BABIN BESSNER SPRY

185 Frederick Street, Suite 101, Toronto ON, M5A 4L4
Tel: 416 637 3244 ■ Fax: 416 637 3243 ■ www.babinbessnerspry.com

Questions to assess the best kept secret about KYC

Advisors must show that clients understood an investment and its risks

By Ellen Bessner BABIN BESSNER SPRY LLP

(Published by Investment Executive | October 18, 2022)

In a previous article on client investment knowledge/sophistication, I explained how judges and regulators assess the client's investment knowledge as well as their understanding of the product risks when assessing the merits of a client suitability complaint. In this article, I will explain how to assess client knowledge and support your choice so that when you are faced with a client complaint and called onto the carpet by your dealer, regulator, and OBSI or a judge, you will be armed with the evidence you need.

To manage your risk in volatile markets that invite an uptick in client complaints, and to adhere to the regulatory requirement (NI 31-103, client-focused reforms or CFRs) to keep notes of each choice made on the know-your-client (KYC) form, it has never been more important to collect the evidence from clients to support the choice you make on the form for client knowledge/sophistication.

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My previous article asked readers to provide their questions to flush out the four criteria in the CFRs' companion policy (31-103CP s.13.2) to determine clients' level of knowledge/sophistication. I am so thankful for the many responses I received, most of which are included below.

Before we delve into the questions to ask clients and the types of answers that indicate their level of knowledge, let's set out a few directives:

1. The first step is always to pull your dealer's policy manual to ensure you are operating consistently with your dealer's requirements, especially reviewing the definitions for each level of client financial knowledge set in the KYC form.
2. Some dealers' policy manuals require the advisor to use a particular questionnaire, so make sure you can prove that you used it, if required.
3. If you use a questionnaire, make further inquiries to the client, especially if the questionnaire results are inconsistent with the client's apparent level of knowledge.
4. Have an evidentiary trail (best to input this into your CRM system) to support information collected from each client, which in turn supports your choice on the KYC form. It is the advisor's judgment that must determine the client's knowledge, supported by a trail of evidence.
5. The quality of clients' questions will also guide the advisor. For example, an insightful or analytical question reflects a client's sophistication; always write this question down to support your choices.
6. The rating of clients' financial knowledge is not a negotiation between you and them. If they disagree with your choice, take them through the evidence that you are relying on to support it.
7. Let clients' evidence guide you; do not reverse engineer. If clients want complicated/high-risk products and you know compliance will not approve the purchases without at least some level of knowledge, do not increase the level on the form without evidence that supports the higher level of knowledge.

Now that you understand these directives, let's plunge into the type of questions that satisfy each of the four criteria set out by the CFRs (31-103CP s.13.2) for investment knowledge.

1. **Understanding of financial markets**

- What is your education, formal or self-learned, relating to markets or finance? Potential answers from “nil” to “sophisticated” are:
    - None, I never finished high school nor studied on my own (nil)
    - Some hotel management with very basic accounting, economics and finance (fair)
    - A business degree in marketing and finance (needs more probing but could be categorized as good)
    - An MBA and the Canadian Securities Course, with ability to read financial statements and interpret ratio analysis (sophisticated)
- What are your hobbies/how do you spend your leisure time?
    - Gardening, sports, the arts (nil)
    - Reading business-related newspapers and magazines and listening to business-related podcasts (fair)
    - Following business media and markets, with a high degree of understanding and interest (good)
    - Day trading in online accounts (potentially sophisticated; more probing required)
- What work experience do you have relevant to the markets?
    - None related to numbers or the markets (nil)
    - Bookkeeping and anything that includes working with numbers (fair)
    - Financial analysis associated with public markets; accountant or lawyer who works in financial services and can read financial statements (good to sophisticated; more probing required)
    - Recently and/or substantially worked in financial services, with a deep understanding of the markets and ability to analyze the value of a company (potentially sophisticated; needs more probing)

- Do you understand different aspects of the markets and products? Ask the client further questions in a way that invites more than one-word answers:
  - Can you name one or more of the stock exchanges?
  - What is the difference between a stock and bond; between a mutual fund, pooled fund and ETF?
  - Can you explain the difference between a large- and small-cap company?
  - Do you know the difference between interest and dividend income and the tax treatment of each?

2. **Understanding relative risk and limitations of various types of investments**

- Market risks. Do clients understand market fluctuations and how they impact particular investments? Gauge clients' understanding based on the following questions: What would make the market go up or down? What is the difference between a bear and bull market?
- Product risks. Gauge understanding based on the following questions: What would make the risk of any product go up or down? What are the different risk criteria found in a prospectus? What level of potential risk is associated with GICs, balanced mutual funds, small-cap mutual funds, small-cap stock? Do you understand the difference between a GIC and a share that trades on the stock market? Do you understand the concept of diversification?

3. **Understanding of how the level of risk taken affects potential returns**

- Does the client understand different types of risks and how they impact returns? Ask how the following risks impact returns of any particular investment product: political unrest, supply/demand dynamics, changes in a company's executive leadership, interest rate fluctuations.
- If risk is higher or lower in any investment, how could that impact the returns?

4. **Client's awareness and previous experiences with finances and investments (depending on the types of products the advisor is licensed to sell)**

- What is your investment experience, generally?
  - Never invested before (nil)
  - I have an RRSP, TFSA, RESP and understand the basics of the investments in each (fair)
  - I had an online account and an active investment portfolio, choosing some of my own securities. I lost a lot of money, so I now work with a full-service advisor who makes recommendations, most of which I follow (good)
  - I have significant investment accounts with a few dealers, and I discuss each trade with them; I do my own analysis and review their analysis before deciding what to invest in (sophisticated)
- What types of investments have you invested in previously?
- How have you made decisions in the past in respect of the choice of securities?
- What types of accounts do you have with your investment dealers?
- Do you review your account statements from the dealer? How? What do you look at? What is your review process? Do you circle back to your advisor with questions?

For potential client answers to the last few questions, as well as a summary in chart form, consult my KYC guide on client financial knowledge and sophistication.

So, before you tick off the box associated with this undervalued category, consider its importance to regulators and judges when assessing suitability. Give client financial knowledge/sophistication the attention required to reduce your risk, potentially saving your licence, livelihood and reputation.

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