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An ounce of prevention is worth a pound of cure

Now is the time to update your clients' KYC and think about their risk capacity

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Investment suitability is most often the basis for client complaints. Like clockwork, my law firm will receive a spike in calls from advisors and firms seeking advice about upset clients because of a market downturn. This was no different following the recent downturn in March (however brief) caused by Covid-19.

Given that the markets rebounded quickly and have performed well through Covid, there is no doubt that many of your clients will want to stay invested, and possibly even increase their amount of risk. As your clients' advisor, however, you are likely concerned (and justifiably so) that these market trends may not continue, particularly with the anticipated second wave of Covid looming on the horizon.

With that in mind, and before the markets shift, now is the time for know-your-client (KYC) updates to ensure that your clients' risk appetite is accurate and their investments are suitable. This review should examine your clients' liquidity needs in both the short and long-term, as well as whether their personal circumstances have changed or could potentially change (e.g., due to job loss) and the potential effect of another market drop due to a second wave of Covid-19, for instance.

Let’s look at the following scenario:

An advisor, Smith, has not obtained a KYC update for a client, Jones, who is 65 years old, for three years. The last time Smith met with Jones, it was determined that Jones was 75% high-risk tolerance and 25% medium risk.

Since Smith’s last meeting with Jones, Jones’s spouse (the main breadwinner) died and Jones recently paid for his grandchildren to attend university, eating into his savings. Jones was happy with his investment returns because they were doing well in medium to high-risk securities.

Neither Smith nor Jones have turned their mind to Jones’s personal changes to consider whether a market downturn could have a significant effect on his financial needs. What would happen if the market took a turn and Jones suffered losses?

Jones was relying on his small income and his savings to support himself for the remainder of his life. If his KYC was not altered to reflect his new circumstances, what would happen if Jones complained that his investments were unsuitable — even though he was happy with the investments up until a market downturn?

Client-focused reforms and suitability

What questions should you be asking your clients to determine investment suitability? Thankfully, the Canadian Securities Administrators have recently addressed this very issue through the new client-focused reforms (CFRs), which focus on advisors’ and portfolio managers’ regulatory obligations to clients.

The CFRs have now expanded the concept of risk (now referred to as the client’s “risk profile”), which includes considerations of both the client’s risk tolerance and the new concept of “risk capacity.” While the CFRs were drafted before Covid, the introduction of risk capacity is a particularly timely change in the wake of the pandemic.

This is because risk capacity is the objective measure of the amount of risk that clients can take based on their current personal and financial circumstances. This is in contrast to risk tolerance, which is simply the client’s own assessment of how much risk they’re willing to take.

The CFRs specify that any assessment of risk capacity and, in turn, the suitability of investments, must consider the following factors:

i. What are the client's liquidity needs?
ii. What is the client's investment time horizon?
iii. What is the client's investment knowledge?
iv. What are the client's personal circumstances?

The CFRs do not, however, expand on these factors. Instead, the advisor must determine the appropriate questions to ask, so we have developed some questions to add to your repertoire when you update your clients' KYCs.

Example questions

Here are some specific questions that you should consider asking your clients to determine their risk capacity:

i. What industry do you work in?
ii. How stable is your employment sector?
iii. Have you lost your job in the past because of market disruptions? If so, for how long?
iv. Are you worried you might lose your job?
v. Do you have any existing significant financial obligations (such as outstanding loans, car payments, mortgages, spousal support, etc.)?
vi. Do you expect to incur any significant financial obligations (such as paying for a wedding, a child's college or university education, big vacation plans, etc.)?
vii. How is your health? What about the health of your partner (if applicable)?
viii. What are the spending habits of you and your family? Do you support any children or grandchildren?
ix. What are your own spending habits? Have these changed since Covid, and if so, how? Do you expect them to change (again)?
x. Do you expect to make any big purchases or have significant expenditures in the near future? If so, what are these purchases/expenditures, and how urgent are they?

The purpose of these questions is, ultimately, to allow you to determine the suitability of your clients' investments and whether you need to make changes — especially before a second wave of the pandemic might impact the market.

A complaint from Jones can be entirely avoided if Smith takes the necessary precautions to regularly update Jones's risk capacity and reassess the suitability of Jones's investments. Otherwise, Smith and her firm could be left to defend a client complaint.

Don't forget that once a client complains — even verbally — you have an obligation to immediately report the complaint to your compliance officer or department. All of the regulators and SROs (IIROC and the MFDA) define complaints broadly. If you suspect that your client is shifting blame to you for their investment losses, this should be reported to your compliance staff.

So, be proactive — while the market is performing, get those KYC updates done in a meaningful way. Ask all the questions necessary to drill down into your clients' changes and how they might impact their risk profile, examining need for liquidity and time horizon in a real way. If your client pushes back and doesn't want to reduce their risk profile even when your assessment finds it necessary, you will need to think long and hard about how this could come back to bite you with a client complaint.