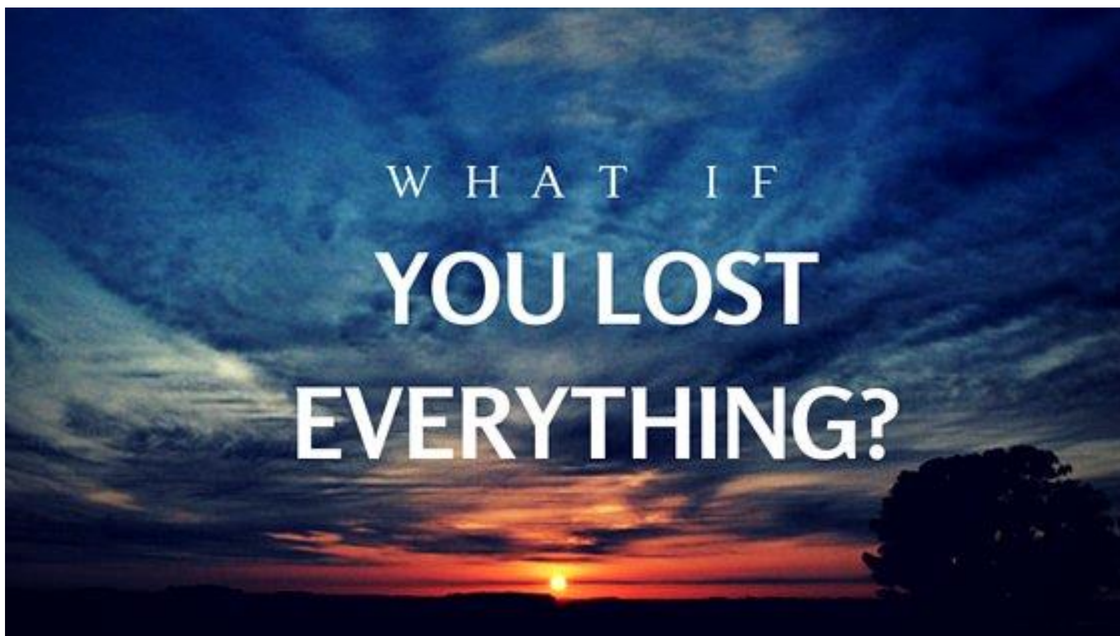
SIPA
SMALL INVESTOR PROTECTION ASSOCIATION

A Voice for Small Investors
Seeking Truth and Justice

The Know Your Client Process Needs an Overhaul

Advice – Suitability Assessment – Know Your Client



A SIPA Report

By the SIPA Advisory Committee

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Introduction

Canadians are being deceived by the investment industry and the regulators in many ways. In order to raise public awareness SIPA has developed a paper entitled Strategic Insidious Deception (S.I.D.) to describe the many ways the public is being deceived. This was published in the SIPA Sentinel in October 2015 available on the SIPA website http://www.sipa.ca.

The industry and its regulators have used optics to create the perception that the investment industry is well regulated and that Canadians can place their trust in the industry. Indeed most Canadians believe that their Financial Advisor has a fiduciary responsibility and that the regulators will protect them in the event of wrongdoing. History shows that this trust is not warranted and the regulators will not get victims' money back.

The facts show that many Canadians are losing their life savings due to systemic wrongdoing, including fraud, by the regulated investment industry. Examining the facts revealed by the many disciplinary investigations indicates the regularity of nefarious acts by registered representatives and the failure of firms to properly supervise their representatives. It would seem that these acts are condoned by the firms as long as they generate profit for the firm.

> *"We need to find out whether these pieces are working, and if not, why not. The test should be simple. Will these regulatory services, taken as a whole, consistently provide satisfactory redress to consumers who have not been treated fairly by players in the financial services industry?"*
> – Former OSC Commissioner David Brown at the Town Hall Event 2004
> http://www.sipa.ca/library/SIPAdocs/800-TownHall-Transcript-20050531.pdf

Since Mr. Brown's public comment in 2004 there has been little change and investors are still at risk with less chance of recovery of lost savings due to the reduced limitation period.

The regulators use optics of headline grabbing fines to reinforce the perception that the regulators protect investors, however the SIPA Report "Unpaid Fines: A National Disgrace" indicates the truth that almost One Billion Dollars in fines remains unpaid. It is shameful that regulators approved by Government participate in this scandalous deception. The report *"Unpaid Fines: It's a National Disgrace"* is available on the SIPA website http://www.sipa.ca.

It appears that fines are levied to deceive the public into thinking the regulators are active in protecting investors but the facts show only a small percentage of fines are collected and the regulators do not help investors get their money back when lost due to industry wrongdoing.

Currently there is discussion of fiduciary duty and it appears the industry and its regulators may accept a best interest standard as a compromise. We feel this is a betrayal of investors' interests. Fiduciary responsibility should be statutorily imposed on any firm or individual dealing with people's life savings and investments.

This report deals with the Know-Your-Client form which is meant to define the client profile and the strategy for investment. The fact is the KYC forms are often not shown to the client, are often prepared after the fact to reflect what the registered representative has done. It is not unusual that client's signatures are forged or traced. It is interesting that the industry uses a term "window signature" when a form is needed to satisfy regulators during superficial inspections.

There are many deficiencies in the current system due largely to industry culture that is unlikely to change in the near future. Therefore it is essential that Governments act to revise Statutes to ensure that all firms and individuals that offer investment advice are held to a fiduciary standard regardless of their registration or business titles.

> *What's in a name? Does the title of your investment professional matter?*
> *"Persons who are registered under the Securities Act (Alberta) as Dealing Representatives (for example) are generally licensed to sell you products sold by the investment firm they work for, and are obligated to provide you with advice on the suitability of those products for your circumstances. In that sense, it's not unlike purchasing a car from a dealership. If you walk into a Volvo dealership, and explain your needs (four-door, certain horsepower) the person working there will suggest the most suitable Volvo for your needs. While they might have a small selection of other makes and models in their inventory, they are not required to know about, or recommend, any make or model that is not in their inventory that might meet your needs as well, or better. This is true no matter what job title they use, be that "personal banking associate," "investment representative," "investment specialist" or any other title."*
> http://www.albertasecurities.com/investor/investor-resources/you-ascd-blog/Lists/Posts/Post.aspx?ID=63

What if you lost everything?

Overhauling the KYC Process

The New Account Application Form (NAAF), a key component of Know-Your-Client (KYC), was originally designed to enable a security transaction to proceed. It has not done a good job at that limited goal. In fact, we believe the KYC system is broken and needs a complete overhaul starting with client onboarding through to the making of recommendations.

ATTACHMENT I lists some of the common KYC process deficiencies that have been observed.

ATTACHMENT II illustrates how the KYC process can and is being abused. Far too often KYC's reflect what a representative wants to sell rather than what a client needs to build savings. In several of the portfolios reviewed, the balanced portfolio [recommended in the KYC] allowed between 0% and 70% in equities. The kind of equities is not specified, and the range is far too broad. Such manipulation cannot be considered sound personalized investment advice.

Assessing suitability is more than a mechanical fact-finding or "tick the box" exercise. It requires meaningful dialogue with the client to obtain a thorough understanding of the client's investment needs and objectives. The proposed investment strategy should clearly demonstrate its appropriateness for the client in light of their personal situation and constraints.

The Mystery Shopping report, published on September 17, 2015 by the OSC, IIROC and the MFDA, describing the results of a "mystery shop" of registrants across Ontario between July and November 2014, found that investors did not always know if they have had experienced a good advice process: while 88% felt they received sufficient information to make an informed decision, 33% of those experiences did not meet regulators' compliance expectations. Just 32% of shops (28) effected a complete collection of core KYC information; 68% did not.

On November 12, 2015, the OSC Investor Advisory Panel published a report entitled Current Practices for Risk Profiling in Canada and Review of Global Best Practice (Reference 1). It found that only 16.7%

of risk questionnaires reviewed would be considered 'fit for purpose' – they have too few questions, poorly worded or confusing questions, arbitrary scoring models or an outright poor scoring model. Clearly, such questionnaires do not provide robust insight into an investor's risk profile.

The current suitability regime, loaded with conflict-of-interest, can hardly be called "advice". But now it is being used as a basis to provide what is purported to be ever more fulsome financial advice and its deficiencies are glaringly apparent. Additionally, with an aging client population, the form's deficiencies and the weak supporting processes are even more harmful. Clearly, the NAAF KYC client data capture process needs to be improved, updated and enhanced.

> *I think a fiduciary duty does clarify the adviser's duty in all situations — put your client first, no matter what. This is particularly important because most people have no idea what sort of financial practices to seek out or avoid in the first place.*
> *It's one of the reasons that the U.S. Department of Labor introduced new rules in April forcing American financial advisers managing retirement and pension accounts to act in their clients' best interests — the so-called fiduciary standard that the Canadian industry is trying so hard to avoid. White House estimates peg the cost of adviser conflicts of interest at US$17 billion a year, primarily due to investors being placed in products with excessively high fees.*
> *As near as I can tell, the only negative impact on seniors and retirement security from a fiduciary standard are on the retirement savings of the unscrupulous financial advisers (hopefully, a minority of advisers out there) who are raking in those bloated fees.*
> http://business.financialpost.com/personal-finance/retirement/why-we-need-regulations-to-protect-seniors-from-unscrupulous-financial-advisers

The KYC information collected should correlate directly with the service represented to the client. The more information collected the more one has to consider when constructing, planning or managing client assets and financial needs. More information requires better processes. There is a reason why the current KYC is short and simple: processes are narrowly focused on the transaction and not the wider whole that impacts proper planning. A wider KYC would increase the parameters for which a dealing representative is responsible. The KYC represents the point through which both regulators and industry misrepresent the nature and standards of service.

Since the KYC is the foundation of the advice process, we have studied prevailing practices and issues. If the KYC information is inaccurate or incomplete, the results could very well be unsuitable investments, an unbalanced portfolio, an improper trading strategy or the wrong type of account. This leads to unnecessary investor losses and complaints.

Dealing representatives too often confuse the know your client duty with the obligation to fill out the NAAF/KYC form via tick marks. The duty to know your client goes far beyond the questions and tick marks on the NAAF/KYC form.

For example, prevailing NAAF/KYC forms requires the client to indicate his/her annual income. More detail is required. We strongly suggest that representatives obtain the following additional information:

- What are the various sources of income?
- Is this income gross or net of tax?
- What was the client's income in the past 2 or 3 years?
- Is there a fluctuating compensation structure?
- Is the current year compensation expected to be consistent with that of previous year(s)?

- Does the client feel secure in his/her employment status?

Given Canada's high level of taxation, understanding the client's tax position is core to providing personalized investment advice. Registrants giving financial advice need more training on taxation matters.

This Report puts forward a number of practical ideas that we believe will significantly improve the integrity of the KYC process.

Opportunities for Improvement

We present here a number of ideas for improvement to increase the robustness of the KYC process and thereby reduce client misunderstandings, losses and complaints:

- CSA educational materials should alert the investor of the importance of an accurate NAAF and that it is used to define the kind of investments that will be recommended to them. Regulators should make it clear that the information is used to support the recommendations made in the event of a dispute. Regulators should also stress that if it is an advisory account the representative and dealer are under no obligation to act in the client's best interests and that if the client wants to rely on the advice of a professional, they will need to seek an alternative relationship/provider.

- There should be one NAAF/KYC for each account. The goals and objectives of a RRIF account may be quite different than a trading or RESP account.

- Control the use of dealer representative titles. Too many NAAF/KYC forms have been superficially completed because of the undue trust paid to the dealer representative. Clients should be encouraged to take the form(s) home and reflect on it, perhaps consulting with friends/family, before signing.

Other improvement recommendations include:

- Change the name of the form from New Accounts Application Form to New Account and Client Information form (NAAIF) [or preferably use a separate form for KYC]. This will alert the investor that he/she is providing personal information that will be used to justify advisor recommendations and that the form is not merely an account application form.
- Take a zero tolerance approach to compliance/enforcement action when signed blank forms, document adulteration or signature forgery have been used.
- Require that a supervisor sign and approve the completed form.
- Require the inclusion upfront, of a brief plain language description of the importance of the NAAF/KYC form and how the advisor and dealer will use it.
- Provide a block on form to indicate existence of a Power of Attorney (POA) and obtain copy for the dealer to validate and understand terms and scope.
- Restrict accounts with stale dated KYC information from making purchases.
- Define in plain language each term used, such as risk tolerance and time horizon, so that investors understand what they are signing off on. Use a separate brochure for this purpose.
- Provide an entry for a trusted person contact to be included. This can be very helpful when dealing with seniors or other vulnerable investors.

- Split "risk tolerance" into two distinct elements – (1) risk ability and (2) risk tolerance on the form. A customer's ability to take risk is dependent on the customer's financial needs and circumstances: the expected returns required to achieve financial goals in combination with the customer's capacity for loss .Risk tolerance is psychological and thus centers on emotions and feelings, which do indeed dictate a customer's willingness to lose some or all of the original investment in exchange for greater potential returns.
- Provide a section of the form for the investor to document in plain language his/her objectives for the account. For retirees, monthly cash flow and liquidity can be very important. Liquidity needs has been interpreted to mean the extent to which a customer desires the ability or has financial obligations that dictate the need to quickly and easily convert to cash all or a portion of an investment without experiencing significant loss in value.(e.g. early redemption penalties with DSC purchased investments)
- Use proven risk profiling processes /tools in an attempt to capture the clients need for risk, tolerance of risk and financial capacity to deal with losses. Any risk questionnaires used are based on sound principles and theory. See Reference 1 The Plan Plus report
- In completing the form, the dealing representative should be encouraged to explore issues not easily captured on a form, discuss the nature of the relationship and describe the type of reporting that will be provided.
- Clients should be explained how a discretionary account works, the risks of leveraging and the risks of using derivatives as applicable.
- Provide a signed and dated copy of the NAAIF to the client for retention. The form should be time stamped and include a supervisor signature.
- Document the annual KYC update of personal information or upon a major life event. At a minimum, the investor's KYC should be annually reviewed and updated.
- Consider providing a Postage paid return envelope with the year-end statement asking the client about material changes.
- Make it clear that a dealing representative must uphold the regulatory rules that the information on the KYC can only be changed if there have been changes in the investor's personal profile. i.e. any changes to the Investment Risk levels and Investment Objectives percentages are illegal and cannot be made based on the assessment or reassessment of investments being held by the investor.

For accounts above $100,000 an Engagement Letter should be considered. The letter defines in some detail the relationship between the parties and the rights and responsibilities of each. It must be written in plain language. In addition, dealers should consider the use of Investment Policy Statements to improve client-advisor communications and provide a linkage to the KYC parameters.

> ¶ 14 In the NCAFs for the accounts first opened by Mr. Mondal, AM showed her risk tolerance as being 80% low, 10% medium and 10% high risk. They showed her liquid assets to be valued at $2.4 million, her fixed assets to be $600,000, and that her investment objective was "growth". All the NCAFs prepared for AM's accounts showed her investment objective to be "growth."
> ¶ 15 Within three months of these accounts being opened, AM's risk tolerance was changed to 100% high risk on the NCAFs for the Accounts. As the Settlement Agreement acknowledges, this change did not reflect AM's true risk profile.
> http://www.iiroc.ca/Documents/2015/13714f5c-52fd-4632-8e9e-1c79ca84e08d_en.pdf

The above text is extracted from Reasons for Decision by IIROC. Although the perpetrators may be disciplined, the penalties pale in comparison to the damage caused to the investor. This example of a case examined by IIROC illustrates the total lack of responsibility for investors' savings and investments and shows sympathetic consideration for the perpetrator. It is shameful that a regulator can operate in this fashion. It is this type of systemic culture that seems to prevail in the industry and warrants Government intervention.

Nevertheless the issues faced by small investors extend well beyond the KYC form. It is not uncommon for sales persons without any fiduciary accountability to unilaterally revise KYCs to enable them to manipulate accounts to generate higher commissions. In addition to the above case there are many examples documented by the regulators which indicate this practice and the failure of supervision to afford any protection for the investor.

CONCLUSION

CRM and improvements to KYC are part of the journey towards implementing fiduciary/best interest type standards. KYC is a critical element in the advice giving process. Today, clients are receiving conflicted advice under the suitability standard. Improvements to the KYC are needed to raise standards and prepare the way for the road ahead. Registrants need to be ready to accept the higher responsibilities via improvements to their core processes .The industry will not be able to move as is to higher standards without change - they need the tools and the KYC is a critical tool.

We believe our suggestions will make it a more robust process. We urge all stakeholders to review this report and consider the changes we are recommending. Ultimately, a Fiduciary standard is required if retail investors are to be able to trust the "advice" they receive. If regulators are unwilling or unable to implement a Fiduciary Standard then Government intervention is a necessity.

References:

1. Current Practices for Risk Profiling in Canada and Review of Global Best Practices
https://www.osc.gov.on.ca/documents/en/Investors/iap_20151112_risk-profiling-report.pdf

2. CFP Financial Planning standards
http://www.fpsc.ca/docs/default-source/FPSC/published---cfp-financial-planning-practice-standards-(2010).pdf

3. Kenmar comment letter to IIROC on KYC and suitability
http://www.iiroc.ca/RuleBook/ProposedPolicy/PPolicy-Notice09-0293-Comment-2009-10-09-Kenmar_en.pdf

4. Suitability from a retiree perspective
http://blog.moneymanagedproperly.com/?p=2790

5. KYC Process Improvement tools
http://www.acamstoday.org/wp-content/uploads/2012/10/xKYCMM-2012.pdf

ATTACHMENT I - Some examples of observed deficiencies

- NAAF information may either be missing, incomplete, illegible or unsigned/undated yet the form progresses through the system;
- KYC information is inconsistent and unreasonable e.g. a client with a speculative investment objective and a low risk tolerance. Most dealers do not seem to have an information system and other controls to prevent such inconsistencies or have robust processes to identify and follow-up where inconsistencies are identified;
- Little or no meaningful explanation of terms used on the NAAF, including risk tolerance, investment objectives and time horizon;
- Staff assigned to approve NAAF's or KYC updates only review them for completeness (are the boxes ticked?) and not for consistency or reasonableness;
- Where ranges are used, at times they are too broad. For example, long-term time horizons defined as greater than 3 years;
- Asserting that a history of investing in mutual funds makes a client an experienced investor;
- The NAAF does not collect sufficient information to assess suitability of particular products or investment strategies e.g. 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. It should also provide a trusted contact name.
- 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. Some dealers define long-term time horizon as greater than 3 years, others as 10 years. There is no consistency;
- DSC products with long redemption schedules sold to the elderly and infirm;
- KYC choices on the NAAF are ambiguous. For example, Time horizon of “None” can be interpreted differently to mean either extremely long-term or very short term;
- For Joint accounts, dealers may collect 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;
- Use of calculators or other formula that focus on the client’s willingness and ability to accept risk rather than the ability to withstand losses;
- Where the so-called 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 too often greater than what the responses from the questionnaire suggest;
- NAAFs are either not approved by supervision or not approved in a timely manner;
- Updates to KYC information are not provided, reviewed or approved or the dealer's back office systems are not updated in a timely manner;
- Supervisors do not question situations where a salesperson has a significant portion of clients with the same or similar NAAF/KYC information. In these cases, it appears the NAAF/KYC information is being determined based upon trading and investment practices used by the salesperson rather than on the clients’ actual circumstances; and
- Dealers 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. There is no explanation of what say, “medium risk”, means in terms of how it will relate to the types of securities that will be sold to the client.

Some excellent Best Practices are delineated in the Plan Plus research report.

ATTACHMENT II - Abuse of Process

If the KYC is filled out, with the “help” and assistance of a salesperson……and if that salesperson is hiding their license and registration from the view and knowledge of the customer, then a game of deception is being played out right in the KYC details itself. The reason is that the salesperson will “coach guide or goad" the unwitting and vulnerable client into asset mix, risk or other answers which predetermine the sales outcome desired by the disguised salesperson……while the client is taking their “guidance” as if it is well and honourably intended. Then, years later, when the client finds himself in OBSI or court, the KYC is referred to as the “holy grail” of source documents, (by expert witnesses for the industry), and the result is that the coached document and everything in it is used a SECOND time against the client. The first time is when the client is duped into nodding his head in agreement with what the “expert” suggests, and second time when in court and it is used against him/her……never is it shown in court that the “expert” was acting in a sales capacity and concealing this fact from the client….and the court.

If (the KYC) is a tainted document at the outset, based upon the concealment of the “advisor’s” true role/obligations, agency duty (or lack of) and concealed registration, problems will and do inevitably arise.

Another example is the question on the KYC form that's one of the most important to judges and regulators: Financial knowledge. From what we've seen, it's also the question that gets the least attention from dealers/representatives. That's because the client is presented with a set of options on the KYC form and asked which category he or she falls into. The client makes his or her choice and the advisor indicates the answer with a tick mark. Clients often overstate their knowledge and do not understand the intent of the question. The client signs the KYC form but later, when a complaint is launched, invariably the dealer uses that inflated self- assessment to defend the case.

The myth of time diversification applies to most new account application forms we see. Dealers new account documents commonly contain the client investment objective entitled “Long-Term Growth.” While this selection may or may not be reviewed with the client, it can be an inappropriately defined objective and is frequently used against the investor in a dispute/ arbitration. For the typical client, “Long-Term Growth” means that they plan on being invested for the rest of their lives and they’d like their investments to grow. For the typical registered representative, “Long-Term Growth” means the conventional time diversification model is in force and they can put the client in more aggressive investments because of their long time horizon. New account forms should ask: “How much money are you willing to lose in any one year?” The question should be answered in nominal terms and it should have a signature line next to it. This would force both client and registered representative to address within-horizon risk before any investments were made and (hopefully) avoid the “get me out at any price” decision.

It is fact that many investors do not participate in the completion of the KYC forms. It is not unusual for the investor to sign a blank form to be completed by the trusted representative who the investor believes has a responsibility to look after their best interests. Most victims of industry wrongdoing speak about breach of trust or breach of fiduciary duty. Regulators are failing to protect investors by allowing the industry to exercise deceptive practices which result in life-altering loss for many Canadians.