Registrant series: Portfolio Managers (PMs)

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OSC ONTARIO SECURITIES COMMISSION

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Agenda

1. Overview of OSC Investor Office's work on issues relating to senior investors

2. Review of PMs with high percentage of senior clients
   - Preliminary findings
   - Best practices

3. Review of PMs operating as online advisers
   - Overview and regulatory obligations
   - Review findings and best practices

4. Guidance on Small Firms Compliance & Regulatory Obligations
   - Review findings
   - Best practices

5. Resources

6. Questions and answers

OSC Investor Office's work on issues relating to senior investors

Overview

- Investor Office overview
- Why a focus on seniors?
- Investor Office initiatives
- Who is a “senior?”
- Issues facing advisors
- Next steps

Who we are

- On October 30, 2015, the OSC launched its new Investor Office.
- The Investor Office was created through the merger of the former OSC Office of the Investor and the Investor Education Fund.
- The Investor Office sets the strategic direction and leads the OSC's efforts in investor:
  - engagement
  - education
  - outreach
  - research
- The Office also has a policy function, plays a key role in the oversight of the Ombudsman for Banking Services and Investments (OBSI), and provides leadership in the area of behavioural insights at the OSC.

Why a focus on Seniors?

- Seniors are the fastest growing demographic group in Canada. More than 5.7 million Canadians – 16% of Canada's population is 65 years or older.
- By 2031, the number of seniors will almost double to nine million people, representing close to one quarter of Canada's population (*Government of Canada, National Seniors Council*)
- Ontario remains Canada's most populous province
- Canadians are working longer and living longer – the average Canadian reaching 65 in 2013 can expect to live until age 85 (*Financial Consumer Agency of Canada*)
- In 2015, OBSI's Annual Report statistics reported 54.8 % of complaints were received from seniors

Investor Office initiatives

- The Investor Office is developing the OSC's seniors strategy, which is expected to include policy, education, outreach and service standard components.

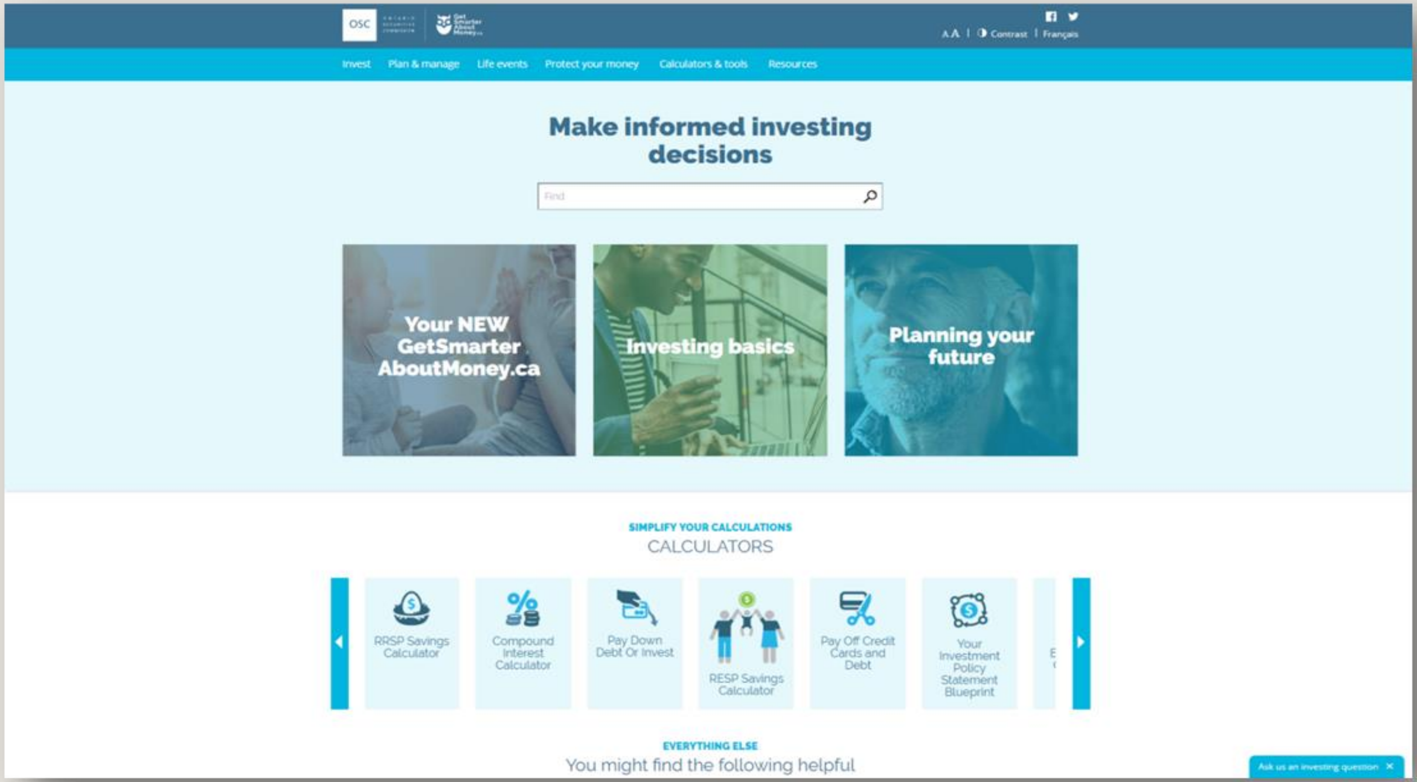
- Seniors Expert Advisory Committee (SEAC) announced September 2016

- The SEAC advises staff on securities-related policy and operational developments that impact older investors and provides input on the OSC's related education and outreach activities.

Investor Office initiatives (cont’d)

- Investor Office initiatives regarding older investors:
  - GetSmarterAboutMoney.ca
  - Teletownhalls – Similar to a call-in radio show; OSC staff provide information, answer questions and conduct live polls
  - OSC in the Community – Senior outreach and educational sessions across the province
  - Stakeholder partnerships – NICE, CARP, Toronto Police Service, Elder Abuse Ontario

GetSmarterAboutMoney.ca



GetSmarterAboutMoney.ca

Growing older

- Retirement planning
- Tracking investment progress
- Estate planning
- Tax planning
- Preventing fraud

Who is a “senior?”

- No universally applicable definition in Canada to determine when one becomes a “senior”
- Senior investors not a homogeneous group
- In Canada, age 65 is generally understood to be the defining age for seniors
- Some react strongly to be labeled “senior”
- Seniors are not all “vulnerable”

Investor Office research

- Findings from a 2016 Investor Office survey on pre- and post-retirement planning among Canadians aged 50 and older revealed that nearly half of Ontarians (48%) do not have a plan for retirement savings
  - Among those with a retirement savings plan, nearly a third (29%) of Ontarians feel they are behind in their plan
  - Among Ontario pre-retirees 50+, 1-in-5 (17%) have not yet started to save money for retirement.
  - 3-in-10 (32%) pre-retirees Ontarians 50+ have no idea of how much money they will need to save to help fund their retirement
- The Investor Office continues to conduct research in this space to support the development of seniors-related initiatives and projects.

Issues facing advisors

- Diminished mental capacity
- Financial exploitation
- Powers of Attorney
- Privacy Laws

Diminished mental capacity

- Diminished mental capacity (cognitive decline) in senior clients is a critical issue facing financial advisors
- 20% of adults 80+ have some degree of diminished capacity
- More than 40% of adults age 90+ have some degree of diminished capacity
- Cognitive decline ranges from the effects of normal aging to some type of dementia, such as Alzheimer's disease
- Symptoms of dementia commonly include: loss of memory, judgment, and reasoning, as well as changes in mood, behaviour, and communication abilities
- One of the early “red flags” of dementia is impaired ability to understand financial issues.

Financial exploitation

- Most common form of elder abuse
- Aging demographic means financial advisors may be more likely to see financial exploitation among their older clients
- Financial exploitation can be particularly devastating for seniors, who often depend on fixed incomes, and who usually do not have the means or time to offset significant losses.

Understanding financial exploitation

- Misuse of funds or property
- Theft, exploitation or scams
- Abuse of power of attorney
- Fraud or forgery of documents
- Taking a senior's money or cashing cheques without their permission
- A family member who sell's a parents house or other property and then uses the money for their own benefit

Source: http://www.seniors.gc.ca/eng/working/fptf/financialabuse.shtml)

Powers of Attorney

- Planning for a POA to deal with financial matters
- Keeping POA up-to-date
- Identification and escalation of the misuse or abuse of POA

Privacy Laws

- Canada’s privacy legislation – *Personal Information Protection and Electronic Documents Act* (PIPEDA)
  - Prohibits organizations from disclosing individuals personal information without consent
- June 18, 2015 – amendments made to PIPEDA through passage of Bill S-4
  - *The Digital Privacy Act*
- New provisions allow financial institutions to contact "a government institution...or the individual's next of kin or authorized representative" without the individual’s consent where:
  - the organization has reasonable grounds to believe that the individual has been, or is or may be the victim of ***financial abuse;***
  - the disclosure is made solely for purposes related to preventing or investigating the abuse; and
  - it is reasonable to expect that disclosure with the knowledge or consent of the individual would compromise the ability to prevent or investigate the abuse.

Potential challenges

- Hard for firms to confidently identify financial exploitation
- Currently, financial services firms and advisors lack guidance on what constitutes financial exploitation, as well as the protective steps they may take to safeguard clients who they believe to be subject to it.
- Privacy laws also raise questions around advisor's ability to raise concerns about a client's capacity with the client's family members.

Next steps

Education and Outreach
Partnerships
Guidance and Training
Policy
Marketing and Communication
Holistic seniors strategy

Review of PMs with high percentage of senior clients

Introduction

- CRR's current compliance sweep focusing on PMs and EMDs with a high percentage of clients who are 60 years and over

- Preliminary findings from the sweep

- Best practices for dealing with "senior" clients

- Guidance from other regulators and organizations

CRR's Senior Investor Sweep Review

- Selected sample of PM firms for review
- Advising representatives were often also over 60 years old
- Main areas of focus of reviews
  - Policies and procedures for dealing with senior clients
  - Challenges and issues faced by PM firms servicing senior clients
  - Client files for senior clients, including KYC and suitability of investments

CRR’s Senior Investor Sweep Review (cont’d)

- Reviewed existing policies and procedures for dealing with senior investors

- Enquired how portfolio managers have dealt with any past issues surrounding senior investors

CRR's Senior Investor Sweep Review (cont'd)

- Reviewed a sample of senior client files for evidence of KYC collection, updates to KYC information, and suitability of investments for seniors

- Staff reviewed
  - KYC information collected at account opening
  - Updates to KYC information on at least an annual basis
  - Any differences to KYC collected or frequency of update to KYC information for senior investors
  - Suitability of investments held, including any restrictions on investments for senior clients

CRR’s Guidance Regarding Vulnerable Investors

- Senior investors, especially those with diminished mental capacity, are vulnerable to investment advice that is unsuitable, investment fraud and financial abuse.

- Firms should have written policies and procedures for dealing with vulnerable clients that include
  - Training for staff interacting with vulnerable investors
  - A process for escalating issues identified
  - Collection of “trusted person” contact information
  - Enhancing communication with senior investors
  - Suitability of investments for accounts of senior investors
  - Use of powers of attorney and their potential abuse

Review of PMs operating as online advisers

Overview

- PMs offering managed accounts to retail clients at low cost primarily through an interactive website
- Use online KYC questionnaire, with answers scored to provide a recommendation of a model portfolio of simple ETFs or funds
- CSA Staff Notice 31-342 *Guidance for PMs Regarding Online Advice* outlines regulatory requirements and expectations
    - No exemption from securities law
    - KYC process must amount to meaningful discussion with client
    - ARs must be actively involved in the KYC & suitability process
    - Clients must be able to communicate with an AR
    - Need to inform OSC/PR if plan to operate as online adviser
    - Materially different models/products/processes to be carefully considered by CSA

Overview (cont'd)

- Different business models:
  - Solely online adviser or hybrid (traditional PM and online adviser)
  - Client contact by AR: "always call" and "call when needed"
- "Call when needed" model requires a more comprehensive online KYC and suitability process:
  - All KYC information must be captured in the KYC questionnaire
  - Systematic process to identify and resolve inconsistencies in answers to KYC questions
  - Systematic process to identify when AR should call the client (e.g. inconsistencies in answers, questions not completed, senior citizens)
- Registration categories
- Terms and conditions where applicable

Types of reviews of online advisers

- Pre-registration review for new PM applicant
- F5 filing for existing PM
- Compliance field review after PM registered, approved as online adviser, and operational

Purpose of reviews

- Assess adequacy of KYC & suitability process
- Assess compliance with securities law, and expectations in CSA Staff Notice 31-342
- Assess compliance with any terms and conditions, and representations in pre-registration reviews or F5 filings

What an online adviser should provide for our review

- Proposed online KYC questions
- Scoring logic for how answers to KYC questions result in recommendation
- Description for each investor profile/IPS used
- Description and securities for each model portfolio
- Role of AR
- How and when clients will be contacted by an AR
- How inconsistencies in answers to KYC questions are identified & addressed
- How client identity obligations will be met
- How cybersecurity risks will be addressed
- How clients are informed they may contact AR with any questions
- Client agreements and disclosure
- KYC updating process
- See OSC Staff Notice 33-748, pgs 62-63 (PDF version) for complete list

What to expect during review

- Key persons interviewed
- Demonstration of the website/portal
- Staff testing of website/portal (from investor and AR/CCO perspective)
- Review of agreements, disclosure, etc.
- Address staff's comments

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Findings and best practices from sweep review

General Observations

- Greater technology focus
- Systems easy to use and understand
- 10+ online KYC questions
- Investor education
- Simple system logic to convert KYC answers to an investor profile and model portfolio
- Answers to risk tolerance and investment time frame questions most highly scored
- 5 to 10 investor profiles
- 10 to 20 model portfolios
- Investments - simple and not overly risky
- 8 to 10 ETFs in each model portfolio

What firms did well

- System development
- Cybersecurity management
- Disclosure of fees, services, investor profile, IPS
- Online access to holdings, performance, costs
- Use of social media, promotions, partnerships and referrals
- Adapting based on investors' feedback
- Advisory boards with industry experts
- No significant suitability concerns

1. Inadequate KYC questionnaire

In some cases:

- No or inadequate questions on financial circumstances, investment knowledge or investment restrictions
- Insufficient or unclear questions on risk tolerance
- No question on debt
- Answers to key KYC questions on financial circumstances not scored to factor into system's recommendation of model portfolio

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Guidance on KYC questions and process from CSA Staff Notice 31-342

A well designed online KYC questionnaire and system will:

- Use a series of behavioural questions to establish risk tolerance and other KYC information
- Require all questions to be answered
- Test for inconsistencies in answers, and not let client complete process until they're resolved
- Flag inconsistencies in answers that would trigger an AR call
- Offer investor education about the terms and concepts involved
- Remind investor that an AR is available to help them through-out

Best practices for KYC questions

- Ask enough questions
- Be clearly and simply worded
- Use of multiple choice
- Include questions on investment needs and objectives, risk tolerance, annual income, net worth, investment time horizon, investment knowledge, age
- For net worth, ask separately for financial and total assets, & debt
- Ask several questions on risk tolerance (willingness and capacity)
- Include question asking if investor has any investment restrictions, or add notice on portal requesting client to contact an AR if they have any investment restrictions

Best practices for KYC questions (cont'd)

- Score answers to key questions (investment needs and objectives, risk tolerance, financial circumstances)
- Test the questions for understandability, outcome, etc.
- Implement systematic process to identify and address inconsistencies in answers
- Use of charts, graphs, examples and definitions that accompany the questions
- Use dollar amounts instead of percentages in questions
- Allow investor enough time to complete questions and review their answers

2. No evidence of approval of model portfolio by AR

- In some cases, no evidence of AR review and approval of client's KYC information and the system-recommended model portfolio
- Applies even if system doesn't flag a call is required (for "call as needed" adviser) or doesn't flag inconsistencies in answers

Best practices – evidence of approval of model portfolio by AR

- AR signs/initials and dates that she/he has reviewed and approved the KYC information and recommended model portfolio
- Use of an online portal (for PM's use only) for AR's review and approval process and tracking
- Document any analysis, comments or follow-up done by AR to support her/his suitability assessment (whether AR call with client takes place or not)

3. No meaningful discussion with clients

In some cases:

- AR did not always have a discussion with every client (for PM approved as "always call" adviser)
- AR did not timely have a discussion with a client that was identified as requiring a call (for PM approved as a "call as needed" adviser)
- AR had a discussion with a client, but it was not a meaningful discussion (e.g. no discussion of client's circumstances)
- AR had a discussion with a client, but did not adequately document what was discussed and the outcome (i.e. no evidence of meaningful discussion)

Best practices – meaningful discussion with client

- Timely arrange for an AR-client discussion
- Let client choose preferred method for discussion
- Discuss client's circumstances, explain recommended portfolio, allow time for client to ask questions
- Use standard checklist of questions to ask, and standard form to document answers
- Document name of client and AR, what was discussed, and when, and outcome of the discussion
- Document KYC information if different from answers to KYC questionnaire, or if supplemental to what is on the KYC questionnaire

4. Inadequate KYC update process

In some cases:

- No process to update clients’ KYC information at least annually, or more frequently when there is a material change in clients’ circumstances

Best practices – KYC update process

- Have existing clients re-complete the KYC questionnaire each year, or when there is a material change in their circumstances
- Send specific notice to each client each year to inform you if there are any material changes in their circumstances, and if so, have them re-complete the KYC questionnaire or set up a call with an AR
- Add general notice on portal for clients to inform you if there is a material change in their circumstances
- Maintain evidence of your attempts to update clients' KYC information

5. No notice to OSC of material changes to business model

- PM did not submit Form 31-109F5 *Change of Registration Information* (F5) when there was a material change to the firm's primary business activities, target market or the products or services they provide to clients (compared to information provided in Form 33-109F6 *Firm Registration*(F6))

- The F6 must be kept current at all times

Examples of material changes to business model

- A PM with a traditional business model wants to add online advising
- A PM approved for online advising wants to add a traditional PM business model
- A PM approved as an "always call" online adviser wants to become a "call as needed" online adviser
- Material new business arrangement to obtain new clients
- More risky/complex securities or strategies proposed in model portfolios
- Material change to the KYC and suitability process
- Any proposed changes that are materially different from model described in CSA Staff Notice 31-342

Last words

- Other findings from sweep consistent with those of traditional PMs
- Sweep review outcomes
- CSA and SRO online advice committee
- OSC Launchpad/CSA Regulatory Sandbox
- Online advisers continue to evolve
- New products in model portfolios
- More service offerings
- Area of continued focus
- Ongoing reviews

Guidance on Small Firms Compliance and Regulatory Obligations

Introduction

- CSA reviewed numerous “small” firms
- CSA Staff Notice 31-350 *Guidance on Small Firms Compliance and Regulatory Obligations*
- Results of the reviews and guidance

CSA's reviews of small firms

- 9 common deficiencies identified
  - Significant business interruptions plan and succession planning – inadequate or missing (35%)
  - Monitoring systems (i.e., inadequate written policies and procedures (71%), incomplete books and records (25%), inadequate marketing materials (15%))
  - CCO annual report – inadequate or missing (29%)
  - Interim financial statements and accounting principles – incorrect accounting method and insufficient procedures (15%)
  - Inadequate excess working capital (9%)
  - Inadequate relationship disclosure information (63%)
  - Inadequate collection/documentation of know-your-client information (54%)
  - Non-delivery of or inadequate client statements (45%)
  - Inadequate or outstanding filings to regulators (34%)

Significant business interruptions and succession planning

- Impact on clients in the event of death, incapacitation or prolonged absence of registered individual
- PMs should identify steps to deal with succession planning, either in their Business Continuity Plans (BCPs) or otherwise
- Consider designating an individual (BCP Executor) to execute the BCP in the event of incapacitation or death of sole advising representative
  - Internal BCP Executor e.g. a director, support or administrative staff at the firm
  - External BCP Executor e.g. spouse, relative, legal counsel or other registrant

Significant business interruptions and succession planning (cont'd)

- BCPs should consider the following relating to succession planning:
  - the firm's business succession or wind-down procedures (e.g., assignment of duties to key persons) in the event of death, incapacitation or prolonged temporary absence of the sole registered individual
  - who is responsible for notifying the regulators in the event of death, incapacitation or prolonged temporary absence of the sole registered individual
  - what information clients need to know about the BCP to ensure that it can be properly executed

Significant business interruptions and succession planning (cont'd)

- Factors to consider when working with an external BCP Executor
  - a written agreement is in place so that the BCP executor understands his or her responsibilities
  - the BCP executor is familiar with the firm's BCP
  - the BCP executor is familiar with the firm's business
  - a confidentiality agreement is in place
  - if the BCP executor is another registrant, conflicts of interest between both firms have been considered
  - the BCP executor understands securities legislation and is aware of costs

Monitoring Systems

- Challenging to have segregation of duties, mitigated by
  - Good documentation practices
  - Controls
- Consider using non-registered staff or technology to perform additional verification procedures
- Maintain adequate books and records
- Have adequate policies and procedures that cover all registration categories

CCO Annual Report and Financial Reporting

- Inadequate or missing CCO Annual report
  - Report should describe steps taken to perform assessment of firm's compliance with securities legislation
  - Can be documented in firm's BOD minutes

- Preparation of financial statements and excess working capital calculations
  - Oversight of outsourced accounting functions
  - Use of cash based rather than accrual accounting
  - Inadequate working capital maintained or inaccurate excess working capital calculations

Resources

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Resources – Senior Investors

- IIROC Notice 16-0114 - Guidance on compliance and supervisory issues when dealing with senior clients (May 31, 2016)
- MFDA Senior Resources webpage - http://mfda.ca/investors/for-seniors/
- FINRA – Report on National Senior Investor Initiative - https://www.finra.org/sites/default/files/SEC%20National%20Senior%20Investor%20Initiative.pdf
- Financial and Consumers Services Commission: http://fcnb.ca/senior-financial-abuse-prevention.html
- North American Securities Administrators Association (NASAA) - www.serveourseniors.org

Resources – Senior Investors

Annual report

- OSC Staff Notice 33-747 – *Annual Summary Report for Dealers, Advisers and Investment Fund Managers (pages 41-42)*

  http://www.osc.gov.on.ca/documents/en/Securities-Category3/20160721_sn_33-747_annual-rpt-dealers-advisers.pdf

- OSC Staff Notice 33-748 – *Annual Summary Report for Dealers, Advisers and Investment Fund Managers (pages 57-58)*

  http://www.osc.gov.on.ca/documents/en/Securities-Category3/20170711_sn_33-748_annual-rpt-dealers-advisers.pdf

KYC, KYP and Suitability Staff Notice

- CSA Staff Notice 31-336 – Guidance for Portfolio Managers, Exempt Market Dealers and Other Registrants on the Know-Your-Client, Know-Your-Product and Suitability Obligations

  http://www.osc.gov.on.ca/documents/en/Securities-Category3/csa_20140109_31-336_kyc-kyp-suitability-obligations.pdf

Topical Guide for Registrants

- Reference guide designed to assist registrants and other stakeholders to locate topical guidance regarding compliance and registrant regulation matters

  http://www.osc.gov.on.ca/en/Dealers_topical-guide-for-registrants.htm

Resources – Online Advisers

- CSA Staff Notice 31-342 – *Guidance for Portfolio Managers Regarding Online Advice*

  https://www.osc.gov.on.ca/documents/en/Securities-Category3/csa_20150924_31-342_portfolio-managers-online-advice.pdf

- OSC Staff Notice 33-748 – 2017 Annual Summary Report for Dealers, Advisers and IFMs (pages 60-63)

  https://www.osc.gov.on.ca/documents/en/Securities-Category3/20170711_sn_33-748_annual-rpt-dealers-advisers.pdf

Resources – Small Registrants

CSA Staff Notice

- CSA Staff Notice 31-350 – *Guidance on Small Firms Compliance and Regulatory Obligations*

  [*http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20170517_31-350_guidance-on-small-firms.htm*](http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20170517_31-350_guidance-on-small-firms.htm)

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Questions

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