Oliver

Continuing Education Series

The Principles and Practice of Know Your Client

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Introduction to the Course

- Know Your Client (KYC) is a term that is used to refer to the absolutely essential requirement that an investment advisor (IA) or representative obtain any information about each client that would be necessary to allow them to offer financial advice and services suitable to their individual needs and objectives.

- KYC is both a requirement for the investment advisor (IA) or representative, and an admonishment. On the surface KYC seems incredibly simple: follow the rules related to what information must be obtained, and the requirement will be satisfied.

- In fact and in practice, Know Your Client is a challenging and demanding directive, because it requires dedication, time, and insight into client motives on the part of the investment professional.

- Initially KYC was essentially a means of customer identification and a way of determining the suitability of the investments recommended by the IA or representative.

- Unfortunately, many interpret KYC as synonymous with the New Account Application Form (NAAF); in fact, NAAF is only one part of KYC, and it should not be construed as the means by which an advisor comes to fully know the client.

- Now, the rigours and intervention of anti-money-laundering client-identification requirements and specifications in the *Proceeds of Crime (Money-Laundering) and Terrorist Financing Act (PCMLTFA)* have changed KYC into a beast that is intended to serve two masters:
  - One of these is the need to report, when necessary, to the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC), detailed customer information on those who undertake a suspicious transaction and may appear to be laundering money and/or financing terrorism.

  - The second, is the continuing requirement that IAs serve the investing public by ensuring suitable and responsible investing for each and every client. In doing so, the advisor must satisfy the regulatory authority to which he/she is indirectly responsible in his or her job.

- Very little debate centres on the role KYC fills for FINTRAC, which lays out very specific information that must be gathered and reported. However a great deal of discussion is engendered by the effectiveness of KYC as a means by which an investment professional can serve and protect investors by directing and monitoring their investment behaviour and choices.

- This course will review KYC, dealing first with the bedrock issue of determining the suitability of investments for each client and then looking at the regulated requirements laid out in *PCMLTFA*. It will also give some attention to ways of facilitating the communication necessary between a client and an advisor. The psychology of investor behaviour will be explored in our sister course, *The Psychology of Investing*.

Chapter 1
KYC as a Regulated Requirement

Overview

Know Your Client is a regulated requirement for recommending investments and accepting orders pursuant to recommendations. The process of knowing the client begins via the New Account Application Form which collects relevant client details about the client and the account in a format that satisfies regulatory requirements. The objective of gathering this information is ultimately for the advisor to be able to understand rules that may apply to the client in addition to client motivation for investment choices.

Requirement for KYC

- KYC is required by:
  - Investment Dealers Association (IDA) Regulations 1300.1, 1300.2, 1800.5, and 1900.4
  - Mutual Fund Dealers Association Rule 2.2.1
  - *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*
  - U.S. Internal Revenue Code Sections 1441 and 1442 for U.S. citizens and those who have accounts and holdings in the United States

- The Investment Dealers Association and the Mutual Fund Dealers Association concentrate on making sure that investments are marketed and sold to clients in an honest and straightforward way. They want assurance that IAs make every effort to get to know the client and the client's needs well enough to recommend the most suitable investments for that client. Their KYC rules and regulations are laid out to serve that purpose.

- The *Proceeds of Crime (Money-Laundering) and Terrorist Financing Act* and the U.S. Internal Revenue Code are more concerned with gathering information about and foiling the attempts of criminal and terrorist groups to launder their money through legitimate financial institutions. Their KYC rules are set up to make sure those in the financial industry know exactly who they are dealing with and that they report any suspicious transactions to the proper authorities.

KYC and Investment Management

- The IDA regulations bring together the concepts of knowing the client with issues of suitability; they address the need for both by its members in *accepting* trades and *making* recommendations:
  - "Subject to Regulations 1300.1(r) and 1300.1(s), each Member shall use due diligence to ensure that the ***acceptance*** of any order from a customer is suitable for such customer based on factors including the customer's financial situation, investment knowledge, investment objectives and risk tolerance.

  - "Each Member, when ***recommending*** to a customer the purchase, sale, exchange or holding of any security, shall use due diligence to ensure that the recommendation is suitable for such customer based on factors including the customer's financial situation, investment knowledge, investment objectives and risk tolerance."

- Investment management is a process that is generally accepted to consist of three steps:

  1. choose asset classes
  2. choose weightings of those classes
  3. select the securities within the class

- Too often, the advisor and client focus on step three, even though it has been shown that the first two steps explain almost all average variations in returns. It is generally individual securities that the media and financial press follow ("RIM closed up today at $124.90, a 2% increase over its previous close"), to the disadvantage of the investor, because the importance of the choice of asset classes when determining suitability of investments cannot be overstated.

- If asset classes are wrong, everything that follows from that point will be wrong. If stocks do not suit the investor, there is no point in determining how much of the portfolio should be invested in stocks and then going through the task of selecting individual stocks.

- On its own, a recommendation by an advisor may be suitable, but if the investment falls within an asset class that is already fully invested, then it cannot be suitable.

- However, even if an error is made in step one, step two provides a chance at correcting that mistake: an unsuitable investment that is a small percentage of the portfolio is not as serious as when it comprises a large percentage of the portfolio.

- Thus, when building and maintaining the portfolio, the advisor must take a holistic view and not one that is narrow.

- This course adopts the view that KYC should be used throughout the investment management process, as a transactional tool to help in giving advice, and in trading.

Investment Dealers' KYC Requirements

- The Know Your Client rule relates to Standard A: Duty of Care. It requires the Investment Advisor (IA) to determine the suitability of trades for the client.

- Duty of care is the legal obligation to have thought or regard for those who may be affected by one's acts or omissions.

- Ensuring trades are suitable protects both the client-investor and the investment advisor.

- To comply with this rule, each IA must:
  - Learn the essential facts that are relevant to each client, each account, and each order.
  - Ensure that all recommendations are consistent with the client's investment objectives.
  - Ensure that acceptance of all orders is ruled by good business practices

- Facts are collected in the New Account Application Form.

The New Account Application From (NAAF)

- The first step towards complying with the Know Your Client rule is the completion of the New Account Application Form (NAAF). (The NAAF is also part of the gathering of information necessary for compliance with money-laundering legislation, but that will be discussed later.)

- The NAAF must be completed when opening each account and must be reviewed at least once a year, as well as when a material change occurs in the client's circumstances.

- The three main purposes of the NAAF in relation to **investment** are to:
  - Appraise the investment objectives and risk tolerance of the potential client in order to establish a suitability profile.
  - Evaluate the creditworthiness of the potential client.
  - Determine which specific rules and regulations apply for opening and trading in the account.

- It records the following:
  - Client information, such as the client's full name, date of birth, residency, citizenship, and social insurance number.
  - Personal information, such as marital status, dependents, and employment.
  - Financial information, including net worth and income.
  - Investment objectives, investment knowledge, and risk tolerance.
  - The client's relationship with any publicly-traded companies.

- A partner, director, senior officer, or branch manager must approve each completed NAAF before the first transaction in the account, or promptly after the first transaction, depending on the policy of the firm.

- Certain changes in a client's situation could require that an existing account be re-approved; if so, another New Account Application Form should be completed. This would be appropriate when there is:
  - a change in the client's investment objectives, risk tolerance, employment, or financial circumstances;
  - an additional person being allowed to place orders (e.g., a power of attorney);
  - a change in the name of the account (e.g., marriage)
  - a request to hold mail and confirmations;
  - a change in legal status (e.g., the client becomes an insider);
  - a change in the client's marital status;
  - a change in the client's permanent address;
  - another person who takes a financial interest in an account or gains control over an account (e.g., power of attorney).

- The general sections of the NAAF that apply to KYC issues are:
  - client information
  - account information

Client Information

The Client's Full Name

- The client's correct, full, legal name must always be used and kept up to date; an abbreviation must never be used.

Confidential, Nominee, or Numbered Accounts

- In order for clients to maintain confidentiality, accounts may be identified by number, nominee name, or other symbol. Sufficient identification to identify the account must be kept at the firm's main office and be available upon the request of the self-regulatory organization.

Date of Birth

- Date-of-birth information is essential for all registered accounts.

- Because minors may cancel a contract, accounts should not be opened for anyone who is not of legal age unless the risk is justified by references from established clients or an acceptable guarantee is obtained.
  - The IA should check with the firm's compliance department to determine if any other special documentation is required to open an account for a minor.
  - The age of majority is 18 years of age in Alberta, Saskatchewan, Manitoba, Prince Edward Island, Ontario, and Quebec, and 19 years of age in British Columbia, New Brunswick, Nova Scotia, and Newfoundland.

- The client's age is also vital to determining investment suitability, since it is the basis of the time horizon available for investing.

- Also, the investment advisor may subscribe to the age approach method of strategic asset allocation. If so, the allocation to equities in the portfolio is determined as 100 – client's age (i.e., a 55-year-old client would have a 45% allocation to equities in the portfolio).

- Strategic asset allocation seeks to create the most efficient portfolio to meet the client's objectives and risk tolerance; it is the best balance between risk and return.

Residency

- The permanent address (residence and business) allows the IA to determine if the client actually qualifies as a client according to the registration of the IA and the firm.

- Changes of address must be received in writing.

- Home and business numbers should also be recorded as well as all other numbers, such as those for pagers, fax, cell phones, etc., to facilitate contact.

- Clients must receive confirmations of all trades. Therefore, it is important to ensure the client's home address is a bona fide address rather than a mail drop.

Citizenship

- Citizenship must be ascertained to satisfy both:
  - Ownership constraints of certain securities;
  - Requirements of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (more on this later)

Social Insurance Numbers (SIN)

- The client's SIN is required for tax reporting.

Personal Information

Marital Status

- The client's marital status can have both a financial and legal impact on the account.

- Information on a client's spouse, common-law spouse, or equivalent to married is needed to:
  - help judge the overall creditworthiness of the account;
  - enable the overall circumstances of all of the parties to be considered when determining risk and investment objectives;
  - determine whether the spouse may be subject to regulatory requirements due to employment, insider status, etc. If the spouse is an insider, the person opening the account must have a written statement, signed by both parties, stating that the insider spouse has no authority or interest in the account.

- When an account is guaranteed by another person, the firm must make a diligent effort to confirm the guarantor understands the obligation.

Dependents

- If the client has dependents, this is central to the advice the IA gives and to the planning of the client's finances for the future

- The number and age of the client's dependents are likely to affect:
  - the amount of money the client has available for investing
  - savings for education
  - insurance needs
  - estate planning

Employment

- There are important reasons for obtaining information about the client's employment:
  - To help establish the client's creditworthiness;
  - To enable the IA to determine if special industry rules apply to the client;
  - To understand whether the income of the client will make certain investment products more attractive due to their tax advantages;
  - To help ascertain client investment knowledge or knowledge of financial services;
  - To ascertain the level of client education and sophistication;
  - To help ascertain risk tolerance.

Creditworthiness

- The current debt load of the client will be especially important to assess if the client is applying for a margin account, in which the client will be responsible for satisfying margin requirements.

- Thus, a regular income will be quite important and self-employed or seasonal workers may deserve special consideration.

Special Account Status

- If the client is an employee or close relative of an employee in the securities business, the account will be classified as "Pro" and be subject to special rules and conditions.

- Similarly, if the client is classified as an insider, restrictions will apply to the trading activity of that individual.

- More detail on these types of accounts is provided later in this course.

Tax Advantages

- Knowing the tax bracket of the client can help make investment decisions and allow the advisor to propose investments that will benefit the client from a tax perspective.

Employment as an Indicator of Investment Knowledge

- Professionals (e.g., chartered accountants), business owners, senior-level business executives (e.g., chief financial officers), or others who by virtue of education or training have a sound knowledge of finance and investments (e.g., financial journalists) will have more complex needs and possibly higher expectations than those in jobs without exposure to financial issues.

- Employment will have a close correlation to the investment knowledge statement on the KYC.

Client Education and Sophistication

- Individuals in highly placed jobs are likely to have more education than those working at a lower level, and they are likely to have more knowledge of finance and investing. This should also be reflected in the investment knowledge statement.

- Retired clients can also be highly self-educated about financial matters and investments since they have the time to devote to reading, research, and sometimes to studying the financial press.

- However, the IA should never **assume** that someone with education in a business discipline is knowledgeable or sophisticated about investing. For instance, an education in business, concentrating in organizational management or marketing, will not provide adequate groundwork for investment decisions.

- In 2004 the Financial Services Authority in the U.K. published a study (*Consumer Understanding of Financial Risk*) on client sophistication, product understanding, and attitudes towards risk. It found clients fell into one of three categories of sophistication and that sophistication and education levels were directly correlated:
  - Trusters – low degree of sophistication, less involvement in the decision-making process and more reliance on the advisor. Generally poor product understanding and an unwillingness to ask questions. These clients need an advisor to say, "This is what you should have."

  - Partners – medium degree of sophistication, moderate involvement in making decisions, and with fairly good understanding of the characteristics of products. Relied on advisors to set up products, and to ensure that all paperwork was completed correctly. Often took responsibility for poor investment performance. Conducted some basic research. These clients need an advisor to say, "These are the different options but this is the one I would advise."

  - Controllers – high degree of sophistication, interested in the financial sector, and had a good knowledge of both products and the markets. They carried out more research, including sending off for annual reports and using the internet. Controllers were most likely to challenge information or advice. They were also more likely to buy products direct, often using an advisor or broker only if they were buying a basic product that failed to excite them enough to justify their time and effort. These clients need an advisor to say, These are the options for you to consider."

Employment as Indicator of Risk Tolerance

- Risk tolerance can sometimes be evidenced by the client's type of employment. For instance, a person who has worked in mid-management at the same firm for 33 years should be questioned closely if he states he has a high risk tolerance. On the other hand, a young entrepreneur beginning her own business would be expected to state a risk tolerance that is, at least, medium.

Financial Information

- The client's financial information is a major factor in determining the suitability of investment recommendations.

- The five most important factors needed to evaluate the client's financial situation are:
  - Age (discussed earlier)
  - Net worth and income (including total funds to be invested, such as money to be transferred from other financial institutions)
  - Investment knowledge
  - Investment objectives
  - Tolerance for risk

Net Worth and Income

- Total net worth (e.g., all assets minus all liabilities) must be calculated. Liquid assets that can be converted to cash are the one likely source for investment capital.

- Investment capital may also be considered as risk capital: money available for trading or investing that will not affect the client's lifestyle if diminished or lost.

- The smaller the percentage that risk capital forms of overall net worth, theoretically the more risk that can be assumed.

- Unfortunately, those with little net worth or with limited risk capital are often drawn to riskier investments like futures or options because of the lure of quick, easy, and large profits. Such investments are grossly unsuitable for these investors.

- The trader who puts everything into one risky trade and loses will find that it takes him or her much longer to recoup the loss because of its magnitude.

- IAs should determine the breakdown of annual income into the categories of employment income, investment income, and income from other sources.

- A net worth statement does not address financial outputs of the client; a client with a high net worth could be "cash poor" and thus be a poor prospect for an investment account, or certain types of investments. The IAs should try to determine financial outputs as accurately as possible.

Investment Knowledge

- Knowledge of investing is one of the key factors in building the client suitability profile, yet it is fraught with the possibility for serious error because of the qualitative nature of such knowledge.

- The client's investment knowledge on a KYC form will typically be stated as none, moderate, or extensive, assessments that are almost meaningless without further elaboration because:
  - there is no evidence to support knowledge or lack thereof
  - the opportunity exists for verbal attitudes to conflict with overt behaviour, i.e., people will generally overstate knowledge and show behaviour inconsistent with their supposed degree of knowledge
  - the client's assessment of his or her own knowledge may be different from the IA's assessment of that client's knowledge
  - the IA's assessment of what the client knows may be tempered by client-specific factors such as whether the client is an insider, the client's age, gender, ethnicity, or ability to speak English

- A client's degree of investment knowledge carries implications of fiduciary duty for the IA.

Investment Objectives and Risk Tolerance

- The client's investment objectives and risk tolerance are closely connected and essential to any investment decisions that are made.

- The client's plans for his or her investment funds determine the percentage to be allocated to safety, income, and growth.

- The client's time horizon is important in assessing risk. It is inadequate to define the time horizon to the investor's objective as short, medium, or long-term, since these terms mean something different to different people. Quantifying these periods into categories, such as: immediate (1 to 3 years), short-term (4 to 5 years), medium-term (6 to 9 years), long-term (10+ years) is far more instructive to the advisor.

- Each investment objective within each time frame should have a KYC, since any single time frame could have vastly different risk and return objectives. For example, a client who is 45 may want to look at tax-efficient means of investing and pay for his or her children's university education within the next five years.

- It is also wise for the advisor to address the holding period for investments, which may vary according to the time horizon. For instance, a client could specify that he/she is comfortable with buying stocks if those stocks are going to be held until a certain return is achieved. However, this may be entirely inconsistent with the need for those funds a specified number of years in the future.

- The advisor will also want to introduce the importance of inflation to the client when quantifying investment objectives and/or returns to make sure he or she understands the client's expectations. For instance, does the client expect returns to be real (the rate of inflation subtracted from returns) or nominal (the stated return)?

- Experienced advisors have seen that both novice and experienced investors almost always overstate their ability to withstand market declines. Advisors find that risk tolerance is arguably the most important of all factors when determining suitability.

- More information on the importance and difficulty of assessing risk tolerance is presented later in this course.

Account Information on the NAAF

- Account information consists of:
  - type of account
  - beneficial ownership
  - currency
  - payment/delivery procedures
  - special instructions

Types of Accounts

Cash Accounts

- Credit is not granted in a cash account; cash account rules require that the client provides the full amount necessary for a trade on or before settlement date.

- Thus the financial information about the client will reveal how much cash is available to open such an account, and how that cash availability could restrict trading.

- Otherwise, clients must have pre-arranged for prompt settlement against delivery of the shares or as soon as delivery can be made.

Margin Accounts

- The firm provides credit in a margin account, based on the market value of the securities to be acquired in the account.
- The client must sign a specific margin agreement.
- The amount of money that the client puts up is called margin.
- Again, the financial information gathered about the client will reveal whether he or she qualifies for this type of account, and the client's investment knowledge will reveal whether buying "on margin" is a suitable strategy.

Futures Accounts

- Trading in commodities futures contracts is done in margin accounts.
- The inherent risks associated with trading these contracts must be made clear to clients.
- IAs must be approved to deal in futures contracts and these accounts must be approved by a Registered Futures Principal (RFP).

Delivery Against Payment (DAP), also known as Cash On Delivery (COD)

- Usually a financial institution acts as an agent or intermediary for the client.
- The institution accepts the delivery of securities and pays for them in full.
- The securities do not show up in the client's brokerage account until the institution is reimbursed.
- DAP accounts are normal for institutional accounts.

Receipt Against Payment (RAP)

- Also known as a COD account, it operates like a DAP account, but in this case the institution will receive cash from a securities firm on behalf of the client when securities are sold by the client.

Registered Accounts

- These accounts are for tax-deferral plans (e.g., RRSPs, RRIFs, RESPs, etc.) and are registered in the client's name with Canada Revenue Agency.

- IAs must be aware of contribution and investment limitations, and tax consequences imposed on these accounts.

Pro Accounts

- All employees of a securities industry (as well as their direct relatives) are considered to be non-client accounts with reference to the client priority rules, which state that client trading takes precedence over employee orders.

Discretionary Accounts

- These are accounts in which the client gives discretionary authority to an authorized IA or senior person in the firm to trade in the account on a temporary basis. The client must state the reason he or she is requesting such an account.

- A discretionary account cannot be solicited.

- A discretionary account agreement must be completed by the client, indicating any restrictions to the trading authorization.

- Discretionary authority is valid up to a maximum term of one year.

- All discretionary orders must be marked as discretionary at the time of entry and approved in writing by a partner, director, senior officer (PDO), or branch manager of the firm.

- Orders initiated by producing branch managers or PDOs must be reviewed no later than next day by head office.

- The performance and strategic executions of these accounts must be reviewed at least once a month by a designated PDO.

- These accounts may be terminated (termination must be written) by the client at any time, and by the firm on 30 days' notice to the client.

Managed Accounts

- Managed accounts are managed by a member firm on an ongoing basis (as opposed to on a temporary basis with discretionary accounts) and the client is generally charged a management fee.

- Member firms must have IDA approval in order to handle managed accounts. Only qualified portfolio managers can handle these accounts.

- IAs can actively promote these services.

- The client must sign a management account agreement that clearly sets out his/her investment objectives. A designated director, officer, or partner of the firm must also sign the agreement.

- Managers of such accounts are restricted from doing the following, unless they have the written consent of the client:
  - investing in an issue in which the manager/registrant is an officer or director;
  - investing in a security bought or sold from the registrant's account to or from a managed account;
  - investing in new or secondary issues of securities underwritten by the firm making loans to a registrant or a registrant's associate.

- Each account must be reviewed quarterly to make certain that the financial objectives are being correctly pursued.

- These accounts may be terminated (termination must be written) by the client at any time, and by the firm on 30 days' notice to the client.

- Managed accounts of a firm's PDOs and employees are exempt from the client priority rule when the account is centrally managed with other client accounts. This rule states that client orders trade first.

Investment Club Accounts

- An Investment Club Agreement must be completed with a NAAF when setting up a new account. The NAAF must have the names, addresses, and signatures of all members of the club.

- One or more members of the club will be authorized to give trading and administrative instructions on behalf of the club.

- If an employee of the firm is a member of the club, the account becomes a pro account; the employee cannot authorize trades for the account unless the account is set up as a discretionary or managed account with the resultant supervisory requirements.

Currency

- Most accounts are Canadian- or American-dollar-based accounts, although some firms allow accounts in other foreign currencies.

- Clients need to be advised that foreign-currency-denominated securities carry currency risk, as well as investment risk.

Beneficial Ownership

- Beneficial ownership information applies to non-individual accounts including the accounts of corporations and partnerships (this will be discussed in more detail under FINTRAC).

Payment and Delivery Procedures

- When purchasing a security, sufficient cash or margin must be available within the specified settlement period.

- Other than a DAP account, any request for payment or receipt of monies to a third party could be a warning that there is someone else with an interest in the account, and management should be consulted.

Special Instructions

- For example, instructions are to be sent in duplicate or dividends are to be paid out

Direct and Indirect Interest

- Full disclosure of any interest the advisor has in the account must be on the NAAF, and senior management must be informed.

- An IA should not have any interest in a client account unless it is an account for a family member.
  - Direct Interest: e.g., a joint account with the IA or if the client is an estate or trust and the IA has a beneficial interest.
  - Indirect Interest: e.g., the IA is a shareholder, partner, officer, or director of a company that has a corporate account, in which case, the account must be opened as a PRO account, such as:
    - the client has granted trading authority for the account.
    - the client is an estate or trust of which the IA is a beneficiary.

Regulatory Information Relevant to the New Account

Insider Status

- Insiders are normally defined as:
  - Directors of companies.
  - Partners and senior officers of a company (president, vice- president, etc.), and each of the five highest-paid employees.
  - Any person or corporation (excluding an underwriter during a distribution) who owns or controls more than 10% of the voting equity.

- Insider trading hinges on the misuse of inside information. Such information could be financial (knowledge that a profit or loss warning will be issued), based on operations (i.e., closure of a plant), about a merger or acquisition, marketing-related (success or failure of a new brand), or based on the comings and goings of key executives (e.g., departure of the president).

- In short, advisors must be very careful speaking with insiders and perhaps learning inside information inadvertently.

- Penalties are specified when inside information has been used.

- In order to ensure insider trading or tipping does not occur (e.g., where an IA passes on inside information), firms must have policies and procedures in writing that must be monitored by senior staff.

- A "control person" generally owns more than 20% of a company and can significantly influence the company's course of action.

- People who have inside information may not:
  - Purchase or sell the securities about which they have information.
  - Pass the information along to another person.
  - Induce someone to trade in the targeted securities.

- IAs must identify potential insiders or control persons and refer all questions concerning their trades to the compliance officer.

- Nominal vice-presidents are individuals who, although part of the decision-making process of a corporation, do not have access to material information as a result of the work mandate.

- Nominal VPs are not subject to the disclosing requirements (insider's report) normally imposed on those employees who share material information.

Undisclosed Interest

- If anyone other than the client has a financial interest in an account, additional information must be obtained, including the reason why they are not named on the account.

- An account for which someone other than the client has an interest cannot be opened without the approval of senior management.

Trading Authorization

- If a client wants another person to have authority to trade in his or her account, a trading authority form must be completed. The authority is usually limited to entering orders.

- A General Power of Attorney is required if more authority is to be granted.

- If trading authority has been given, the IA's first responsibility is to the client, especially in terms of investment objectives and risk tolerance.

Banking Information

- This is required under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act.*

- The credit department should check the banking information before an account is opened.

Documentation

- Additional documentation is often demanded, depending on:
  - the type of account to be opened
  - the type of client opening the account.

- IAs are also required to provide clients with documents (when applicable) relating to:
  - risks associated with borrowing to finance securities (Leverage Risk Disclosure Statement)
  - risks associated with trading in strip bonds (Strip Bond Information Statement)
  - service fees
  - the Investor Protection for Clients of IDA Member Firms statement
  - risks associated with trading options and futures

- the relationship of the firm (if an introducing broker) to the carrying broker
- the role of the IA as agent
- referral fees

Separate NAAFs and Supporting Documents

- One NAAF can cover all of a client's accounts (i.e., a registered account and a non-registered account), unless different objectives based on time horizon, return objective, and risk tolerance are set for the different accounts.

- In that case, if the client has different interests in an account, then separate NAAFs are required.

- By signing, the client acknowledges receipt of the terms and conditions of the relevant agreements and documents.

- Forms offering multiple-account openings must clearly bear the signed endorsement of the client with regard to each type of account to be opened.

Chapter 2
Know Your Client Exemptions

Overview

The advisor should understand the exemptions to the know your client rule and particularly be aware of investing decisions the client may make for life insurance products that are sold outside KYC requirements.

Conditions Under Which KYC is Not Required

- The IDA makes exemptions for suitability when:
  - orders are accepted from a customer where no recommendation is provided. Therefore, discount brokers are exempt from suitability requirements;
  - the trading is being done within the context of a testamentary trust;
  - a member executes a trade on the instructions of another member, portfolio manager, investment counsel, limited market dealer, bank, trust company, or insurer.

The Absence of Know Your Client: Life Insurance Investments

- Segregated funds and mutual funds share many characteristics, yet there is no requirement for insurance agents to adhere to Know Your Client strictures for segregated fund sales.

- To date, agents have been assumed to fulfil the requirement Know the Client by the fact-finding exercise they use to determine types and amounts of insurance coverage.

- Fact-finding is not a legislated requirement, and is open to the individual interpretations of each insurer in regards to type and depth of client information required.

- In July 2007, the Life Insurance Council of Saskatchewan released its proposed guidelines for the marketing of segregated funds, including the need for KYC. It is anticipated that KYC requirements will be introduced for segregated funds at some point in all provinces.

- KYC is particularly relevant to universal life policies in which the investment account portion of the policy is invested in funds that are virtually identical to mutual funds. However, the KYC is not required due to universal life being governed by the insurance acts of each province instead of by securities acts.

- Many universal life clients have high expectations for the returns in their universal life policy, given that the account value:
  - can be received upon death in addition to the death benefit and can thus increase the death benefit quite substantially
  - can be leveraged against a loan to provide income, during retirement for instance.
  - can be used for withdrawals, for whatever reason the client chooses

- Because universal life is a n investment product – in addition to providing insurance –, universal life clients should be treated as if KYC is in existence to ensure suitability and expectations are in line with the investment decisions that are made.

- Despite the absence of KYC requirements, it is good practice for life agents to gather KYC information in a form that would suggest attention to client quantitative details and suitability so that a purchase of segregated funds or universal life insurance could withstand scrutiny should such an investment decision be challenged by the client.

Chapter 3
KYC in the Anti-money Laundering Context

Overview

Separate from the need of investment regulators for client information is the need for client details as specified in the anti-money laundering legislation, the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*. The Act requires certain information in order to identify suspicious people and activities in order to detect and deter the laundering of money and financing of terrorist activities. It is very important for financial advisors to be aware of the breadth and depth of money laundering within Canada and internationally, their possible exposure to the crime, and how KYC and anti-money laundering go hand-in-hand.

Background

- The International Monetary Fund estimates that laundered funds account for between 2-5% of the gross domestic product of the world.

- The true scale of the activity is not known and cannot be accurately measured by virtue of the fact that no one can estimate the amount of money generated illegally.

- However, it is certain that money laundering is proliferating, not just as a result of an ever-increasing amount of criminal activity, but because the internet and electronic banking have provided a more sophisticated and circuitous means to convert laundered funds into legal tender and assets.

- There is widespread knowledge of money laundering occurring throughout the financial services industry, including banking, securities, money service businesses, and life insurance. But, the activity is far more pervasive than financial services; money laundering impacts the global economy through many sectors of business activity.

- The actual transactions used to legalize the proceeds of crime are both legal and commonplace; they include making bank deposits, wiring funds, and exchanging currency.

- There are four classes of money launderer:
  - the criminal whose activity produces the dirty money;
  - those who assist in the legitimization of the money;
  - those who enjoy assets derived from the proceeds of crime;
  - those who help to create the money laundering schemes.

- Anyone who helps a person launder money–despite the fact that they may not be directly involved in the underlying criminal activity–is a money launderer.

- Therefore, bankers, lawyers, accountants, and life agents are money launderers if they either use their business to help someone legitimize money earned as proceeds of a crime or provide expertise to such a person.

- Professionals may claim that they were unaware of their laundering activities and that their money laundering was inadvertent. However, in a trial, this defence requires that a negative event be proven ("I did not launder money.") which can be highly prejudicial in front of a jury.

Money Laundering and Financial Services

- The financial services industry depends on the perception that it operates in a framework of high legal, professional, and ethical standards.

- If an institution turns a blind eye to suspicious activities, or its employees or directors have been bribed, that institution becomes a money launderer.

- It will not only face regulatory action, and loss of its customers and reputation but by association, all companies within the industry become tarnished.

- Thus, there are three risks assumed by an institution that launders money:
  - risk to reputation;
  - risk of censure;
  - risk of regulatory intervention.

- There are also macroeconomic consequences of money laundering. Those cited by the International Monetary Fund include:
  - inexplicable changes in money demand;
  - risks to the soundness of banks;
  - contamination effects on legal financial transactions;
  - increased volatility of international capital flows and exchange rates due to unanticipated cross-border asset transfers;
  - the damping effect on foreign direct investment when a country is perceived to be controlled or influenced by organized crime.

Securities

- Securities are popular with money launderers since once they have been successful in placing funds in the system, pursuant cheques or wire transfers appear clean.

- Firms must be vigilant in regards to the suspicious movement of funds through wire transfers and cheques, cash deposits, and withdrawals.

Commodities and the Futures Market

- In the futures market, the opportunity for transgression exists because the brokers do not trade in the names of their clients, and thus the names of the beneficial owners are not known.

- Because commodities can only sell if there is a market, the money launderer will buy and then sell the same commodity.

- The contract will be paid from dirty money, a commission paid to the broker, and profits or proceeds of selling the contract paid by the broker to the money launderer.

- The money launderer then has a legitimate cheque for integration purposes.

Proceeds of Crime (Money Laundering) and Terrorist Financing Act

- The core of Canada’s anti-money laundering efforts is the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*.

- The objectives of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (the Act) are:
  - To detect and deter money laundering
  - To detect and deter the financing of terrorist activities
  - To investigate and prosecute money laundering and terrorist activity financing offences.

- The Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) is an agency created by the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*. As the central clearing-house for information related to money laundering in Canada it:
  - receives, analyzes, and assesses transaction reports and other information relevant to money laundering, terrorist financing, and threats to Canadian security
  - receives reports on the cross-border movement of large amounts of currency or monetary instruments;

  - provides intelligence about financial transactions to law enforcement agencies and to CSIS
  - ensures that personal information under its control is protected from unauthorized disclosure
  - monitors and ensures compliance in the business sector and by financial institutions with obligations under the Act
  - enhances public awareness and understanding of matters related to money laundering and terrorist financing

- The PCAMLFTA applies to almost 180,000 entities in Canada including:
  - banks
  - investment counsellors
  - portfolio managers
  - securities dealers
  - employees of all these entities

- To meet the objectives of the *Act*, persons or entities covered by the *Act* must meet:
  - record-keeping requirements,
  - reporting requirements and
  - compliance requirements

Record Keeping Requirements

- The following entities are required by FINTRAC to identify clients and keep client information records for specified periods of time:
  - life insurance companies, brokers, and agents
  - securities dealers that are provincially authorized to:
    - deal in securities
    - manage portfolios
    - advise on investments
  - foreign exchange dealers
  - financial entities

- Records that must be kept include, but are not limited to:
  - large cash transaction records
  - signature cards
  - copy of corporate records
  - account holder information (not including corporations)
  - account operating agreements
  - deposit slips
  - debit and credit memos

- account statements
- cleared cheques
- client credit files
- foreign currency exchange transaction tickets
- copy of the trust deed and settlor's identification

- Any large cash transaction must be recorded; requirements for what must be in each record are the same for all entities:
  - the amount and currency of cash received
  - the date and nature of the transaction
  - the purpose of the transaction, and relevant details
  - the involvement of any third parties in the transaction
  - how the cash was received
  - the account affected by the transaction
  - the name of the client with the account

- Also, all entities share similar obligations in terms of third-party involvement in a transaction; these requirements are waived for a financial entity when an account is opened by a legal counsel, accountant, real estate broker or sales representative and the account is to be used by their clients.

- Failure to retain records carries a possible fine of up to $500,000 and up to 5 years' imprisonment.

Reporting Requirements

Suspicious Transactions (Money Laundering)

- A suspicious transaction is a financial transaction in which there is reasonable grounds to suspect money laundering or an attempt to launder money. There is no dollar limit threshold.

- Reasonable grounds is largely determined by normal business practices in the business in which the transaction occurs.

- Suspicious transactions are more easily defined by what does not occur, than by what does. If a transaction does not fall within normal business practice, or does not feel "right" because it give rises to feelings of discomfort, apprehension, or mistrust, then the transaction becomes suspicious.

- A transaction may also appear suspicious if the person who requested the transaction exhibited suspicious behaviour or he or she has suspicious associates.

- A suspicious transaction must be reported when the financial transaction has occurred or been attempted. For example, a real estate agent who deposits a cheque on behalf of a buyer has made a financial transaction. If the deposit is refunded, that would also be a financial transaction. If a cheque was received and returned to the buyer before it had been deposited, then an attempted financial transaction has occurred.

- The following entities and their employees must report suspicious transactions:
  - financial entities (banks, trust companies, and others)
  - life insurance companies, brokers, and agents
  - securities dealers, portfolio managers, and investment counsellors
  - foreign exchange dealers

- A suspicious transaction report must be submitted electronically if the technical capability to do so exists; computer requirements are the same as those described for large cash transaction reports. FINTRAC will acknowledge receipt of the form.

- A report may be submitted in paper only when the electronic option is not feasible; forms may be accessed at www.fintrac.gc.ca/publications/pub_e.asp#5 and mailed to the FINTRAC address. FINTRAC will not acknowledge receipt of the form.

- A suspicious transaction report must be submitted within 30 calendar days of the transaction.

- It is essential not to alert the suspect when preparing a report by asking for information outside the norm.

- An employee or reporting entity cannot disclose that a suspicious transaction report has been made, or disclose the contents of a report with the intention of prejudicing a criminal inquiry.

- Failure to report a suspicious transaction carries penalties that include up to 5 years' imprisonment, a fine of $CAD 2 million, or both.

- No criminal or civil proceedings may be brought against an entity or person who makes a report in good faith.

Financial Entities

- Financial entities are required to <u>record</u>:
  - large cash transaction records
    - records on opening an account including:
    - signature card with the individual's date of birth, the type of document used to confirm identity, its reference number, and place of issue
    - if a cleared cheque was used, the financial entity and account number of the account on which the cheque was drawn

  - records on operating an account including:
    - a copy of every account statement
    - a deposit slip of every deposit
    - every cleared cheque drawn on or deposited to the account

  - foreign currency exchange transaction tickets
    - the amount, date and currency involved
    - the method, currency, and amount of the payment
    - if $3,000 or more, the name and address of the individual making the transaction

  - certain records created in the normal course of business including an:
    - account operating agreement
    - debit or credit memo
    - client credit file

  - transactions of $3,000 or more with non-account holders

  - trust-related records

  - client identity of an individual or a third party, within six months of opening the account, by the client's original (not a copy):
    - birth certificate
    - driver's license
    - passport
    - provincial health card, except in Ontario, Manitoba, or PEI

  - when the client is a corporation, the names and directors of the corporation must be confirmed within six months of opening the account by:
    - the certificate of corporate status
    - any record that has to be filed annually under provincial securities legislation

  - any other record that confirms the corporation's existence

- when the client is a settlor or co-trustee of a trust, identification must be provided within 15 days.

- Financial entities are required to report:
  - every large cash transaction by an individual or third party involving $10,000 or more in cash or when two or more cash transactions within a 24-hour period total $10,000 or more.

- Financial entities are not required to report:
  - cash received from a financial entity or public body
  - identity of an existing client
  - if an account exists, it is not necessary to meet the identification requirements for the signature card
  - identification is not required by a public body or a large corporation[1] or if the account holder is a federally or provincially-regulated pension fund

Life Insurance Company, Broker, or Agent

- Members of the life insurance industry are required to record:
  - large cash transaction reports
  - client information including client identity of an individual within six months of opening the account, by the client's original (not a copy):
    - birth certificate
    - driver's license
    - passport
    - provincial health card, except in Ontario, Manitoba, or PEI
  - Or, by use of:
    - a cheque cleared in the name of the individual
    - an account in the individual's name with a financial entity

[1] A large corporation is defined as one with minimum net assets of $75 million, publicly-traded on a Canadian or certain foreign stock exchanges, and operations in a country that is a member of the Financial Action Task Force (FATF).

- when the client is a corporation within six months of opening the account:
  - the certificate of corporate status
  - a record that has to be filed annually under provincial securities legislation
  - any other record that confirms the corporation's existence

- other clients can be confirmed by:
  - a partnership agreement
  - articles of association
  - any other record that confirms the corporation's existence

- Members of the life insurance industry are required to <u>report</u>:
  - every large cash transaction by an individual or third party involving $10,000 or more in cash or when two or more cash transactions within a 24-hour period total $10,000 or more

  - every annuity or life policy in which premiums are $10,000 or more over the duration of the policy

- Members of the life insurance industry are <u>not</u> required to report:
  - cash received from a financial entity or public body

  - an annuity purchased directly by transfer of funds from a registered pension plan

  - purchase of a registered annuity or RRIF

  - purchase of an annuity with the proceeds of a group life policy

  - a reverse mortgage

  - a structured settlement

  - a registered plan account

  - purchase of an exempt policy

  - purchase of a group life policy without a cash surrender value or savings component

  - a pension that is provincially or federally regulated

  - a purchase by a public body or a large corporation

Securities dealers

- Securities dealers are required to record:
  - large cash transaction reports

  - account opening records:
    - new account applications
    - signature cards
    - account operating agreements

  - certain records created in the normal course of business
    - confirmations of sales or purchases
    - guarantees
    - trade authorizations
    - powers of attorney
    - joint account agreements
    - all correspondence about the operation of accounts

  - client statements

  - every individual authorized to give instructions for an account or if a corporate account, no more than three individuals who are authorized to give instructions.

  - client identity of an individual within six months of opening the account, by the client's original (not a copy):
    - birth certificate
    - driver's license
    - passport
    - provincial health card, except in Ontario, Manitoba, or PEI

  - Or, by use of:
    - a cheque cleared in the name of the individual
    - an account in the individual's name with a financial entity

  - When the client is a corporation, the names and directors of the corporation must be confirmed within six months of opening the account by:
    - the certificate of corporate status
    - any record that has to be filed annually under provincial securities legislation
    - any other record that confirms the corporation's existence

- Other clients can be confirmed by:
    - a partnership agreement
    - articles of association
    - any other record that confirms the corporation's existence

- Securities dealers are required to report:
    - every large cash transaction involving $10,000 or more in cash or when two or more cash transactions within a 24-hour period total $10,000 or more

- Securities dealers are not required to report:
    - registered plans
    - an account opened for the deposit and sales of shares from a corporate demutualization
    - an account opened for an employee stock purchase plan
    - an account opened for privatisation of a Crown corporation
    - a registered plan account
    - an account in the name of a foreign affiliate of a financial entity that accepts deposit liabilities
    - an account opened for the sale of mutual funds if another securities dealer is involved

Ascertaining Identity

- The following individuals or entities must be properly identified:
    - a person who signs a signature card or who has a large cash transaction
    - a person who is not an account holder who requests an ETF of $3,000 or more, or who has a foreign exchange transaction of $3,000 or more
    - a corporation or entity that opens an account
    - a settler or co-trustee of a trust

- If a person opening a banking or investing account is a non-resident and is not present, verifying his or her identity may require hiring an agent in their country of residence to handle the transaction. The client's lawyer, for example, is not acceptable.

- Anti-money laundering and anti-terrorist financing procedures must not be in place only for retail clients but also for institutional clients (especially when dealing with intermediaries of these institutional clients).

- These client identification requirements are important and must be followed regardless of how the accounts are opened, including accounts opened via the internet. Unless bank or cheque verification is done, **original copies** of personal identification documentation used to open the accounts must be viewed and verified to substantiate the identity of the account holder.

- If this information is not received within a period of six months, the account must be liquidated and closed.

Compliance

- Proper compliance is mandated by FINTRAC, however, compliance should be a matter of personal will and corporate ethics.

- Compliance with the Act and its regulations can illustrate a serious desire to deter money laundering within the organization rather than the attitude that it has been forced on the individual or entity.

- Compliance is required of:
  - financial entities
  - life insurance companies, brokers, and independent agents
  - securities dealers, portfolio managers, and investment counsellors
  - casinos
  - real estate brokers or sales representatives
  - agents of the Crown that sell or redeem money orders
  - foreign exchange dealers
  - money service businesses
  - accountants and accounting firms

- For these entities, a compliance regime is required of the firm (when there are employees or agents) or of the individual (when the individual is an independent).

The NAAF and FINTRAC

- Some sections on the NAAF gather information that is particularly useful for FINTRAC's purposes.

Personal Information

- As stated in the preceding pages, the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* requires that the identity of an individual client be proven within six months of opening an account by an **original**:

  - Birth certificate
  - Driver's licence
  - Passport
  - Provincial health card, except in Ontario, Manitoba, or P.E.I.
  - Cheque cleared in the name of the individual drawn on an account that is not a credit card account
  - Proof of an account in the individual's name with a financial entity

- Beginning in June 2008, the latter two options will no longer be valid for identifying a client who is not physically present to open the account. An agent, or a mandatory in Quebec, can be used or the individual must be identified by one of these methods:
  - Collecting his or her name, address, date of birth, and identification from an affiliated financial entity, life insurer, or securities dealer in Canada or one with similar activities outside Canada. An affiliate is a company owned by the company in which the account is being opened, or one that owns the company in which the account is being opened or one that is owned by the same company as the account-opener. The information (name, address, etc.) must be verified in the records of the other entity as corresponding with the information provided.

  - Referring to an independent identification product or credit file with an attestation of an identification document from a commissioner of oaths or a guarantor

  - Referring to an independent identification product or credit file AND
    - confirmation of a cheque cleared on a deposit account with a financial entity OR
    - confirmation that the individual has a deposit account with a financial entity

- Obtaining an attestation of an identification document from a commissioner of oaths or a guarantor AND
    - confirmation of a cheque cleared on a deposit account with a financial entity OR
    - confirmation that the individual has a deposit account with a financial entity

  (More information is available at www.fintrac.gc.ca/re-ed/summaries/sd-cvm_e.asp)

Social Insurance Numbers (SIN)

- As mentioned above, the client's SIN is required for tax reporting. If a client refuses to disclose it or claims not to have one, the IA's sales supervisor or the new accounts department must be informed.

Citizenship

- Citizenship must be ascertained to satisfy both:
  - Ownership constraints of certain securities;
  - Requirements of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*

Ownership constraints

- There are restrictions on the ownership of securities of banks, trust and insurance companies, and broadcasting and communications firms (**called constrained share companies**). A certain percentage of shareholders in these constrained share companies must be Canadian citizens, domiciled in Canada.

- Clients may be required to complete an Ownership Declaration to prove domicile and citizenship.

Proceeds of Crime (Money Laundering) and Terrorist Financing Act Requirements

- Domestic entities must be properly identified as to ownership as well as to the person(s) designated to act on behalf of the entity, beneficial owners who own more than 10% of a private entity, and especially off-shore entities.

- Extra care must be taken when dealing with non-residents. Identity should be verified according to those procedures previously described.

Beneficial Ownership

- IDA members must obtain specified information about beneficial owners with a 10% or more ownership position. When such ownership is through other corporations or partnerships, the identity of the ultimate individual owner must be ascertained.

- Financial institutions and testamentary trusts are exempt from this requirement.

- The purpose of determining beneficial owners is to prevent:
  - deceptive trading;
  - manipulative trading;
  - money laundering;
  - terrorist financing;
  - insider trading;
  - tax evasion;
  - avoidance of securities requirements.

- Brokerage accounts may be used where the beneficial owners are not known:
  - If the account is an off-shore account, this information must be supplied, especially if from a non-cooperating jurisdiction as identified by the international organizations that combat money laundering.

Client Red Flags

- The following would be reasons to deny the opening of a new account:
  - Client's reluctance to disclose full information and/or supporting documentation.
  - Altered, counterfeit, or suspicious documentation.
  - Attempts to dissuade you from using the standard methods of opening an account.
  - Questions about the firm's compliance or anti-money laundering procedures that imply some type of intent to avoid reporting.
  - An attempt to use an alias or to open accounts in various names.
  - An attempt to use a P.O. Box or mail drop address versus a regular street address.
  - Not providing – or an unwillingness to provide – detailed ownership information, especially for off-shore accounts.
  - A local resident is opening or maintaining an off-shore account.
  - The provision of documents that are photocopies, fax images, or other reproductions, even when certified as true copies by an attorney acting on behalf of the client.
  - Information that seems vague or untrue.
  - An address that is out of the general area.
  - The provision of a phone number through which the client cannot be reached.
  - The impression that the client is acting as an agent for a third party who is not named – and an unwillingness to identify that party.

- The following could be red flags in the behaviour of an existing client, and should prompt an IA to review and/or revisit his or her KYC documentation and information about the subject. Remember that, legally, ignorance of the client's criminal activity is not a defence if the IA failed in doing due diligence:
  - Cash transactions, and not simply those over $10,000. Some individuals structure their transactions to be small but frequent, and to total just under that "magic" amount.
  - A discrepancy between the size of transactions and the client's net worth.
  - The appearance of a great deal of OTC stock going in and out of an account.
  - A number of transfers or wire transfers in and out of countries that are known to be tax havens.
  - Transferring money out of an account immediately after it has been deposited.
  - Activity in multiple accounts held by the same client, either under one or multiple names, particularly if there are a lot of transfers occurring between the accounts or with outside accounts.

Chapter 4
The Suitability Issue

Overview

Information collected via the New Account Application Form helps the advisor determine suitability of recommendations. Suitability is a huge hurdle for the advisor to cross if the NAAF is the only means of collecting information. The advisor must learn to become a skilled communicator in order to extract all the information from the client that can provide clues to what is or is not suitable according to the client's needs. Honing listening, dialoguing, speaking, questioning, and interviewing skills will improve the advisor's ability to truly understand the message the client is sending, and the motivation that underlies decisions.

KYC, the NAAF and Suitability

- KYC, as evidenced by the NAAF, is the mechanics for account opening and operations; as stated, it is the accepted foundation for the suitability profile.

- However, as also seen from the preceding review, the NAAF is a one-size-fits-all means of collecting information. It may perform adequately in the anti-money laundering context since the PCMLTF Act is about gathering and reporting hard facts.

- The NAAF is a poor basis for assessing suitability, however, because suitability can only ultimately be satisfied if the advisor invests his or her time, expertise, and energy in building a discovery dialogue with the client and the investor understands the investments being proposed by the IA, the relationship of the investments to the portfolio, and the nature of investment risk. Suitability is a much larger picture than suggested by the completion of a single form.

- Because of its weaknesses, the NAAF has been very effectively used to determine fault in arbitration between IAs and clients.

- In the October 2007 edition of *Advisor's Edge*, Rebecca Cowdery and Prema Thiele, both securities lawyers, write: "Two essentially synonomous rules – "know your client" (KYC) and "suitability" – have governed the transactions of brokers, dealers and advisors in Canada for many years. . . . Canadian securities regulation imposes KYC and suitability obligations on a registrant both at the opening of a client's account and for each transaction the registrant carries out for the client." They add that "Complying with KYC and suitability rules . . . should be considered an absolute business necessity."

- Though many cases exist, the case of Laflamme (client) v Roy (advisor) is especially instructive about the actions of advisors and expectations for their behaviour. It concluded by finding against Roy (**emphasis ours**) for:
  - **Failure to be properly knowledgeable about his client's situation;**
  - **Failure to act in accordance with the client's objectives;**
  - **Failure to adequately inform the client concerning the nature, return on, and risks of the investments;**
  - Failure to comply with the client's specific instructions;
  - Failure to deal with his client in good faith and in accordance with good practice;
  - Extremely large numbers of transactions for the purpose of increasing commissions;
  - Failure by the defendant company to exercise proper supervision.

- Here, also, is an extract from the literature of a legal firm specializing in "investment fraud" claims:

  "Suitability: These claims arise from recommendations by a stockbroker or financial advisor that result in losses in your account from investments that were not appropriate for your risk tolerance, overall financial situation, or investment objectives. Suitability claims frequently involve recommendations by stockbrokers to invest all of an investor's money in stocks, to borrow money from the brokerage on margin, or to invest heavily in a single stock or mutual fund or a small group of stocks."

- Unfortunately many accounts contain unsuitable investments, but unsuitability is never challenged when results are better than expected. When losses occur, clients are far more likely to pursue suitability claims.

- No IA should put himself or herself in a situation where suitability can be challenged.

So, the question becomes: how does an IA move beyond the NAAF to do a better job at determining suitability to ensure client interests are better served?

Beyond the NAAF – Getting It in Writing

- One excellent way to be sure that clients have told you everything you need to know about their situation in order to provide advice that is suitable to their financial and life situations, their goals, and their tolerance for risk is to design your own questionnaire for you to fill out as you talk to the client (it will also record that certain issues were raised with the client). At the very least, you should keep detailed notes.

- Advisor.ca offers an excellent downloadable questionnaire (look for the Ultimate Fact-Finder Questionnaire). Some of the sections deal with Goals, Needs and Priorities; Taxation; Retirement; and Investments. The questions in these sections are very specific, and – importantly – give the client examples to which he or she can react (What does "medium risk" mean anyway?) Some examples are:
  - "Tell me a bit about your short, medium, and long-term goals. What sort of things do you hope to accomplish in the next 1 to 5 years? For example, are you planning to buy a new car? Want to pay off a debt? Rank them in order of importance, from most to least, and attach specific deadlines when possible."

  - "How much of your current investment portfolio would you want to keep available in case of emergency?"

- In the interests of the client getting to know you and your services, and also as a way of managing expectations, it is helpful to prepare a Disclosure document, outlining just what services you understand that you are to provide, how you are compensated, the financial service companies you use, conflicts of interest (and how they are to be dealt with), the way decisions are to be made, the limits of the services you provide, etc.

Beyond the NAAF: Building a Discovery Dialogue

- The Industry Practices Review Committee of the Financial Service Commission of Ontario has stated that product suitability revolves around asking questions to identify needs and recommend products.

- Thus, the foundation for suitability is largely based on good communications between advisor and client that will be developed primarily through time spent together getting to know each other better.

- The advisor will arrive at an understanding of the client's goals by asking the right questions in the right manner, at the right time, and by actively listening to what the client says, picking up clues in the client's verbal and non-verbal messages.

- Goals can then be aligned with product recommendations.

- The advisor/client relationship is a two-way street when it comes to communicating: it is just as important for the client to understand the advisor as it is for the advisor to understand the client. The disclosure document mentioned above can be a real help in this.

- When investment performance is directly attributed to the success of a manager, the client may also expect information about the manager, his or her style, background, areas of specialization, and record of results.

- Advisors should be prepared to address their:
  - background, including how long they have been in business; their education, professional designations, or studies;

  - areas of interest or specialization, or be prepared to justify their work as a generalist;

  - network of professionals with whom they work; most financial advisors work closely with others in the financial services industry, including bankers, accountants, life insurance agents, real estate agents, mortgage brokers, and lawyers;

  - fee structure; an explanation of the three types of fees structures (the traditional advisory relationship in which the client may choose among fee only, commission only, or the fee and commission combination; or a professional arrangement in which hourly fees are charged for deliverables; or a customer arrangement in which the advisor simply facilitates transactions) and the advisor's place within that structure, in addition to any other types of compensation that the advisor may receive, e.g., via referrals;

  - record of results; a client may want references from current or former clients, or a sample of other financial plans with the results that were obtained.

- Just as the IA or life agent must extract details about the client in order to prepare the NAAF or to fact-find, the client may also use such a meeting as the time in which to interview the advisor and assess him or her for suitability.

- Thus it should be apparent that Know Your Client is the forum by which the communication channels between advisor and client are opened to facilitate sharing of information.

The Skill of Communication

- Good communication skills are also key to managing fiduciary risk. The relationship of a broker and client is not a fiduciary relationship per se. A fiduciary relationship is established when the courts find that there is a measure of confidentiality and trust on the part of the client towards the particular advisor, and the ability of the plaintiff to establish that reliance.

- On the other hand, securities regulators have approached some way of dealing with this grey area of fiduciary responsibility with the so-called Shingle Theory. This theory asserts that, when a registered broker hangs out his or her “shingle” (lets it be known that they are setting up in that business), he or she raises the expectation that professional levels of conduct and qualifications will be met. This applies when they suggest that they are doing more than accepting orders on buying and selling stocks.

- The rule that a dealer, broker, or advisor must know enough about a client’s financial situation and investment objectives to give “suitable” advice – that is, KYC – is rooted in this theory.

- A client who is totally reliant on the advisor for information, a truster or partner as defined earlier in the *Consumer Understanding of Financial Risk* report, is highly vulnerable to the exercise of power by the advisor. The concepts of unequal bargaining power and undue influence are also often linked to discussions of the fiduciary principle and the finding of the existence of a fiduciary relationship.

- Therefore, if the client is empowered to make independent decisions – perhaps partly due to evidence of the advisor’s efforts at communicating and imparting relevant information about transactions, products, and recommendations – this will have reduced the obligations of the advisor as a fiduciary. But this understanding must be recorded for the protection of the advisor.

- The following information on listening, speaking, and generally fostering good communications is important for the advisor who seeks to reduce fiduciary responsibilities while developing a relationship of trust and confidence, and independence in the client

Listening

- Active or effective listening is a skill that must be learned and practised by the advisor; the failure to listen has been identified as one of the greatest barriers to communication.

- Active listening requires an expenditure of mental effort, as the advisor works to understand the client's experiences from his or her point of view.

> Active listening means listening with the intent to truly understand. It involves identifying the meaning and feeling behind and beyond the actual words expressed. The feeling level is picked up largely through a reading of non-verbal cues: the way the client hesitates, the inflection of his or her voice, etc.

- An advisor needs to keep a series of questions in mind which will help him focus, not only on the immediate conversation, but also on its meaning and his or her part in it. While listening, the advisor should ask himself or herself:
  - What is the client saying?
  - What is the client really saying?
  - What do I know about what he is saying?
  - How do I feel about what he is saying?
  - How can I respond effectively to what he is saying?

- During guided communications, it is quite common to hear someone ask, "Any questions?" Use of this question rarely elicits a good question or questions in response. Typically, the standard answer is, "No." Equally typical is the fact that listeners provide the "no" response, because they do not want to publicly display a lack of knowledge. "No" is a very easy answer.

- A lack of understanding may have occurred due to a true absence of knowledge or factors such as distractions while the advisor is speaking, a hearing disability, or poor comprehension of spoken English.

Useful Techniques for the Dialogue with Clients

- Instead of asking "Any questions?" invite the client to repeat what he or she heard and understood. Such an invitation might sound like: "Tell me what you think a reasonable return on the investments in this account would be." If the adviser is sincere, and then listens, the client will slowly demonstrate what he or she heard – or believes he or she heard – and understood.
- The adviser can paraphrase what he or she is hearing by politely saying: "If I understand you correctly, you said..." or "Let me repeat what you just said so that you can be sure that I understand." In most cases, a correction of what was intended will immediately follow from the speaker. Sometimes, the speaker will repeat the exact words used the first time, in which case the adviser will require more precise information and might suggest, "When you say make the returns large, does that mean they should be more than 3%?" This paraphrasing can lead to a more precise understanding of the client's perceptions and needs.
- Restating is repeating what the client has said but with emphasis on specific items of content. It is useful to check facts: "Your RRSP account is $748,900 and your spouse's account is $378,938."
- Summarizing is similar to paraphrasing and restating but it does not relate to a particular part of a conversation but rather to an extended or entire conversation. It is particularly useful after a lengthy discourse by the client.
- Summarizing is not only helpful for closing and opening sessions, but is good for tying together the issues discussed in a session and pointing ahead to what needs to be accomplished in future sessions. Summarizing at the start of a session provides a review of previous discussions with that client.
- One effective way to communicate with clients is the use of dollar amounts in speech instead of percentages. A much clearer picture of losses, and risk, is painted by asking the client about the loss of $100,000 versus the loss of 20% of principal.

- The advisor must deliver clear messages that are consistent with the client's level of investment knowledge and learning style, and a clear message often interpreted as one that avoids the use of jargon. However, financial terminology may well be appropriate for the experienced or sophisticated investor. In fact, not speaking at this level to such a client may be construed as being patronizing or talking down to the client

- Speech must accommodate the learning style of the client. People very seldom exhibit only one learning style; however, one style usually is preferred and dominates. It is useful to know your client's dominant learning style. It is also useful for the agent/advisor to know which style is predominant in him- or herself.

- The visual learner likes to see information and learns best by reading words or looking at diagrams. This person will want to read the mutual-fund prospectus completely before making a commitment to buy. A visual-style learner will embody visual references in his or her language. His or her speech is characterized by references to seeing, visualizing, and reflecting.

- The auditory learner is most comfortable listening and talking. He or she learns by listening to someone else explain and analyzing what he or she hears. This type of learner will probably engage you in lengthy telephone conversations. An auditory style will use language related to hearing.

- The kinaesthetic learner is action-and sensory-oriented. He or she must relate physically to information and learns best by hands-on experiences. Putting a calculator in the hands of the kinaesthetic learner is a positive learning experience. This modality is represented by words like sensing, feeling, doing, being, and acting.

- The digital learner is the logical thinker who processes information and responds with comments such as "that makes sense." The digital style is thought-oriented and is represented by words such as logical, sensible, or useful.

The Challenges of Dealing with Differences in Language and Culture

- The assumptions about correct behaviour in one culture are not consistent across all cultures.

- Each culture has its own rules and customs and the wise advisor must try to become aware of some of these – especially prior to meeting new clients from another culture to complete the KYC form will be completed. For instance, clients who have immigrated to Canada from Islamic countries may only be acquainted with sharia law that, from a financial-services perspective, governs areas such as inheritance, banking, and contract law. These clients may not be aware of the need for or function of KYC.

- Goals of immigrants are also likely to be different from native Canadians, or those who have lived in Canada for a number of years. In a study released in November 2007, 46% of new immigrants said that funding their children's education was a major financial goal. While saving for retirement and paying down their mortgage accounted for 41% and 40% of the group respectively, 70% were concerned with just covering day-to-day expenses. Whether this is a cultural or economic issue is a moot point; the fact is that most immigrants are from a culture different from Canada's and their cultural and economic differences are intertwined.

- Selling investments to people with another first language is a challenge. The advisor needs to check carefully as to how well they understand the language that is being used.

- The greater challenge is that the advisor will be using investment-specific terms, which even people whose first language is English may not understand. (For example, the word "convertible" has a special meaning for a bond. For someone else it means a type of life insurance policy. Other terms, such as "margin," "options," "debt," and "security" all have special meaning to the advisor, but not necessarily to the customer.)

Effective Questioning

- There are right ways and wrong ways to go about questioning the client.

- **Open-ended questions** imply an open response rather than an "expected response". Open-ended questions give the agent/advisor an opportunity to listen, observe, and learn something about the client's goals, values, and lifestyle. For example: "Have you started to think about what you would like to do when you are retired?" is opened-ended.

- By contrast, **closed-ended questions** ask for a concise response, such as a "yes" or "no". They are useful when the agent/advisor needs a particular piece of information or needs to know exactly how the client feels so that he or she can go on with the problem-solving. For example: "At what age will you retire?" is closed-ended.

- **Leading questions** are phrased in such a way that they suggest a preferred answer. Leading questions are generally inappropriate and make the person being interviewed defensive by trying to force him in a particular direction. For example: "Don't you think buying shares in a Canadian financial institution can help you meet your goals?" is a leading question.

- **Indirect questions** or comments ask for information through the making of a statement. These are the least threatening types of questions and are particularly useful with resistant clients. For example: "A registered education savings plan is a good way to save for your son's education," is an indirect way of asking the client if he or she knows about the plans and the benefits they provide.

- **Follow-up questions** are prompted by the answers the client has provided to previous questions. Some follow-up questions encourage the client to continue.

- **Pauses** can be effective. This tactic may be useful with a client who you perceive as neutral and who you want to encourage to be open.

Advisor Tips for Effective Interviewing

- Know your client's learning style and formulate questions in keeping with it.

- Be aware of your client's attitude (receptive, cautious, resistant), and design your approach accordingly.

- Ask only one question at a time.

- Allow time for the client to answer fully.

- Use a mixture of open- and closed-ended questions, mainly the former.

- Avoid stringing questions together so that the client does not know which question to answer.

- Avoid playing twenty questions or sounding as though you are interrogating your client.

- When asking a question, think about the following: How will the client react? How might it affect your relationship with the client? Will it result in useful information?

- If your client seems intimidated by direct personal questions, generalize the situation and make it an indirect question which you and the client can discuss objectively.

- Use natural curiosity to guide your questioning.

KYC Dialogue and the Effect of Gender

- Men are quick to want a business card, and will want to "get down to business" without delay.
- They are impatient, both for answers and results. They are going to compare the evidence that reflects the status of the adviser against their own: degrees or professional accreditation (e.g., CFP™), business address, membership in clubs, or recognition of success. This does not mean the adviser should limit providing this information; after all, the adviser may be more successful than the person giving him or her the mental "once over."
- Women like to establish a relationship with those they meet and will often spend time speaking about personal matters before starting the business part of the discussion.
- When confronted with a woman who speaks about family issues first, the adviser should respond with a similar family-based comment so that the client does not feel belittled or "stranded," as she might feel if the discussion immediately turns to business.
- Asking questions can be a good way to engage her in this type of conversation, but the adviser must be sure to listen to her answers or this technique can backfire.
- Also be aware that all men and all women will not fit into this behavioural mode; if a woman shows evidence of the male behavioural traits, she expects to be treated accordingly, i.e. to get right down to business.
- Communicating with couples therefore presents a challenge. It is essential to establish a line of communication with each person individually as well as with both in their relationship as a couple.
- To meet the needs of the male, present a business card at the start of the meeting but place it in a neutral position, not directly in front of either person, where both can see the card.
- To meet the needs of the woman, be ready to make some small talk that begins to lay the groundwork for a relationship.
- Finally, try to bring forward issues that may confront the couple as a whole without becoming a marriage counsellor in the process. Asking the pair about their collective needs, instead of individual needs, is one way to do this.

Chapter 5
KYC and the Benefits of Goal-Setting with Clients

Overview

Most clients are already goal-directed. They are interested in financial products and services, not for their features but for what they represent: the means with which to attain their objectives. A financial services advisor who is aware of the client's goals should seize the opportunity to help him or her set goals and achieve those goals using the products and services of the advisor's firm.

Financial Goals

- A financial goal indicates the way in which an individual wishes to utilize his or her financial resources to accomplish an end.

- Once identified, its achievement becomes the focus for the combined efforts of the advisor and client.

- The advisor's role is to focus on clients' financial goals with the knowledge that they represent clients' greater personal needs, values, and beliefs.

- Financial goals can be classified into three general types, reflecting their relationship to a client's budget and financial resources:
  - balancing
  - maintaining
  - increasing

- Clients who are having difficulty making ends meet are usually preoccupied with **balancing** their finances with their lifestyles so that they do not have an unmanageable deficit.

- Their discomfort with their present situation provides motivation to make changes.

- Those clients who have their financial capacity and lifestyle in balance, will want to keep it that way. They will be interested in finding ways to **maintain** their lifestyles.

- They will be concerned with controlling expenses and guarding against any unexpected expenses through the use of insurance and wise savings decisions.

- Clients who generate enough revenue to have significant disposable income available after expenses will be interested in **increasing** or enhancing their lifestyles. Their interest will be largely in the areas of savings and asset accumulation.

- The categorizing of goals into different time frames helps the family to plan by getting a picture of the time sequence that is involved.

- When goals are viewed on a time line, it is easier to get an idea of how they might be funded and also for identifying periods when the budget will be strained.

- A family that knows where it wants to go can use financial counselling to find the best way to get there.

- There are a number of opportunities for the sale of products and services to this family over time, if the agent/advisor looks beyond the immediate sale and helps them with their goals.

Goal-Setting with Clients

- Knowing the client and his or her goals culminates in the recommendation of specific products and services needed to achieve the client's needs.

- The objective for the advisor is a long-term relationship, in which the client will look to the advisor and the institution for help when his or her goals, lifestyle preferences, or financial situation changes.

- Knowing the client, including his or her goals, will also provide follow-up opportunities.

- People cannot achieve every worthwhile goal they desire. Accomplishment depends upon two important aspects: the goal itself and the effort the goal setter is willing to put into achieving it.

- Goals have a higher importance when they have been freely chosen by the client and given thorough consideration.

Important Attributes of Quality Goals

- Quality goals are specific. Making goals specific is part of the process of clarification.

- Specific goals are clear with respect to the cost necessary to achieve them and the time frame in which they will be worked on and accomplished.

- The process of making goals feasible requires refining the goals so that they are realistically achievable, given the person's resources and constraints.

- A balance must be struck between goals which are too high and those which are too low.

- The advisor should encourage clients to choose goals that are neither too easy nor too difficult by the client's own standards.

Helping the Client Achieve Goals

- Goal accomplishment begins with the desire to achieve a certain objective.

- For example: Someone who is constantly on the edge of a budget deficit will have a strong desire to balance his or her inflows and outflows. Both the longing for a new condition and the dislike of the present unacceptable condition create the desire to achieve goals.

- Commitment to a goal arises as the individual considers possibilities and chooses a course of action.

- The individual must not only feel that a particular goal is desirable, but must also believe that it is valuable.

- Commitment is necessary to accomplish goals. Motivation is aided by the use of benchmarks and choosing goals that are challenging.

- Several financial products and services exist to reinforce a goal commitment to money management (e.g., pre-authorized chequing and systematic savings accounts).

- Goals seem more manageable if short-term targets or benchmarks are established that signify notable accomplishments along the way.

- The arrival at significant mileposts can reinforce motivation.

- By establishing benchmarks, the individual does not have to wait until the final goal is accomplished to feel good about his or her efforts.
  - Benchmarks for a retirement account could be:
    - $100,000 account value of an RRSP by age 45
    - $250,0000 account value in an RRSP by age 60
    - $500,000 account value in an RRSP by age 71 to transfer to a RRIF

- An important part of goal-counselling is helping clients to take on challenging rather than safe goals, knowing that a realistic challenge will be more motivating and will sustain their efforts over the long term.

- More challenging goals appear to lead to higher levels of sustained effort and degrees of accomplishment.

- The strength of motivation to accomplish a goal varies directly with its degree of difficulty, but challenge should be balanced with feasibility.

- The amount of challenge an individual will assume depends upon a number of things: the person's past experiences, the support he or she feels from others, such as the advisor, and his or her character and temperament.

- At various stages, as the individual moves towards a goal, he or she may run into situations that cause a reconsideration of that goal.

- At these times, the individual must be ready to modify or revise goals and cycle back through the process.

Chapter 6
The Advisor as Psychologist

Overview

Beyond knowing the facts, knowing the client also means the ability of advisor to recognize client character traits so that actions and reactions can be predicted and appropriately managed. This includes the management of client expectations in order to reduce possibilities for conflict and tension.

Classifying Clients

- The advisor who knows his or her clients should be better able to recognize their character traits. This will help the advisor provide the amount and type of service a client will expect.

- To do so, the advisor will find categorizations of client behaviour helpful to identify client needs. At its simplest, there are two types of clients, differentiated by how they engage in decision-making – active or passive:
  - **Active investors** want to control and participate in decisions affecting their finances. They believe they can make a difference in total return by intervening in the course of an investment, often by short-term market timing.
  - **Risk-tolerant active investors** will own high-growth stocks, operate income property, and maintain individual options or futures accounts.
  - **Risk-averse active investors** prefer safe investments but will still be active in switching between funds or short-term Guaranteed Investment Certificates.
  - **Passive investors** lack the time or expertise to make the necessary decisions. They need an advisor to make decisions on their behalf and especially to conquer their tendency to buy and hold as their only strategy.
  - **Risk-tolerant passive investors** will own aggressive mutual funds, hedge funds and managed options accounts.
  - **Risk-averse passive investors** own balanced mutual funds and long-term bonds.

- The following characterizations also enable advisors to recognize client types and behaviours:
  - **Adventurers:** confident, strong-willed and entrepreneurial; willing to take risks; not generally willing to take advice
  - **Celebrities:** ego-driven; looking for the next hot "tip" or investment; not well-informed about investing

- **Individualists:** strong-willing; competent but not rash; like to research, think, and avoid volatility
- **Guardians:** older people who are careful and a little worried; do not want volatility or excitement; need guidance; can be very loyal
- **Disengaged:** lack time and interest in investing; most inactive; least educated

Managing Client Expectations

- Managing client expectations has a function in the discussion of suitability, as long as it is not simply a Machiavellian manipulation of the client to suit the agenda of the advisor. ("If I tell the client to expect a 3% return when 5% would be more realistic, the client is bound to be happy when a 4% return comes in.")

- Client expectations and suitability deserve co-consideration, since they must align. If not, conflict will result in the relationship. For instance, a client who states: "I expect returns to exceed 15%, but I do not expect to see my principal diminished," has a clear conflict between expectations and suitability, because an investing strategy suitable for this type of return would be one in which significant risks involving principal would have to be run.

- Setting and managing expectations is crucial to suitability.

- How is an expectation different from a requirement? Expectations are deeper and broader than requirements. Expectations are formed early in a relationship, and they may or may not change over the course of that relationship.

- Typically it is not actual results that determine whether a client's expectations are met, but the process by which the client and advisor work together.

- Sources of expectations can include such things as the client's personal or professional background and preferences or expectations set by another person whose opinion influences the client. Many advisors will have first-hand experience with a client who has a set of expectations based on an investing experience his or her friend, acquaintance, or family member has had. Those advisors will know how often those expectations can be inappropriate or incorrect.

- The advisor is better able to influence client expectations when he or she:
  - earns the client's trust; people are influenced only by those they trust;
  - educates the client to establish knowledge of products and services and also an understanding of the complexity of the advisor's work and the impact client expectations have on the advisor;

- provides underlying reasons, i.e., why this or that is so and why a particular recommendation has been made;
- illustrates benefits concretely, instead of using sales techniques, i.e., “Here are the returns on this investment fund for the last three years, adjusted for inflation,” instead of, “This is our best-selling investment fund”;
- identifies a client expectation that is rationale and feasible and ensures that the expectation is met.

Chapter 7
Risk and Its Assessment in the KYC Context

Overview

Along with determining suitability, assessing the client's risk tolerance is one of the major purposes of KYC, and a central responsibility of the advisor. Once risk tolerance has been determined the advisor can apply strategies to reduce risk, such as compounding and dollar cost averaging.

Assessing Client Risk

- To investment advisors who must deal with the vagaries of individual clients, risk must seem like a "four letter word":

- If risk is overemphasized by the advisor, irrational fears can be instilled in the client that can prevent him or her from taking on a prudent amount and type of risk. The advisor will be blamed for inadequate performance, and likely replaced by the client with another advisor who perhaps seems less risk averse.

- If risk is underemphasized, the advisor will surely find that suitability has been sacrificed for returns. The advisor can, rightly, be blamed for failing to address risk in his or her product recommendations; as charged in Laflamme *v* Roy, "failure to adequately inform the client concerning the nature, return on and risks of the investments."

- Attitudes towards risk are dependent on the investor's:
  - personality
  - circumstances
  - financial knowledge
  - experience with investing
  - portfolio, specifically its size and structure

- These attitudes are not fixed but will change at any point as needs alter and the capacity to afford losses varies.

- The *Consumer Understanding of Financial Risk* report from the Financial Services Authority made some interesting findings about risk and investors:
  - typically, it was investors of medium or high financial sophistication who actively sought information regarding risk, but this mainly concerned the risk-to-return ratio as opposed to different types of investment risk.

  - among the more financially sophisticated, risk was an integral part of the decision-making process. It was accepted as a core part of most investment decisions and actively examined in relation to the type of product, the fund or the industry sector.

- Investors who were most worried by risk actively sought to avoid being exposed to it. This group tended to be non-investors or those with only saving accounts.

- There was generally a poor recollection of discussions about risk with financial advisors. Investors said that the emphasis was on potential product performance as opposed to product risk. Some investors believed the matter of risk was never raised and often had no recollection of the discussion of alternative product options with their advisors either. The advisors in the study refuted this claim and stated vehemently that they had raised the issue of risk, but client lethargy about the subject replaced any information or knowledge about risk that had been imparted.

- Further, despite attempts by financial advisors to inform consumers about risk, they admitted that many consumers did not fully understand the information.

- Conversations appeared to be oriented towards the risk appetite of the investors, rather than information about the level of risk associated with different funds.

- The underlying personality of an investor typically confined them to a particular financial strategy. For instance, cautious investors were highly unlikely to own adventurous or even balanced investments without being advised to do so.

- There are many sources of risk, some of which are very personal and subjective. Some risks to consider:
  - the risk of outliving savings
  - the risk of not being able to emotionally tolerate market fluctuations
  - the risk of not having the financial capacity to tolerate market fluctuations
  - the risk associated with underdiversification, especially coupled with unreasonable expectations
  - the risk associated with poor or non-existent planning

- Client tolerance for risk will be a function of:
  - risk of product
  - amount or percentage of capital at risk
  - use of proceeds

  – time frame for investment returns
  – economic factors

- Where a client is placed on the risk continuum between aversion and tolerance is based on their perceived need for financial security versus their need for returns.

- Assessing where the client falls on this scale is a challenging task for the advisor; there is no magic formula that can accurately predict what level of risk tolerance a client will have. Whereas one might think that an association would exist between people who take financial risk and those who take physical risks (i.e., the person who climbs mountains would be a financial risk-taker), it has been shown that high financial risk-takers are obsessed with investing and strive for the emotional rewards that they derive from taking financial risk, just as those do who take physical risks. The two types of risk-takers may be mutually exclusive.

Mitigating Investment Risk

- The risks of investing are well documented and run the gamut from inflation risk to event risk, such as that associated with a natural disaster. Appendix A provides a list of many of these risks for review purposes.

- Understanding these risks in order to properly explain them to a client specifically for the investments he or she is considering or which already exist within the portfolio is helpful to educate the client about financial risks.

- The next task to assess investment suitability will be to properly assess the risk of the investment by providing the investor with a meaningful illustration of the impact of their risk preference.

- The use of illustrations to show performance should be closely monitored and regulated so that expectations are not based on unrealistic numbers. However, an advisor may show the impact of various risk scenarios.

- Stock- and bond-specific risk information will typically be provided by the research department of the advisor's firm. Other tools, like the Morningstar Rating™, also called the Star Rating, quantifies the risk-adjusted performance if mutual funds. Morningstar data is publicly available on that website.

- Risk assessment must take into account risks that could impair portfolio performance and risks of an investment style.

Investment Strategies to Reduce Risk

Dollar-Cost Averaging

- Most investors now recognize that risk is mitigated by diversification. The use of dollar-cost averaging to reduce risk is also an excellent strategy that can be easily illustrated by the advisor. By investing the same amount on a regular basis, the investor blends the highs and lows and market risk is reduced.

An Example of a Dollar-Cost-Averaging Plan

Your client wants to invest $15,000 in Loco common stock. The date is January 1, 2000. He has two options: he can invest the money as a lump sum now or he can set up a dollar-cost-averaging plan and ease into the stock. He opts for the latter and decides to invest $1,250 each quarter for three years.

Had he invested $15,000 in January 2000, he would have purchased 264.46 shares at $56.72 each. When the stock closed for the year in December of 2002 at $13.69, his holdings would only be worth $3,620.

Had he dollar-cost-averaged into the stock over the past three years, however, he would own 746.21 shares; at the closing price, this gives his holdings a market value of $10,216. Although still a loss, Loco stock must only go up to $20.10 to break even, not $56.72, which would have been required without the dollar-cost-averaging.

To go a step further, without dollar-cost-averaging he would break even at $56.72. With dollar-cost-averaging, he would have turned a profit of $27,326 when the stock hit that price thanks to his lower cost basis ($56.72 sell price - $20.10 average cost basis = $36.62 profit x 746.21 shares = $27,326 total profit.)

Invest date	*Amount*	*Price per share*	*Shares purchased*
Jan. 2000	$1,250	$56.72	22.04
Apr. 2000	$1,250	$54.19	23.07
Jul. 2000	$1,250	$31.34	39.27
Oct. 2000	$1,250	$22.60	53.31
Jan. 2001	$1,250	$22.10	56.50
Apr. 2001	$1,250	$19.05	65.62
Oct. 2001	$1,250	$18.13	68.95
Jan. 2002	$1,250	$16.14	77.45
Apr. 2002	$1,250	$14.58	85.73
Jul. 2002	$1,250	$8.66	144.34
Oct. 2002	$1,250	$11.64	107.39
Total	**$15,000**	**$20.10 avg.**	**746.21 shares owned**

Use of Credit Rating Information

- Investors with assets in fixed-income securities should also be provided with credit-rating information from sources such as Moody's and Standard & Poor's.

- These bond-rating services provide an objective assessment of the investment grade of bonds and debentures. The rating is important to investors because it indicates the probability of interest payments being uninterrupted and principal being repaid.

- Based on their ratings, securities are classified from investment grade to speculative. Ratings can be used to compare the ability of companies to meet their debt obligations. These classifications of risks inherent in fixed-income products can provide the investor with justification to buy, or not, on the basis of risk alone.

The Credit Ratings of Bonds

	Rating	**Quality**
	AAA	highest
investment grade	AA	superior
	A	satisfactory
	BBB	adequate
	BB	speculative
high-yield or junk	B	highly speculative
	CCC/CC/C	very highly speculative
	D	in default
	Suspended	Rating suspended

Compounding

- Employing the concept of compounding is typically used to illustrate returns. Compounding can also be an effective way to limit the risk a client assumes.

- Consider the investor whose stated objective is high-growth, high-risk investing and whose portfolio is constructed in such a way that it earns 0% in year one, 0% in year two, and 30% in year three for a total three-year nominal return of 30%. That investor has assumed considerable risk in such a volatile investment.

- Now, compare this to the investor who achieves 10% in each of the three years. This investor has less volatility and yet sees a 33% nominal return over the three-year period, due to compounding.

Chapter 8
Suitable Recommendations

Overview

The objective of Know Your Client is that the advisor's recommendations to the investor are suitable in light of the many variables that have been reviewed in this course, such as investment knowledge and time horizon. The series of questions provided in this chapter are an excellent summary of assessing how well the advisor has gathered information and the client has imparted information.

Advisor Recommendations

- Recommendations must also take into account other factors that do not fall strictly within the parameters of Know Your Client. This is another reason why the NAAF is not in and of itself a complete representation of client data on which recommendations can be based.

- These factors revolve around asset allocation and the role individual investments play in the total investment universe of the client. They include:
  - The need to define degrees of suitability, because all investments are not created equally suitable. Thus, there will be some investments in the total portfolio that may satisfy a higher standard of suitability than others. If this was not so, diversification could be absent.

  - The need to identify asset allocation gaps in the portfolio, which cannot be accomplished by conducting transactional buying and selling.

  - The changes that occur in asset classes over time, and how these can be accommodated within the suitability framework.

- Finally, the price of the security must be in line at the time of recommendation. An overpriced security, while theoretically suitable in its characteristics to the client's need, contributes risk to the portfolio. Both the advisor and the client start playing the market-timing game.

Next Steps

- Successful KYC enables the advisor to move forward with recommendations based on suitability. Ultimately the investment policy statement will be created to mark the start of a long and mutually-rewarding relationship between advisor and client.

- The following reminder questions from Jeffrey H. Rattiner, *Rattiner's Financial Planner's Bible*, serve to reinforce the amount and depth of information that the advisor must impart and that the client must provide about his or her investment objectives so that the advisor truly accomplishes a Know Your Client profile and arrives at a framework of suitability.
  - Did you discuss your client's expectation about the scope and nature of the investment planning service to be delivered?
  - Did you explain the trade-off between risk and return, the concept of real return, and the asset allocation process?
  - Did you convert financial planning goals and objectives into investment planning goals and objectives?
  - Did you identify the time horizon for each separate investment goal?
  - Did you identify the risks inherent in each asset currently owned by the client?
  - Did you explain systematic and unsystematic risk?
  - Did you identify tax-deferral opportunities?
  - Did you discuss the difference between yield and total return?
  - Did you determine important tax issues that may affect the selection of investment products?
  - Did you develop a risk profile of the client and spouse that will serve as a guide to the types of investment products that can be recommended to the client?
  - Did you determine the rate of return required for each client portfolio, based on the analysis completed for each separate funding need?
  - Did you develop an asset-allocation strategy to reallocate the existing portfolio into one that can achieve the clients' goals?
  - Did you determine whether an RESP is an appropriate savings vehicle?
  - Did you determine how much of a dollar loss of the total portfolio value might upset the client?

- Did you discuss the tax treatment of all proposed investments, and how their timing could affect the client (e.g., mutual-fund distributions)?

- Did you discuss mutual fund sales charges and management fees in dollar terms, relating percentages to the amount of money invested?

- Did you discuss the benefits of using dollar-cost-averaging to implement product decisions?

- Did you determine the appropriateness of benchmarks for portfolio performance?

- Did you use yield curves to help guide decisions for fixed-income securities?

- Did you explain correlation and its use in diversification to prevent all assets in the portfolio from declining simultaneously?

(Source: Jeffrey H. Rattiner, Rattiner's *Financial Planner's Bible,* John Wiley & Sons Inc., 2002.)

Conclusion

- The advisor has a fiduciary duty to advise; it therefore follows logically that that duty can only be properly fulfilled if advice is based on the client, his or her needs, and what is suitable for those needs.

- The more an advisor can educate a client and the better the advisor can assess risk and communicate rationale and strategy, the less chance a client will take issue with the advice the advisor provides and the course of the relationship.

- The advisor who takes the high ground when it comes to Know Your Client requirements will be assured that ethical standards and fiduciary duties have both been observed. Such professionalism on the part of the advisor reflects positively on the advisor, his or her firm, and the investment industry as a whole.

Note: Oliver's Learning *Psychology of Investing* Continuing Education course is a good extension of Know Your Client knowledge and understanding.

Types of Risk

Credit Risk or Default Risk

- The risk that an issuer may default on interest and/or principal payments is often referred to as credit risk, but is more accurately termed default risk.
- Creditors receive a higher-ranking claim on the borrower's income (and, in the case of bankruptcy, on assets) than do owners or shareholders.
- Evaluating an issuer's ability to meet timely payments is known as credit analysis.

Credit Analysis

- Credit analysis comprises:
  - evaluating an issuer's ability to service and repay its debt
  - determining the issuer's existing obligations and the assets that are available as protection for debt holders in the event of a default.
  - analyzing liquidity and borrowing needs.
  - analyzing cash-flow needs.
- For governments also analyze:
  - economic structure.
  - growth prospects.
  - fiscal policy and budget flexibility.
  - monetary policy and price stability.
  - public debt burden.
  - external debt levels and liquidity.
  - political risk.
- For a corporation:

– Adjust the firm's financial statements to reflect current market value.

Interest Rate (Market) Risk

- The price of a debt security moves in the opposite direction to a change in interest rates: when interest rates rise, the price of debt securities fall; conversely, as interest rates fall, prices rise.

Reinvestment Risk

- The risk that an investor cannot invest the coupon income or principal at maturity at the same or a higher rate, and there will be a lower rate of return than originally anticipated.

Timing or Call Risk

- Some bonds contain call options, which allow the issuer to call the debt instrument prior to maturity, or prepayment options, which allow the borrower to pay down a portion of the principal amount of the loan before maturity.
- These are a disadvantage to the investor, because the cash flow of the investment is not certain.

Yield Curve/Maturity Risk

- Yield curve risk refers to the risk that changes in the shape of the yield curve will cause debt instruments of different maturity dates to change in value at different rates than originally expected.

Inflation/Purchasing Power Risk

- Arises because of changes in purchasing power over time.
- If the rate of interest is ultimately less than the rate of inflation, then the purchasing power of the investment has declined.

Marketability/Liquidity Risk

- Marketability risk concerns the ease with which a debt security can be sold prior to maturity at or near its true value.

Exchange Rate/Currency Risk

- For an investor purchasing foreign currency debt securities, there is the risk that the value of the currency at each interest payment date and on maturity will have declined relative to the investor's home currency.

Volatility Risk

- As interest rate volatility rises, the value of a bond's call option rises. This is a negative factor from the perspective of a callable bond investor.

Political/Legal Risk

- Changes in the legal landscape governing taxes and allowable investments can affect debt securities.

Event Risk

- Natural disasters, industrial accidents, corporate takeovers, or lawsuits can all impair borrowers' ability to meet their financial obligations.

Sector Risk

- Debt securities in different sectors of the market respond differently to economic, financial, environmental, or interest-rate changes relative to other sectors, because of any of the above risks.