



Best kept secret about KYC

Advisors ignore this important know-your-client item to their detriment

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Consider a common allegation against advisors: clients sue alleging they lost money in unsuitable investments. So, I ask you — as I do at many speaking engagements — what is the item on the know-your-client (KYC) form that advisors gloss over but that judges spend a ton of time digging into when determining whether the client should win?

Yes, the client's investment knowledge/sophistication.

Until the client-focused reforms (CFRs), little attention was paid to this topic except when it was too late: at trial or in a regulatory investigation or enforcement matter.

Why is the client's investment knowledge/sophistication an important criterion impacting both a judge's and regulator's decision on suitability? Here is the reason: judges and regulators will seek to determine whether the investment risk was accepted by the client, and for that to have happened, the client must have understood the investment and its risks.

The client's understanding and thus acceptance of investment risk is determined by assessing both or either of the following:

1. Did the client have the sophistication to understand the investment risk?
2. Was the product explained to the client at their level of sophistication/investment knowledge? There is an inverse relationship here: the explanation needs to be more detailed and simpler for less sophisticated clients than for more sophisticated clients.

Either way, the judge and the regulator will assess the client's investment knowledge as well as their understanding of the product's risks.

Don't get me wrong: risk profile also plays into the suitability determination. But that is not the topic of this article, especially since risk profile has received loads of attention and is much more obvious.

What most advisors don't know is that judges devote pages upon pages in their written reasons in suitability cases analyzing the evidence of client investment knowledge and, therefore, the client's ability to understand the risks of the investments.

Invariably, inexperienced lawyers representing sophisticated clients make the mistake of alleging that the client is unsophisticated. I have been involved in many cases, and there are many that have also gone to trial, where the judge doesn't buy the argument and the client loses.

However, there are also cases in which the client is unsophisticated and asserts the risks were never explained. While the advisor may have explained the risks, there is no paper trail, so the judge has to make a credibility call. As professionals, this is not a good place for advisors to find themselves.

A dispute on the issue of sophistication leads to considerable time and mountains of money in the form of legal fees spent by both sides, through the litigation process and through the trial, proving (by the client's lawyer) or disproving (by the advisor/dealer lawyer) a client's alleged unsophistication and lack of understanding of the product risks.

It all comes down to evidence — and, without a paper trail, who is believed.

If advisors realized in advance both the costs and risks associated with their lack of evidence of client sophistication, they would give this KYC item more attention.

This lack of appreciation is not advisors' fault, however. Until Dec. 31, 2021, client investment knowledge received little regulatory attention. There is now a reference in the CFRs (NI 31-103, s. 13.2(2)(c)(iv)) in the context of the registrant's obligation under *suitability determination* to collect sufficient information of the "client's investment knowledge." Furthermore, the companion policy (31-103CP, s. 13.2), includes guidance for advisors:

- The need for clear language describing the meaning of the different levels of sophistication (and different levels of other criteria) on the KYC form is required, especially for unsophisticated clients completing their own KYC forms.
- If clients give instructions to an advisor that are "unclear or give inconsistent responses to KYC questions," the advisor should make further inquiries of the client, with particular attention to "less sophisticated clients."
- Perhaps most helpful is the companion policy's list of what should be examined to determine a client's investment knowledge, including the following four criteria:
 1. Understanding of financial markets
 2. Understanding the relative risk and limitations of various types of investments available
 3. Understanding of how the level of risk taken affects potential returns
 4. Client's awareness and previous experiences with finances and investments
- There is a suggestion that advisors "may" use questionnaires to determine a client's investment knowledge, but advisors should "always" make further inquiries if a client's KYC information appears to be inconsistent with their apparent level of investment knowledge and experience, while also indicating a willingness to accept a high level of risk.

An example of this would be if Jessie and Johnny, both age 60, are unsophisticated but know they should be saving more to support their retirement, so they tell the advisor to invest in high-risk products, hoping for high returns. This presents a red flag for the advisor, who has assessed Jessie and Johnny as unsophisticated and sees the risk of them losing money they cannot afford to lose. The clients have shown both a lack of understanding of the markets and a lack of appreciation of their own risk capacity. The advisor cannot just take their instructions but must explain to the clients that they cannot afford to take these risks and instead tell them what indeed is suitable for them.

Now that you understand what is required from a regulatory standpoint, and the attention judges pay to this topic, the hard work begins with the open-ended questions and active listening skills to ensure you collect the evidence in a paper trail of this (and every) KYC item to satisfy both judge and regulator. Ask yourself, What can I ask each client to flush out each of the four criteria?

I invite you to send me the questions you think should and can be asked to flush out the four criteria (ebessner@babinbessnerspry.com). I will take your suggestions and add my own recommendations to prepare a second article drilling down the specific questions to ask clients.

Remember not to get distracted by questions that flush out risk profile — we can do that in another article. Just send me questions associated with assessing client sophistication and knowledge. I look forward to hearing from you.

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