FINANCIAL AND CONSUMER SERVICES COMMISSION OF NEW BRUNSWICK

COMMISSION DES SERVICES FINANCIERS ET DES SERVICES AUX CONSOMMATEURS DU NOUVEAU-BRUNSWICK

Financial and Consumer Services Commission (New Brunswick) Staff Notice 33-703 Review of Investment Dealer Practices

October 18, 2013

Introduction

Staff of the Financial and Consumer Services Commission (formerly the New Brunswick Securities Commission) reviewed the practices of registered investment dealers in New Brunswick. This notice provides a summary of the review, as well as staff guidance on certain practices observed during the review.

This guidance focusses on three key investment processes:

- the Know your client (KYC) Process;
- the Know your product (KYP) Process;
- the resulting Suitability Process.

The guidance in this notice will be used by staff in the future, where appropriate, when assessing the KYC, KYP and Suitability processes of registered firms. Staff also encourages registered firms to use this notice as part of their regular self-assessment practices.

Background

Section 13.2 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) requires a registrant to establish the identity of each client and to conduct due diligence regarding the client pursuant to the KYC obligation. Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (31-103CP) provides guidance in this regard. Section 13.3 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) requires a registrant to take reasonable steps to ensure that a proposed trade is suitable for a client before making a recommendation or accepting trade instructions from the client. Registrants are also required to have in-depth knowledge of all securities that they buy and sell on behalf of, or recommend to, their clients. This is often referred to as the KYP obligation.

Objectives of the Review

The main objectives of the review were to:

- assess compliance by investment dealers with KYC, KYP and Suitability obligations and related securities legislation;
- broaden staff's understanding of the current practices surrounding the suitability obligation (i.e. collecting and analyzing data, developing a plan, recommending products and accepting

trade instructions).

Scope and Methodology

In September 2011, we sent a questionnaire to a representative sample of registered firms in New Brunswick. The sample included 17 firms registered solely as Investment dealers.

The firms sampled provided products and services to retail, private and institutional clients. The questionnaire asked the firms to provide information regarding accounts, investments, fees, investment suitability, distribution and supervision. We assessed the firms' responses to the survey questions and, based on the results, conducted the second phase of the project, which looked specifically at KYC, KYP and Suitability processes.

Outcome

This notice is to serve as guidance on the collection, analysis and synthesis of KYC and KYP information in making suitability assessments when recommending investment products.

Regulatory Requirements

All responses to our questionnaires were assessed against the requirements in NI 31-103. Subsections 13.2 and 13.3 of NI 31-103, require a registered firm to establish the identity of their client and collect sufficient "**Know your client"** information so as to satisfy applicable suitability obligations. This includes inquiring into the reputation of a client if there are grounds for concern, and identifying insiders of publicly traded companies.

The suitability obligation also applies to the establishment of the registered firm's "Product Shelf" and the application of due diligence also extends to the "**Know your product**" obligation for the registered individual when selling the investment product to clients. Our intention is not to prescribe all processes for KYC, KYP and Suitability, but instead provide guidance on some key elements to meet obligations required under securities law.

Our intention is to provide guidance on subsections 13.2 and 13.3, which require a registered firm to collect specific information from a client to enable the registered individual to make a suitable investment recommendation. We also considered the requirement that a registrant deal fairly, honestly and in good faith with clients[1].

Concerns with the collection of client information and KYC Processes

Registrants rely on information collected in their KYC Processes in making investment decisions. As a result, the information must be complete and accurate in order to make a suitability recommendation for investment products to clients. If KYC information is deficient, there is a risk that advisors may:

- incorrectly gauge the risk tolerance of an investor;
- misunderstand liquidity requirements of an investor;
- make an unsuitable investment based on incomplete or inaccurate KYC information.

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1 In New Brunswick, this requirement is in subsection 54(1) of the *Securities Act* (New Brunswick).

Concerns with product due diligence and KYP processes

Clients rely on a registered firm's product due diligence and research in making investment decisions. The information should be full, meaningful, and provided to clients in a manner they can understand. Clients should understand what the investment will cost, how it is intended to benefit them, and how it is suitable for them based on their personal circumstances, as described in the KYC information provided. If the KYP Process is deficient, there is a risk clients may:

- incorrectly gauge the level of risk of the investment product or strategy recommended;
- not be aware of the fees and costs associated with the investment product or strategy.

Collecting, analyzing, synthesizing KYC information and recommending suitable investment based on KYP

Practices

As part of the review, we asked registered firms to describe how they collect, analyze and synthesize KYC information, and how they use this information to recommend suitable investments to clients. We found the following acceptable practices:

- Firms had a formal KYP and product due diligence process that included product review and approval committees, which serve as a control to determine that new products fall within the dealer's and client's investment knowledge.
- Firms had a formal new account / KYC process that went beyond the collection of basic KYC information and provided a more complete financial picture of the client.
- Firms had a formal suitability process that demonstrated the analysis and synthesis of the total financial situation of the client before discussing investment options. A needs assessment was completed based on that analysis, a plan was developed, and then suitable investment options were presented to the client in support of that plan.
- Firms had books and records that were well documented, organized, standardized, and readily available so that file reviews by compliance staff or securities regulators could be handled effectively and efficiently.
- Firms had scheduled face to face annual meetings with clients to discuss actual portfolio performance compared to planned portfolio performance, and to discuss any actions required to achieve goals and objectives and manage client expectations.
- Firms had clear and concise documents, such as the Investment Management Agreement (IMA), Advisory Agreement, Investment Policy Statement (IPS), and KYC forms and offering documents. Together these documents gave the client the required information to understand the investment plan, and provided the firm with the information required to assess suitability.
- Firms had an education process that was an integral part their compliance program.

While registered firms maintained a formal process for Trade Supervision, there was some indication that the underlying policies and procedures designed to address the specific requirements under section 13.2 and 13.3 of NI 31-103 were not well communicated to the individuals responsible for this task. More frequent internal compliance work is required by firms at their respective branch and sub-branch levels to close the communication gap and ensure that trading is supervised according to the formal processes established.

Guidance

We intend the following guidance to assist registered firms with satisfying their suitability obligations:

- Under section 11.1 of NI 31-103, registered firms must have policies and procedures that

establish a system of controls and supervision sufficient to provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation. This extends to the collection of KYC information. Written policies and procedures should reflect the registered firm's practices for handling information when collecting, analyzing, synthesizing and making investment recommendations.
- KYC information maintained by registered firms must be accurate, complete and up-to-date. We suggest that registered firms take all actions necessary to gain a complete understanding of the client's financial circumstances and that they be proactive when reviewing client files and in maintaining current the status of the client's financial circumstances.
- The investment strategy and investment plan advice that registered firms provide to clients should contain meaningful information that is understood by clients and enables them to make informed decisions in pursuing investment strategies.
- Registered firms should ensure that their representatives clearly explain how the products and services the firm offers are going to meet the needs of the client based on the analysis of the client's financial circumstances and KYC information collected.

Summary of Results

Staff identified a number of common areas with increased incidence in deficiencies in KYC practices. The following is a list of risk areas ranked in order of most to least frequent:
- Know your product obligation – Requirement to determine individual client suitability after investment approved for product shelf - paragraph 13.3
- Know your client obligation - Information a firm must collect about the client – paragraph 13.2 (2)
- Obligation to assess suitability prior to executing a transaction – paragraph 13.3
- Suitability Determination- paragraph 13.3

Specific Issues and Guidance

The following section discusses the requirements under subsection 13.2(2) of NI 31-103 in the order stated in that section, and provides details about the requirement and guidance to registered firms in order to meet their obligations.

1. ***Establish the identity of a client***

Under paragraph 13.2(2)(a), establish the identity of a client and if the registrant has cause for concern, make reasonable inquiries as to the reputation of the client.

There were no deficiencies found in this area.

We found the following practices:
- Firms required an in person meeting with the use of government photo I.D. to establish the identity of clients.

Observation:
- Registered firms were not aware of all the various methods of client identification permitted for securities dealers by the Financial Transactions and Reports Analysis Centre of Canada.

2. ***Establish whether the client is an insider of a reporting issuer***

Paragraph 13.2(2)(b) requires a registered firm to establish whether the client is an insider of a reporting issuer or any other issuer whose securities are publicly traded.

There were no deficiencies found in this area.

3. ***Ensure the registrant has sufficient information to meet the Suitability Obligation***

Paragraph 13.2(2)(c) requires registered firms to ensure they have sufficient information regarding each of the following to enable it to meet its obligations under section 13.3 or the suitability requirement imposed by an SRO.

i) The client's investment needs and objectives
ii) The client's financial circumstances
iii) The client's risk tolerance

14% of firms had insufficient notes evidencing their understanding of their clients' complete financial circumstances.

Areas of concern:

- Registered firms collected basic KYC information using new account application forms, but the analysis of the KYC information and synthesis of this information into an investment strategy was not always well documented. Client files did not always contain notes and other supporting documentation demonstrating a robust suitability analysis based on the KYC information obtained.
- Registered firms appear to be over reliant on internal controls and safeguards incorporated into the supervisory modules in their information systems. Some firms appear to use these controls as a substitute for doing a proper and independent suitability analysis. Dealing representative must conduct a suitability analysis resulting in an investment recommendation, which is then checked using the internal control. The recommendation should be generated independently of the control.

4. ***Establish the creditworthiness of the client***

Paragraph 13.2(2)(d) requires registered firms establish the creditworthiness of the client if the firm is financing the client's acquisition of a security.

There were no deficiencies found in this area.

5. ***Establishing the identity of a client that is a corporation, partnership or trust***

Under paragraph 13.2(3)(a), registered firms must establish the nature of the client's business. Under paragraph 13.2(3)(b), registered firms must establish the identity of any individual, who is the beneficial owner of, or exercises direct or indirect control or direction over, more than 25% of the voting rights attached to the outstanding voting securities of the corporation or in the case of a partnership or trust, exercises control over the affairs of the partnership or trust.

There were no deficiencies found in this area.

6. ***Maintaining required KYC information current***

Under paragraph 13.2(4), registered firms must take reasonable steps to keep KYC information current.

There were no deficiencies found in this area.

We found the following practices:

- Registered firms updated the KYC information prior to recommending any trades in securities to ensure suitability obligations were satisfied.

7. State the Obligation to Assess Whether a Purchase or Sale of a Security is Suitable for a Client

Under paragraph 14.2(2)(k), registered firms are required to deliver a statement to clients that the firm has an obligation to assess whether a purchase or sale of a security is suitable for a client prior to executing the transaction or at any other time. This requirement is straightforward and directly relates to the obligation of a registered firm to meet their suitability obligations under sections 13.2 and 13.3 of NI 31-103.

Areas of concern:

- The registered firms' disclosure information did not include the specific statement required under paragraph 14.2(2)(k). Some firms thought it was sufficient to:
    - Have policies and procedures in place for assessing suitability;
    - Manage client accounts consistent with the KYC information and investment objectives for each client but not provide the statement;
    - Include language other than what is required in paragraph14.2(2)(k) or no statement at all.

Guidance

Registrants must include the specific statement required in paragraph 14.2(2)(k) in their Relationship Disclosure Information documentation.

8. Disclose the Information that must be Collected About Clients

Under paragraph 14.2(2)(l), a registered firm is required to disclose the information that they must collect about their clients as required by section 13.2 of NI 31-103 (know your client). Section 13.2 sets out the information a registrant must obtain and document to establish the identity of a client, determine if the client is an insider, and assess the suitability of proposed investments.

We found the following deficiencies in 14% of firms:

- Registered firms routinely collected adequate KYC information and provided a copy of the completed KYC form to clients, but did not explain in their Relationship Disclosure Information the terms on the KYC form or state that the firm uses this information to assess suitability;
- Registered firms did not include disclosure of the KYC information that they are required to collect under section 13.2.

Guidance

Registered firms should provide clients with a statement that lists and describes the information that they must collect, and an explanation of how the firm uses this information to assess the suitability of investments for clients.

Registrants should also refer to the guidance on the requirements that are provided under subsections 13.2 and 13.3 of 31-103CP.

Conclusion

This guidance notice serves to identify some of the issues observed during the reviews in order to help registered firms improve their compliance. The sweep represented an important part in understanding what investment practices were in use by investment dealers in New Brunswick when it comes to KYC, KYP and Suitability Obligations. Where any significant deficiencies were found we will take appropriate steps to bring the registered firms into compliance.

Next Steps

We will review the KYC, KYP and Suitability practices of registered firms during our ongoing compliance reviews and will apply the guidance in this notice when assessing whether a firm is complying with Know your client and Suitability obligations in subsection 13.2 & 13.3 of 31-103. The guidance in this notice will be used by staff in the future, where appropriate, when assessing investment practices regarding KYC, KYP and Suitability processes of registered firms. Staff encourages registered firms to use this notice as part of their regular self-assessment practices.

Please refer questions to:

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