability. Members and APs must consider a client's financial circumstances when assessing the suitability of using borrowed funds to fund an investment as part of their obligations under MFDA Rule 2.2.1.

D. Additional Concerns Regarding Supervision of Leveraging

MFDA staff has also identified the following concerns with respect to the supervision of leveraging conducted by Members:

- Loan documentation submitted to the financial institution varies significantly from the KYC information on file for the client;
- No policies and procedures with respect to criteria to assess suitability of leveraging for APs or supervisory staff;
- No policies and procedures in place (at the Member) regarding referrals to lending institutions or from mortgage brokers relating to leveraging programs;
- Misleading advertising or unrealistic projections used to market leveraging strategies; and
- Projections only depict positive returns without any examples of potential negative returns.

5. COMMON MISCONCEPTIONS

Some common misconceptions identified by MFDA during compliance reviews include the erroneous notion that disclosure justifies an unsuitable recommendation. For example, a recommendation to a client with a medium risk tolerance to purchase a high risk investment is unsuitable, even if the client has been provided with disclosure that shows the investment is high risk. Similarly, the fact that a client was given a prospectus that fully disclosed the risk level of the fund is not a valid defense by a Member or AP to an unsuitable trade or recommendation. If an AP recommends securities that are not suitable for a particular client, then disclosure to the client is irrelevant to the suitability obligation.

The AP's failure may have been the result of not knowing the client, not knowing the securities, or an error in the suitability determination but, once the improper recommendation has been made, it does not matter whether or how the Member or AP discloses the material negative factors, or whether the client claims to understand and accept the risks involved in the investment.

It should also be noted that the existence of a signed order or trade form does not in any way lessen Member's and AP's suitability obligation and does not constitute a valid defense to an unsuitable trade or recommendation. Unsuitable trades can only be made on an unsolicited basis in accordance with Rule 5.1(b) and 2.2.1 and Member Regulation Notice MR-0025 "Suitability Obligations for Unsolicited Orders".

As stated above, suitability must be analyzed for each individual account. The fact that the client may have other assets in other accounts, or with other institutions, should not be taken into account.

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APPENDIX 1: EXAMPLE OF KYC INFORMATION

Please complete the following information regarding your personal circumstances. We will use this information to ensure that any recommendations we make regarding investments are suitable for you.

DATE OF BIRTH: _____
(DD/MM/YYYY)

INVESTMENT KNOWLEDGE

Which of the following categories best describes your knowledge of investing?

- Extensive _____
- Moderate _____
- Limited _____

CLIENT(S) INCOME (includes spouse)

Please note your approximate annual income from all sources.

- \$0 - \$24,999 _____
- \$25,000 - \$49,999 _____
- \$50,000 - \$74,999 _____
- \$75,000 - \$99,999 _____
- \$100,000 - \$149,999 _____
- \$150,000 - \$199,999 _____
- \$200,000 or more _____

TIME HORIZON

Indicate the period from now to when you will need to access a significant portion of the money you invest in this account.

- Less than 1 yr. _____
- 1 – 3 yrs. _____
- 4 – 5 yrs. _____
- 6 – 9 yrs. _____
- 10 yrs. or more _____

CLIENT(S) NET WORTH (includes spouse)

Please provide an estimate of the value of your assets and liabilities.

- Estimated Liquid Assets (eg. investments, cash) _____
- + Estimated Fixed Assets (eg. real estate) _____
- Estimated Liabilities (eg. mortgage, car loan) _____
- = Estimated Net Worth _____

RISK TOLERANCE

This section documents your willingness and ability to assume risk and should reflect the relative weighting of the types of investments you wish to hold in the account. The value of the investments we recommend should not exceed the allocation thresholds described below.

Low (Low risk investments demonstrate a low volatility and are for investors who are willing to accept lower returns for greater safety of capital and may include such investments as Canada Savings Bonds, GICs and money market mutual funds.) _____%

Low to Medium (Low to Medium risk investments demonstrate a low to medium volatility but a higher volatility than those described above and may include bond or balanced funds.) _____%

Medium (Medium risk investments demonstrate a medium volatility and are for investors that are looking for moderate growth over a longer period of time and may include Canadian dividend, Canadian equity, U.S. equity and certain international equity funds.) _____%

Medium to High (Medium to High risk investments demonstrate a medium to high volatility and are for investors that are looking for long term growth and may include funds that invest in smaller companies, specific market sectors or geographic areas.) _____%

High (High risk investments demonstrate a high volatility and are for investors who are growth oriented and are willing to accept significant short term fluctuations in portfolio value in exchange for potentially higher long term returns and may include labour-sponsored venture capital funds or funds that invest in specific market sectors or geographic areas such as emerging markets, science and technology, or funds that engage in speculative trading strategies including hedge funds that invest in derivatives, short sell or use leverage.) _____%

Total 100%

INVESTMENT OBJECTIVES

Income (Your objective is to generate current income from your investments and you are less concerned with capital appreciation. Investments that will satisfy this objective include fixed income investments such as funds that invest in bond or money market instruments.) _____%

Growth (Your objective is capital appreciation and current income from investments is not a requirement. This may lead you to hold a relatively high proportion of funds that invest in equities if you also have a higher risk tolerance and long term time horizon.) _____%

Balanced (Your objective is a combination of income and growth. An account with a balanced objective should typically include at least 40% in fixed income investments and no more than 60% in equity mutual funds.) _____%

Total 100%