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Member Regulation Policy
Investment Industry Regulatory Organization of Canada (IIROC)
Suite 2000
121 King Street West
Toronto, Ontario M5H 3T9
e-mail: memberpolicymailbox@iiroc.ca

Client Focused Reforms – Proposed Guidance on Know-your-client (KYC) and Suitability Determination

C.A.R.P. welcomes the opportunity to provide commentary on the KYC- suitability determination proposals.

Our comments are as follows:

While the new client-focused reforms (CFRs) are a positive step forward, they do not include several key proposals that are needed to protect Canadian investors. Consequently, the CFRs represent a minimum standard. While we appreciate that the objective of the consultation is limited to bringing IIROC rules and processes in line with the CFRs, we believe there is an opportunity for IIROC, as a self-regulating organization, to go further. C.A.R.P. fully supports any initiative that would move IIROC KYC and investment suitability standards closer to the creation of making financial advice-giving a true profession. See our submission to the CSA on best interests here.

The proposals are to be applied against a difficult backdrop. The OSC's Investor Office's 2017 *Investing As We Age* report found that only 14 per cent of Ontarians age 45 or older have a formal, written retirement plan, while 54 per cent have no retirement plan at all. IIROC should therefore consider strengthening the proposals with respect to financial planning and Investment Policy Statements, as the lack of a basic plan is a constraint on the provision of suitable advice in the best interests of clients.

An OSC Investor Advisory Panel (IAP) research study *A Measure of Advice* confirmed that the advice provided to retail clients with small and medium sized portfolios is not as high as believed. The report stated "Accordingly*, in situations where communication with advisors occurs only once or twice in the course of a year, and where total duration of that communication is less than an hour for the entire year, we question not only whether investors are receiving reasonable value in exchange for what they pay for advice, but also whether they are truly receiving much advice at all and, most importantly, whether they are* *receiving the measure of advice necessary to meet their needs."*[1] IIROC should ensure its guidance incorporates this valuable baseline research.

Basic KYC information

- The frequency of KYC updates should be at least annual for seniors, retirees and vulnerable clients.
- Net worth should isolate out the principal residence for increased visibility.
- KYC should include expenses, not just income.
- Any changes to a client's name, emergency contact details, address or banking information should be approved in writing by the client.
- Firms should be required to pro-actively seek out KYC changes from clients, not depend on happenstance. In this day and age, technology exists to automate this in various ways.
- The existence of an emergency fund (if any) and its size should be collected.
- The Trusted Contact Person name and contact details should be provided as an integral component of KYC.
- Suitability should be tied to a financial plan or equivalent with a target return rate.
- A copy of the captured KYC information and risk profile should be provided to the client for retention.

C.A.R.P. fully endorses the obligation for Dealers to provide their clients with the opportunity to express their investment needs and objectives in plain language, such as saving for retirement to maintain a certain lifestyle, supporting their adult children or investing for the post-secondary education of their grandchildren.

Risk profile

The methodology used to determine risk capacity and risk tolerance should be validated by behavioural professionals to ensure they measure what they are intended to measure. As with any psychometric test, an investor risk tolerance questionnaire must be *reliable* and *valid,* fully documented and approved by senior management. Many of the commonly used "investor risk" questionnaires are actually asset allocation calculators mislabelled as risk tolerance tests. An OSC IAP empirical research study found that most of the questionnaires (83.3%) in use by the industry are not fit for purpose.[2]

The consultation document defines risk profile as comprising risk tolerance and risk capacity but a number of IIROC Member Firms also include "Risk need" – the risk needed to achieve the stated objectives and needs of a client. For example Canaccord Genuity, an IIROC Member Firm, includes *Risk need* in its risk profile.

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[1] https://www.osc.ca/sites/default/files/2020-10/iap_20190729_survey-findings-on-how-much-advice-investors-receive.pdf

[2] https://www.osc.ca/en/investors/investor-advisory-panel/investor-advisory-panel-notices-and-information/osc-iap-releases-research-risk-profiling

C.A.R.P. fundamentally agrees, and we recommend that the guidance include the assessment of Risk need.[3] The CFA institute, a respected international body for professional advice givers, also lists *Risk need* as the third dimension of a client's risk profile.[4] The inclusion of *Risk need* could help retail clients, and especially seniors and retirees from taking on unneeded investment risk. That would be congruent with putting the needs of clients first. If *Risk need* is not part of the investor risk profile, clients of IIROC Member Firms could be placed in harm's way.

Client's investment time horizon

"Time horizon" should be clearly defined and explained to investors and how it relates to portfolio risk management. Investors should be requested to provide estimated time horizons for each major objective applicable to the account.

Use of leverage or borrowing to finance the purchase of securities

As written, the proposals seem focussed on the client's ability to repay the loan. The use of borrowed funds (use of Margin) is a high-risk strategy that is justifiable only if it is consistent with the individual's risk capacity and risk needs. Text should be added that Dealers should be required to assess and document *Risk need* and if it is concluded that the client has no need to take on leveraging risk to meet objectives, the client should be so informed.

KYC should capture debt obligations. For instance, if a client is carrying a large amount of 18%+ credit card debt, any investment recommendation made would be unsuitable, including leveraging, unless it could reasonably be argued that the recommendation is more likely than not to exceed an 18% annual return. Unless a client's significant debt obligations are known, it is not possible to ensure leverage investment actions are suitable and consistent with risk capacity constraints.

Account Type

1. Certain elements of KYC are unique to the type of account. For instance, time horizon for a RESP may be quite different than that for a margin trading account. The guidance should ensure this aspect is covered.
2. IIROC should provide guidance on the suitability of fee-based accounts as the momentum of the financial services industry seems biased towards such accounts even if they are unsuitable for retirement accounts where portfolio turnover is usually low.
3. Discretionary accounts should be bound by a fiduciary duty.

[3] See: https://www.canaccordgenuity.com/wealth-management-australia/investment-management/your-risk-profile/
[4] Ref: https://www.cfainstitute.org/-/media/documents/survey/investment-risk-profiling.ashx

Unsolicited client trading requests

At a minimum, the client should acknowledge the discussion regarding unsuitability and accept the conditions that make the recommendation unsuitable. Should the unsolicited trade request be expected to have a material impact on the portfolio, the Rep should use this opportunity to update the IPS and/or KYC. Doing so would allow the client to fully understand the potential effect of the requested trade on his or her objectives, goals and risk profile.

An investment policy statement (IPS) is mentioned in the proposals as a nice to have. We recommend it become a standard practice. KYC and other information should be incorporated into a written IPS that addresses the client's risk tolerance, return requirements, and all relevant investment limitations (including time horizon, liquidity needs, tax concerns, and legal and regulatory factors). For some clients, the IPS may include unique constraints or preferences, such as incorporating ESG factors during the investment decision-making process. Without identifying such client factors, one cannot judge whether a particular investment or strategy is suitable for a particular client. The IPS also should identify and describe the roles and responsibilities of the parties to the advisory relationship and investment process, as well as schedules for review and evaluation of the IPS. This process would be a definitive step forward in improving advice professionalism.

Suitability of product shelf

Dealers must implement formal policies and procedures appropriate to their business to perform appropriate product due diligence before allowing any product to be offered to clients, including senior clients (e.g., thoroughly vetting any new product from a regulatory, risk management, disclosure, and business perspective). Examples of such products include leveraged exchange-traded funds (ETFs) and crypto investment funds.

Seniors titles

Although not directly related to the guidance, C.A.R.P. firmly believes that misleading titles can cause seniors to place undue trust in a Rep when responding to KYC questionnaires. Based on an OSC mystery shop a few years ago, IIROC has some work to do in corralling the industry's proliferation of meaningless titles.

Mutual funds

Mutual funds represent hundreds of billions of dollars invested with IIROC dealers. We recommend that the suitability guidance be enhanced to cover such issues as:

- Dealers should be required to recommend the lowest fee fund series available to clients who qualify for the series in order to comply with the CFR client first standard.
- The guidance should deem as unsuitable any recommendation where trailing commission payments are made when the fund is held in a fee-based or discount brokerage account.
- Dealers should have a reasonable basis for determining that active management is in the best interests for their clients.
- The guidance should make it clear that Fund Facts risk ratings are not appropriate for use in suitability determinations. The actual risks inherent in the mutual fund should be used as the basis for determining suitability.

Complaint process and suitability

The consultation is silent on recommendations made in dealer complaint responses. As seniors are disproportionately represented in complaint statistics, we recommend that IIROC rules dedicate a section of the guidance to providing suitable recommendations guidance for the resolution of complaints in the best interests of clients. Too often the process is adversarial and exploitive. The impact of an unfair (unsuitable) compensation recommendation can have a material adverse impact on a senior's financial well-being.

Dealers should be prohibited from recommending or permitting the use of a dealer's internal ombudsman since such a recommendation is inherently unsuitable. Internal ombudsman are not independent of the dealer, are not under the regulatory mandate of IIROC and are not accountable to anyone but the Board of Directors of the dealer's parent corporation. If a complainant seeks an external review of a complaint response, the complainant shall be referred to OBSI as that would be in the client's best interest.

Advisor competency and proficiency

Elderly clients provide some unique challenges for Firms and their advising staff. The guidance should, in our opinion, address the need for advisor training and education related to advising elderly and vulnerable clients. This would include training in how to communicate with the elderly and how to manage de-accumulating accounts. One of the major socio-economic issues facing seniors is running out of money in retirement. Most advisor training and industry compensation practices are centred on account growth, not investing as a form of pension plan. In addition, advisors need education on how to integrate income tax rules and govt. social programs into portfolio design and tax-efficient investing strategies. A RRIF account is unique in that new contributions are not only not permitted, but certain minimum annual withdrawals are mandatory.

Many choices that would best serve an older client- like deferring CPP withdrawals and drawing down one's investments, or not attempting to increase one's investments by taking out a home equity line of credit - might not serve a financial advisor well. It remains to be seen whether CFR can materially improve senior outcomes. In any event, we

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encourage IIROC to keep a close eye on how CFR is being applied in practice and be prepared to make mid-course corrections.

In closing, we would like to stress the importance of Dealers implementing policies and procedures to provide for heightened supervision of senior clients and their advisors.

We trust this input will prove useful to you in finalizing KYC –suitability guidance.

Respectfully,

Bill VanGorder

Chief Operating Officer & Chief Policy Officer
VanGorder@CARP.ca
902 999 3572 (cell)
416 607 7712 (Toronto office)