



CIRCULAR
September 30, 2003

REQUEST FOR COMMENTS

MINIMUM STANDARDS FOR INSTITUTIONAL ACCOUNT OPENING, OPERATION AND SUPERVISION

ADDITION OF POLICY C-7

Summary

The Special Committee – Regulatory Division of Bourse de Montréal Inc. (the "Bourse") has approved the addition of Policy C-7 "Minimum standards for institutional account opening, operation and supervision" to the Rules and Policies Manual of the Bourse. The proposed Policy C-7 will ensure that all approved participants implement standards relating to institutional accounts in a uniform and equitable way. The Policy has also for purpose to define what is an institutional account as well as to establish procedures and provide instructions in regards to standards relating to the supervision of institutional accounts.

Process for Changes to the Rules

Bourse de Montréal Inc. is recognized as a self-regulatory organization (SRO) by the Commission des valeurs mobilières du Québec ("the Commission"). In accordance with this recognition, the Bourse carries on activities as an exchange and as a SRO in Québec. In its SRO capacity, the Bourse assumes market regulation and broker-dealer regulation responsibilities. The broker-dealers regulated by the Bourse are its approved participants. The responsibility for regulating the market and the approved participants of the Bourse comes under the Regulatory Division of the Bourse ("the Division"). The Division carries on its activities as a distinct business unit separate from the other activities of the Bourse.

Circular no.: 136-2003

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The Board of Directors of the Bourse has delegated to the Special Committee – Regulatory Division its powers to approve or amend some aspects of the Rules and Policies of the Bourse governing approved participants, among which, the Rules and Policies relating to admission as approved participant, approval of persons, disciplinary matters and the management of client accounts. These changes are submitted to the Commission for approval.

Comments on the proposed addition of Policy C-7 to the Rules and Policies Manual of the Bourse must be submitted within 30 days following the date of publication of the present notice in the bulletin of the Commission. Please submit your comments to:

*Mr. Jacques Tanguay
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A copy of these comments shall also be forwarded to the Commission to:

*Ms. Denise Brosseau
Secretary
Commission des valeurs mobilières du Québec
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Appendices

For your information, you will find in appendices an analysis document of the proposed rule amendments as well as the proposed regulatory text. The implementation date of the proposed amendments will be determined with the other Canadian self-regulatory organizations, if applicable, following approval by the Commission des valeurs mobilières du Québec.



MINIMUM STANDARDS FOR INSTITUTIONAL ACCOUNT OPENING, OPERATION AND SUPERVISION

- ADDITION OF POLICY C-7

I - OVERVIEW

A -- Current Rules

Proposed new Policy C-7 of Bourse de Montréal Inc. (the “Bourse”), entitled “Minimum Standards for Institutional Account Opening, Operation and Supervision” (the “Policy”) was developed to fill a void in the guidance available to registered representatives and approved participants in dealing with customers other than retail customers. In 1993, the Bourse implemented Policy C-2, “Minimum Standards for Retail Account Supervision”, in order to not only ensure that registered representatives comply with the rules of the relevant self-regulatory organizations, but also that supervisory personnel has guidance in exercising their responsibilities in regards to compliance with the relevant rules and policies. The minimum standards for institutional account opening, operation and supervision were designed for the same purpose.

Although the development of proposed Policy C-7 started not long after the implementation of Policy C-2, its submission for approval has been delayed until now due to the fact that, in the interim, discount brokers began seeking relief from general transaction suitability obligations. It was then determined that as long as the issue of suitability regarding retail brokerage activities would not be resolved, further development of

Policy C-7 should be delayed and then reconsidered in the context of changes to the transaction suitability regime in Canada. Once those matters were resolved, the review and the redrafting of the proposed Policy C-7 was undertaken.

B -- The Issue

Current Rules of the Bourse do not contain specific provisions with respect to what constitutes adequate procedures for opening institutional accounts, suitability obligations with respect to transactions made by such accounts, establishment of general procedures and supervision of these accounts.

C – Objective

It has long been recognized in the procedures and organization of approved participants that clients fall into either one of two major categories: retail clients or institutional clients. Approved participants generally have separate departments and structures to deal with retail and institutional clients. Also, many approved participants specialize in dealing with only one of these two major types of clients. The current Minimum Standards for Retail Account Supervision Policy recognizes this distinction. However, from a regulatory perspective, this categorization has been an informal one for institutional accounts.

A Policy, which establishes procedures and provides guidance in the area of standards for the supervision of institutional accounts has been lacking. Proposed Policy C-7 seeks to address this issue.

D -- Effect of Proposed Policy

Proposed Policy C-7 will ensure that approved participants apply institutional accounts standards in a consistent and equitable manner.

II -- DETAILED ANALYSIS

A -- Present Rules, History and Proposed Policy

The current rules of the Bourse set out the general requirements for “know-your-client” and suitability in Rule Seven for securities in general, Rule Eleven for options, and Rule Fourteen for futures contracts. In addition, article 3011 of the Rules of the Bourse requires from approved participants that they implement supervisory systems and written policies and procedures regarding the management of the types of business in which the approved participant is involved. Additional guidance on “know-your-client”, suitability and general supervision requirements is also found in Policy C-2 of the Bourse. The standards in this Policy provide guidance on items such as:

1. establishing and maintaining procedures, delegation and education;
2. opening of new accounts; and
3. branch and head office account supervision.

Further guidance is needed on the same matters for institutional accounts. Consequently, proposed Policy C-7 seeks to provide guidance on:

1. the definition of an institutional account;
2. client suitability;
3. opening new accounts;
4. money-laundering considerations;
5. establishing and maintaining procedures, delegation and education; and
6. account supervision.

The proposed Policy provides a definition of what is an institutional account and enumerates factors, which should be considered in determining whether the approved participant has a suitability obligation to an institutional client. If it is determined that such an obligation

exists, then the client shall be treated in the same manner as a retail client.

In order to provide more clarity when determining whether or not a client is an institutional client, the Policy suitability discussion has been simplified and a list of factors has been incorporated.

The approach is flexible and its use will depend upon the nature of the approved participant, its procedures and the nature of its clientele. The implementation of the Policy C-7 will require that each approved participant review its business activities and determine the manner in which the Policy is to be applied.

Also, contrarily to Policy C-2 which deals with the supervision of retail accounts, Policy C-7 does not contain specific sections dealing with supervision at branch office and head office levels. It was determined that such provisions were not necessary due to the introduction of the Universal Market Integrity Rules (“UMIR”) in March 2002. More specifically, Policy 7.1 of UMIR entitled “Policy on Trading Supervision Obligations” addresses the need for trade compliance monitoring and trade desk reviews. It was therefore concluded that it would have been redundant to repeat supervision provisions that can already be found elsewhere. Although the Bourse itself does not have a Policy similar to Policy 7.1 of UMIR, it does use it as a reference in the course of its market surveillance activities and derivatives trading desk reviews. It is the intent of the Bourse to eventually develop a similar trading supervision policy adapted to the derivatives market.

Regarding clients’ complaints, the matter was discussed by a committee of the Investment Dealers Association of Canada (IDA), the Institutional Sub-Committee, and it was concluded that based on the sophistication of institutional clients and the relatively narrow definition of “institutional client”, the number of client complaints in the past has always been extremely low and therefore provisions for this matter were not required.

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The definition of an institutional client was studied a great deal by the Institutional Sub-Committee. The Sub-Committee reviewed various existing definitions including the definition of “accredited investor” under Ontario Securities Commission Rule 45-501, “Exempt Distributions”, and the definition of “retail client” under National Instrument 33-102, “Regulation of Certain Registrant Activities”.

Also, an earlier draft of the definition section in the Policy included individuals having a net worth exceeding \$5 million in the definition of institutional client. The definition of “retail client” that is currently included in National Instrument 33-102 excludes these individuals and it could therefore be interpreted as meaning that any individual having a net worth in excess of \$5 millions can be deemed, by default, to be an institutional client.

However, after considering comments on this issue submitted by the Bourse, the Sub-Committee agreed to remove from the definition of institutional client the section concerning individuals. The Bourse argued that although the Policy requires a firm to determine if the client is sufficiently sophisticated and capable of making its own investment decisions in order to be considered as an institutional client, the individual category seemed to open the door to a second approach by allowing that such a determination be made based on net worth when proper documentation substantiates that net worth. According to the Bourse, once the documentation obtained has established that an individual has a net worth of more than \$5 million, there is a danger that the person will be automatically qualified as being an institutional client.

The Bourse also mentioned that in the United States, the National Association of Securities Dealers (NASD) includes in its definition of an “institutional account” a natural person with total assets of \$50 million US. However, with respect to suitability for institutional customers, the interpretation in the NASD Rules states that the guidance should be applied to a customer

with at least \$10 million US invested in securities.

Finally, the Bourse argued that the evaluation of an individual’s net worth is a very subjective exercise as such figures cannot be audited appropriately and very often the net worth declared by individuals is significantly overvalued. Consequently, the Bourse was of the opinion that very limited relevance can be given to declared net worth of individuals. The Sub-Committee agreed with the position of the Bourse on this issue and as a result, the section of the definition pertaining to individuals having a net worth exceeding \$5 million has been removed from the definition of an institutional client.

B -- Other Alternatives Considered

Other than the above-discussed considerations related to the incorporation of individuals in the definition of what is an institutional client, there were no other alternatives considered.

C -- Comparison with Similar Provisions

The suitability provisions in the proposed Policy are based, in part, on NASD Interpretation IM-2310-3 entitled “Suitability Obligations to Institutional Customers”, which sets out various factors and elements to consider when determining a NASD member’s suitability obligations in making investment recommendations to an institutional customer. According to the NASD interpretation, once a member has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk (based on factors enumerated in the interpretation bulletin), then a member’s obligation to determine that a recommendation is suitable for a particular customer is fulfilled.

Both proposed Policy C-7 and the NASD Rule recognize that these factors are guidelines only and that a determination must be made on a case-by-case basis taking into consideration the

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factors and circumstances of a particular broker-client relationship.

In the United Kingdom, the Financial Services Authority has set requirements for categorizing counterparties with which a firm deals. If a broker's customer belongs to one of the several types of financial institutions or a government, then rules allow the broker to categorize the customer as market counterparty. There are also additional categories for experts and "non-private" customers, which are individuals of certain sophistication in their investments.

D -- Systems Impact of Policy

It is not anticipated that the Policy will have a significant impact on approved participants' systems since most of those that have institutional clients already have systems in place to monitor and supervise these accounts.

E -- Interests of the Capital Markets

The Bourse has determined that proposed Policy C-7 is not detrimental to the interests of the capital markets.

F -- Public Interest Objective

Proposed Policy C-7 addresses the need for completing the guidance available to approved participants in satisfying "know-your-client" and suitability rules in the context of institutional accounts. In addition, the proposed Policy provides guidance and procedures, which will standardize industry practices and ensure increased client protection.

The proposed Policy does not permit unfair discrimination among clients, issuers, brokers, dealers, approved participants or other persons. It does not impose any burden on competition that is not necessary or appropriate.

III -- COMMENTARY

A -- Filing in Other Jurisdictions

Proposed Policy C-7 will be filed with the Commission des valeurs mobilières du Québec for approval and with the Ontario Securities Commission for information.

B – Effectiveness

The proposed Policy is an effective means of providing guidance and consistent standards for approved participants who operate institutional accounts.

C – Process

The first step of the approval process for the regulatory amendments discussed in the present document consists in having the proposed amendments approved by the Compliance Subcommittee of the Regulatory Division of the Bourse. The amendments are then submitted to the Special Committee – Regulatory Division. Once the approval of the Special Committee obtained, the project is simultaneously published by the Bourse for a 30-day comment period and submitted to the Commission des valeurs mobilières du Québec for approval.

IV -- SOURCES

- Article 3011 of the Rules of Bourse de Montréal Inc.
- Rules Seven, Eleven and Fourteen of Bourse de Montréal Inc.
- Policy C-2 of Bourse de Montréal Inc. - Minimum Standards for Retail Account Supervision
- Policy C-3 of Bourse de Montréal Inc. - Joint Regulatory Financial Questionnaire and Report, General Notes and Definitions
- Ontario Securities Commission Rule 45-501 – "Exempt Distributions", definition of "accredited investor"
- Commission des valeurs mobilières du Québec, Staff Notice issued in

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connection with OSC Rule 45-501, Weekly Bulletin, 2002-03-15, Vol. XXX111, No. 10

- National Instrument 33-102 – “Regulation of Certain Registrant Activities”, definition of “retail client”
- Policy 7.1 of Universal ‘Market Integrity Rules - “Policy on Trading Supervision Obligations”
- National Association of Securities Dealers, Interpretation Bulletin IM-2310-3 – “Suitability Obligations to Institutional Customers”
- National Association of Securities Dealers, Rule 3310 (c) 4
- Financial Services Authority Handbook – “Principles for Businesses”, Chapter 1.2 – “Introduction: Clients and the Principles and Conduct of Business” and Chapter 4.1 – “Accepting Customers: Client Classification”

**POLICY C-7
(00.00.03)****MINIMUM STANDARDS FOR INSTITUTIONAL ACCOUNT OPENING,
OPERATION AND SUPERVISION****1. INTRODUCTION**

This Policy covers the opening, operation and supervision of institutional accounts, which are accounts opened for sophisticated investors, and sets out minimum standards that must be applied to such accounts. Since it concerns accounts of sophisticated investors, application of Policy C-2 of the Bourse, Minimum Standards for Retail Account Supervision, is not warranted. Accordingly, it is not necessary for approved participants, when recommending securities transactions to such investors or executing transactions for them, to make a suitability determination.

Pursuant to article 3011, approved participants must provide adequate resources and qualified supervisors to achieve compliance with the Rules and Policies of the Bourse.

Adherence to minimum standards of the present Policy requires that approved participants have in place appropriate procedures to open and operate institutional accounts and monitor their activity. However, adhering to these minimum standards does not:

- a) relieve an approved participant from complying with specific self-regulatory organization by-laws, rules, regulations and policies and with securities or other legislation applicable to particular trades or accounts (e.g.: best execution obligation, restrictions on short selling, order designations and identifiers, exposure of clients orders, trade disclosures);
- b) relieve an approved participant from the obligation to impose higher standards where circumstances clearly dictate the necessity to do so to ensure proper supervision; or
- c) preclude an approved participant from establishing higher standards.

Any account which is not an institutional account governed by the standards must be governed by the Minimum Standards for retail Account Supervision (Policy C-2).

II ACCOUNT OPENING**1. Definition of Institutional Account**

For the purposes of this Policy, institutional clients are defined as including:

- a) acceptable counterparties (as defined in the “Joint Regulatory Financial Questionnaire and Report” of Policy C-3 of the de la Bourse);
- b) acceptable institutions (as defined in the “Joint Regulatory Financial Questionnaire and Report” of Policy C-3 of the de la Bourse);

- c) regulated entities (as defined in the “Joint Regulatory Financial Questionnaire and Report” of Policy C-3 of the de la Bourse);
- d) registered persons (other than individual registrants) under securities legislation, or members of a recognized exchange (as defined in Article 1102 of the Rules of the Bourse);
- e) a non-natural person with total securities under administration or management exceeding \$ 10 million.

2. Opening of an Institutional Account – Client Suitability

At the time of opening an account for an institutional client, the approved participant must make a determination whether the client is sufficiently sophisticated and capable of making its own investment decisions and therefore, if an institutional account or a retail account must be opened. If the approved participant determines that the client should be treated as an institutional account, the approved participant must either obtain from the client a written acknowledgement that the client is not relying on the approved participant to determine or review the suitability of recommendations or trading, or otherwise put the client on notice. If not, the account must be treated as a retail account.

In making that determination, the approved participant must take the following factors in consideration:

- a) the knowledge and resources available to the client to make informed investment decisions, which may include:
 - i) the use of one or more investment dealers, portfolio managers, investment counsel or other third party advisors;
 - ii) the general level of experience of the client in financial markets; and
 - iii) the specific experience of the client with the type of instrument(s) under consideration, including the client’s ability to independently evaluate how market developments would affect the security and ancillary risks such as currency rate risk.

The above-mentioned factors are guidelines only. The presence or absence of any of these factors is not dispositive of the determination of suitability. Such a determination can only be made on a case-by-case basis taking into consideration the facts and circumstances of a particular relation between an approved participant and the client, assessed in the context of particular types of transactions.

A client may operate as an institutional client in one type of investment in which it has independent decision-making expertise but as a retail client with respect to another product in which it does not. Any activity with respect to an institutional client done on a retail basis must be conducted in a separate retail account.

3. New Account Documentation and Approval

The necessary documentation at the opening of each institutional account must at least include the following:

- a) the new client account application;
- b) the necessary documentation to substantiate the declared net worth when this one is used as the basis for determining the eligibility of the client as an institutional account; and
- c) all documentation required under the *Regulations under Proceeds of Crime (Money Laundering) Act* and *United Nations Suppression of Terrorism Regulations*.

An approved participant may establish a “master” new account documentation file, containing full documentation and, when opening sub-accounts, refer to the principal or “master” account with which it is associated.

Each new account must be approved by a responsible officer or by a person designated by him, prior to the initial trade or promptly thereafter. Such approval must be documented in writing or auditable electronic form.

Approved participants must exercise due diligence to ensure that new client applications are updated whenever they become aware that there is a material change in clients’ information.

4. Non-Cooperative Countries and Territories Accounts

Approved participants must take the following measures when dealing with clients who are residents in non-cooperative countries and territories, as identified by Financial Action Task Force on Money Laundering (FATF) of the Organization for Economic Cooperation and Development:

- a) ensure adherence to the client and third party identification and verification requirements of the *Regulations under Proceeds of Crime (Money Laundering) Act* and of the *United Nations Suppression of Terrorism Regulations*; and
- b) ensure that concerned staff and operational personnel are made aware of the countries and territories that have been identified as non-cooperative and give special supervisory attention to transactions with clients domiciled therein.

III. ESTABLISHING AND MAINTAINING PROCEDURES, DELEGATION AND EDUCATION

1. Introduction

Effective self-regulation begins with the approved participant establishing a supervisory environment, which fosters both the business objectives of the approved participant and maintains the self-regulatory process. To that end, an approved participant must establish procedures and have them supervised by qualified individuals.

2. Establishing Procedures

Approved participants must appoint a designated supervisor, who is a partner, director or officer and has the necessary knowledge of industry regulations and approved participant’s policies to establish

procedures reasonably designed to ensure adherence to regulatory requirements and to supervise institutional accounts.

- a) Written policies must be established to document and communicate supervisory requirements.
- b) All supervisory alternates must be advised of, and adequately trained for their supervisory roles.

3. Maintaining Procedures

- a) Evidence of supervisory reviews must be maintained for a minimum period of five years from the date on which such reviews were made.
- b) A periodic review of its supervisory policies and procedures must be carried out by the approved participant to ensure that they continue to be effective and that they reflect any material changes to the business involved.

4. Delegation of procedures

- a) Tasks and procedures may be delegated but not responsibility.
- b) the supervisor delegating the task must take steps designed to ensure that these tasks are being performed adequately and that exceptions are brought to his/her attention.

5. Education

The continuous education of personnel constitutes a major aspect of self-regulation. It is the responsibility of approved participants to ensure an adequate training of institutional sales and trading staff as well as ensuring that continuing education requirements are being met.

6. Compliance Monitoring Procedures

Approved participants must establish compliance procedures for monitoring and reporting adherence to rules, regulations, requirements, policies and procedures. A compliance monitoring system must be reasonably designed to prevent and detect violations. The compliance monitoring system will ordinarily include a procedure for reporting results of its monitoring efforts to management and, where appropriate, to the Board of Directors or its equivalent.

IV. SUPERVISION OF ACCOUNTS

- a) Approved participants must implement policies and procedures for the supervision and review of activity in the accounts of institutional clients. Such procedures may include periodic reviews of account activity, exception reports or other means of analysis
- b) The policies and procedures may vary depending on certain factors including, but not limited to, the type of instrument, type of client, type of activity or level of activity.
- c) The supervisory procedures and the compliance monitoring procedures must be reasonably designed to allow detection of the following:

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- i) manipulative or deceptive methods of trading ;
 - ii) establishing artificial prices;
 - iii) trading on the basis of material non-public information available to the approved participant through corporate finance, knowledge of pending trades or other sources of information;
 - iv) trading in restricted list securities;
 - v) frontrunning;
 - vi) sales from control blocks;
 - vii) exceeding position or exercise limits on derivative products; and
 - viii) transactions raising a suspicion of money laundering or terrorist financing activity.
- d) Policies and procedures must outline the action to be taken to deal with problems or issues identified from supervisory reviews.