

Know-your-client and Suitability Obligations

December 4, 2013

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The logo for the Ontario Securities Commission (OSC) consists of the letters 'OSC' in a large, white, sans-serif font. The letters are positioned on a light blue horizontal bar that spans the width of the slide. Below this bar, there is a dark blue horizontal bar containing the text 'ONTARIO SECURITIES COMMISSION' in white, uppercase, sans-serif font.

ONTARIO SECURITIES COMMISSION

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Agenda

- Overview of securities regulatory requirements on know-your-client (KYC), know-your-product (KYP) and suitability obligations
- Recent cases on suitability
- Findings from the suitability sweep
- Suitability guidance
- Questions

Regulatory framework

- National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**)
 - Introduced September 2009
 - Sets out national registration regime for dealers, advisers and fund managers
 - Principal KYC, KYP and suitability obligations
 - Section 3.4 – Proficiency (KYP)
 - Part 13, Division 1 – KYC & suitability

Overview of KYC obligation

- Basic KYC obligation for registrants requires registrant to take reasonable steps to
 - establish identity (and reputation) of client
 - establish whether client is an insider
 - ensure registrant has sufficient information to meet suitability obligation
 - establish creditworthiness if margin account

- Additional requirements if client is a corporation, partnership or trust
 - corporation – person who owns or controls more than 25% of voting securities (IIROC rules 10% or more)
 - partnership or trust – person who exercises control

Obligation to “know” client’s essential facts

- Requires registrant to “know” client’s
 - investment needs and objectives (including the client’s time horizon for their investments)
 - financial circumstances (including net worth, income, current investment holdings, and employment status), and
 - risk tolerance for various types of securities and investment portfolios (taking into account the client’s investment knowledge) (collectively, **investment needs and objectives**)

- Obligation to take reasonable steps to keep information current
 - generally need to update at least once a year

KYC includes determining AI status

- If a registrant proposes to make a trade in reliance on the accredited investor (**AI**) exemption in NI 45-106 *Prospectus and Registration Requirements (NI 45-106)*, the registrant is required to determine whether the client is an AI
- For additional guidance, see
 - Section 1.9 [*Responsibility for compliance*] and subsection 3.5(6) [*Time for assessing qualification*] of the Companion Policy to NI 45-106 (**CP 45-106**)
 - Section 3.3 [*Responsibility for compliance*] of the Companion Policy to OSC Rule 45-501 *Ontario Prospectus and Registration Exemptions (CP 45-501)*
 - OSC Staff Notice 33-735 *Sale of Exempt Securities to Non-Accredited Investors (OSC Staff Notice 33-735)*

Why is KYC important?

- Section 13.2 of the Companion Policy to NI 31-103 (**CP 31-103**):

Registrants act as gatekeepers of the integrity of the capital markets. They should not, by act or omission, facilitate conduct that brings the market into disrepute. As part of their gatekeeper role, registrants are required to establish the identity of, and conduct due diligence on, their clients under the [KYC] obligation... KYC information forms the basis for determining whether trades in securities are suitable for investors. This helps protect the client, the registrant and the integrity of the capital markets.

When does KYC apply?

- Under NI 31-103, a registrant is required to have current KYC information whenever a suitability determination is required
- A registrant (other than SRO member) is required to make a suitability determination before a registrant
 - makes a recommendation to or accepts an instruction from a client to buy or sell a security, or
 - purchases or sells a security for a client's managed account
- In addition, registrants are required to make reasonable efforts to keep KYC info current

What is the KYP obligation?

- Section 3.4 of CP 31-103 [*Proficiency – initial and ongoing*]:

an individual “must not perform an activity that requires registration unless the individual has the education, training and experience... including understanding the structure, features and risks of each security the individual recommends”

- These requirements apply to all registrants, including SRO members
- This proficiency requirement (also referred to as **KYP**) is in addition to the suitability obligation in section 13.3 and applies even when there is an exemption from the suitability obligation

What is the KYP obligation?

- KYP is also an essential element of the suitability obligation in Part 13 of NI 31-103
- Registrants should know each security well enough to understand and explain to their clients the security's risks, key features, and initial and ongoing costs and fees
- Products sold under a prospectus exemption may require a more extensive review because of the limited disclosure available about them
 - *Sawh and Trkulja (2012)*
- See CSA Staff Notice 33-315 *Suitability Obligations and Know-Your-Product* dated September 2, 2009

What is the suitability obligation?

- NI 31-103 requires a registrant to take reasonable steps to ensure that, before it makes a recommendation to, or accepts an instruction from, a client to buy or sell a security, or makes a purchase or sale of a security for a client's managed account, the purchase or sale is suitable for the client
- As explained in CP 31-103, suitability obligations cannot be:
 - delegated to a third party,
 - satisfied simply by disclosing the risks of the trade, or
 - waived (except by investors that are "permitted clients" as defined in NI 31-103).

Why is suitability important?

- Suitability is a fundamental obligation owed by registrants to their clients and a cornerstone of our investor protection regime
- Staff expect firms to comply with both the letter and the spirit of these requirements
- This requires a meaningful suitability assessment,
 - Not just a mechanical fact-finding or “tick the box” exercise
 - Requires a meaningful dialogue with the client to obtain a solid understanding of the client’s investment needs and objectives, and to explain how a proposed investment is suitable for the client in light of the client’s investment needs and objectives
- Appropriate documentation is essential

Recent cases on suitability

- Recent Court decisions (including *Sawh v. Ontario Securities Commission* (2013) and *Ridel v. Cassin* (2013))
- Recent Commission decisions (including *Re Trapeze Asset Management Inc.* (2012) and *Re Sawh and Trkulja* (2012)),
- Recent decisions of the Director under s. 28 of the *Securities Act* (Ontario):
 - *Re FCPF Corporation (formerly Redev Corporation)* (2013)
 - *Re White Capital Corporation* (2013)
 - *Re Morgan Dragon Development Corp.* (2012)
 - *Re Blueport Capital Corp.* (2012)
 - *Re Waterview Capital Corp.* (2011)
- Recent IIROC and MFDA decisions
 - IIROC 2012 Annual report
- Recent initiatives of other CSA members
 - ASC Staff Notice 33-704 *Review of Exempt Market Dealers* (January 2012), BCSC 2012 Compliance Report Card

Suitability Sweep

- CRR Branch conducted a suitability sweep of 87 portfolio managers and exempt market dealers – largest sweep
- Implemented a new review procedure of calling investors to verify KYC, KYP and suitability information provided to us during reviews
- Published sweep findings in OSC Staff Notice 33-740 (May 2013)

Purposes of the sweep

- Review and assess compliance with KYC, KYP, and suitability obligations and take regulatory action in appropriate cases
- Further staff's knowledge regarding registrants' compliance with KYC, KYP, and suitability obligations
- Assist in determining whether further guidance is needed
- Enhance the overall level of compliance with KYC, KYP, and suitability obligations

Major findings from reviews of 45 EMDs

- EMDs selling securities to non AIs (with no other exemption available) (18% of reviews)
- Inadequate suitability assessments due to over-concentration (15%)
 - Some clients invested more than 30% of net financial assets in a single product
 - Particular concerns with mortgage investment corporations (MICs) and real estate-linked products
 - Sales to non-AI individuals in reliance on \$150,000 exemption

Major findings from reviews of 45 EMDs (cont'd)

- Inadequate suitability assessments due to inadequate documentation (22%)
- Misuse of a client-directed trade instruction in an attempt to circumvent the suitability assessment (2%)
- Improper delegation of KYC and suitability obligation to third parties (6%)
- Inadequate processes for the collection, documentation and maintenance of KYC information (75%)

Major findings from reviews of 42 PMs

- Inadequate suitability assessments (5% of PMs reviewed)
- Inadequate relationship disclosure information (45%)
- Inadequate processes for the collection, documentation and maintenance of KYC information (70%), and
- Inadequate policies and procedures (35%)

Other sweep outcomes

- In several cases, where firms had made trades in breach of securities law requirements, the trades were unwound and proceeds refunded to investors
- Further regulatory action taken on two registrants (one PM and one EMD)
- Three registrants (two EMDs and one PM) discontinued operations after our review
- Increased overall awareness and enhanced compliance by all registrants

Suitability guidance

- Publish a CSA staff notice on suitability guidance (anticipate to publish in early January, 2014)
- Provide staff interpretation of the regulatory requirements on KYC, KYP and suitability obligations
- Set out staff's expectation of registrants on how to comply with the requirements
- Provide examples of suggested practices and unacceptable practices

Suitability guidance (cont'd)

- How to collect and document adequate KYC information?
- How often should I update my KYC information?
- What process should I use to determine whether investors are AIs?
- What are the key areas to consider in assessing KYP?
- How to demonstrate compliance with the suitability assessment?

Suitability Guidance - KYC

- Get to really “know-your-client”
 - engage in meaningful discussions with clients (e.g. use of questionnaire)
 - develop an “investor-friendly” KYC form (define KYC terms like risk tolerance, investment objectives in plain language)
 - consider a client’s willingness vs ability to accept risk
 - review the KYC information to ensure completeness and accuracy

Suitability guidance – KYC information

- Review the KYC information with the client to ensure accuracy
- Sign and date the KYC information (both the client and the registrant)

Suitability guidance - KYC update

- KYC information must be current when assessing suitability of investment
- Update KYC information at least annually or more often if there is a material change in client's circumstances (e.g. marriage, birth of a child, loss or change in employment, etc.)
- Updated KYC information should be signed by the client and the registrant

Examples of unacceptable practices

– KYC information

- Delegate the KYC obligation to an unregistered individual
- Collect KYC information solely by asking a client to tick a box that best describes their investment objectives or risk tolerance
- Process a trade with missing or conflicting KYC information
- Use outdated KYC information to assess suitability of investment
- Use a KYC form or other document that contains inappropriate disclaimer language

Suitability guidance – AI investors

- Understand the definition of accredited investor and terms used in that definition (e.g. differences between “financial assets” vs “net assets”)
- Develop a form that collects sufficient information (e.g. minimum income and asset thresholds consistent with NI 45-106)
- Obtain a breakdown of financial assets and net assets of the client
- Make further enquiries about the client’s financial circumstances if there is reasonable doubt
- Provide training to dealing and advising representatives to ensure they understand the prospectus exemptions

Examples of unacceptable practices

- AIs

- Rely solely on the investor's representation on the AI certificate without collecting KYC information to assess reliance on prospectus exemption
- Process trades without complete and adequate KYC information to support reliance on the exemption

Suitability guidance – AI investors

- For additional guidance, see OSC Staff Notice 33-735 *Sale of Exempt Securities to Non-Accredited Investors* (dated May 13, 2011)

Suitability guidance - KYP

- Must conduct own product due diligence and be able to explain to clients about the security's risk, key features, and initial and ongoing cost and fees
- Consider additional risks such as liquidity risk, valuation risk, and conflict of interest risk (particularly if you are distributing a product of a related or connected issuer)
- Conduct further due diligence if the offering memorandum or offering documents do not contain sufficient information
- Do not solely rely on third-party analysis and reports prepared by unregistered third parties
- For additional guidance, see CSA staff notice 33-315 *Suitability Obligations and Know-Your-Product*

Examples of unacceptable practices

– KYP

- Fail to fully understand the structure and features of the products and recommend the product solely based on information from issuers or other third parties
- Rely solely on a product being on the firms' "approved product list" without understanding the product features and risks

Suitability guidance – suitability assessment

- Establish policies and procedures for assessing suitability of investment
- Consider all relevant KYC information
- Review each trade independently
- Develop a system to identify and reject trades that are inconsistent with client's investment needs and objectives
- Maintain adequate documentation of each trade and be able to demonstrate how each trade was assessed for suitability
- Establish a process to periodically review a sample of client files to ensure that the suitability process is applied consistently
- Provide adequate training

Suitability guidance – use of client-directed-trade instruction

- Perform suitability assessment of the client-directed-trade based on client's KYC information
- Inform the investor the reason why the proposed trade would be unsuitable
- Maintain adequate documentation of the suitability analysis
- Maintain the investor's written instruction to proceed with the trade (assuming the client still directs the registrant to trade)
- Develop a separate disclosure document for the client-directed-trade instruction
- Assess the suitability of the client-directed-trade considering the client's entire portfolio holding within the same account for PM accepting a client-directed trade
- Provide adequate training

Suitability guidance – concentration of investments

- Recognize that diversification is an important factor when assessing investment suitability
- Consider and document reasonable concentration thresholds to prevent overconcentration in a particular stock, sector or industry
- Establish procedures to monitor and manage concentration risks in a client's portfolio
- Explain the concentration risk to the client and how it affects the overall account position
- Discuss other potential risks to clients (e.g. real estate-linked products may expose to risks if there is a downturn in the real estate market)

Suitability guidance – concentration of investments

- Raise suitability concerns for investment in a single issuer/group of related issuers >10% of the investor's net financial assets
- Document the suitability analysis and be able to explain why a concentrated position is suitable for the client
- Follow the client-directed-trade instruction guidance if the client still insists to proceed with the trade after you have explained to the client that the investment would be unsuitable due to overconcentration or other reasons

Examples of unacceptable practices – client-directed-trade

- Promote a security actively and then seek to rely on boiler plate disclaimer language that the trade was a “client-directed” trade
- Bury or hide the client-directed trade instruction in the KYC form

Examples of unacceptable practices

– concentration of investments

- Fail to consider diversification as an important factor when assessing suitability
- Fail to have adequate policies and procedures to monitor the concentration level of a client's investments or evaluate the diversity of the portfolio

Additional SRO Guidance

■ IIROC

- IIROC Guidance Note 12-0109 *Know your client and suitability*
- IIROC Guidance Note 09-0087 *Best practices for product due diligence*
- IIROC Guidance Note 13-0039 *Recommendations and best practices for distribution of non-arm's length investment products*

■ MFDA

- MFDA Member Regulation Notice *Know-Your-Product* (MR-0048)
- MFDA Member Regulation Notice *Suitability* (MR-0069)

Questions?



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