

The Brave New World of Suitability

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Suitability in Perspective

- [IIROC 2013 Enforcement Report](#) :

- “Consistent with previous years, cases involving seniors and/or suitability represented well over one third of all disciplinary cases in 2013. Among those cases were recurring examples of investment advisors failing to adequately understand the products recommended and properly assess the suitability of complex investment products, including leveraged or inverse exchange-traded funds (ETFs).”
- “The significant number of suitability-related cases also translated into a material number of cases involving a Dealer Member’s failure to properly supervise their retail activities.”
- “The vast majority of cases involving seniors dealt with suitability violations relating to the risk profile of an investment itself and/or the improper use of leverage (i.e. borrowing funds to invest).”
- “Suitability remains at the core of much of Enforcement’s activities. Unsuitable investments was the most common matter investigated in 2013, in fact, over 45% of all investigation files opened by Enforcement in 2013 related to suitability issues. This translated to over 40% of our disciplinary cases, against individuals, involving suitability.”
- Unsuitable investments always in top 3 most common complaints as reflected on ComSet

- [OBSI 2013 Annual Report](#) :

- “Suitability of investments continued to be the number one issue. On the product front, we saw an increase in issues involving unrated high-yielding debt securities. In this low interest rate environment, investors are looking for higher returning income investments.”

Suitability Developments

- Still no specific regulatory definition of “suitability”
- IIROC CRM Enhanced Suitability recap:
 - In addition to the previous suitability requirement for trades accepted and recommendations made on retail client accounts, IIROC now requires that an account suitability review must be performed when certain "trigger" events occur (i.e., transfers/deposits into an account, material change in client circumstances, change in the account representative).
 - IIROC also clarified how suitability assessment reviews are to be performed. Specifically, amended rules 1300.1(p) through (r) make it clear that all suitability assessment reviews must be performed by taking into consideration the client's "investment objectives and time horizon" and the "account's current investment portfolio composition and risk level.”
 - Effective March 26, 2013
- OBSI:
 - Policies - “Process for Assessing Investment Suitability and Compensable Losses”
 - Case Studies are also informative
 - See OBSI website (www.obsi.ca)
 - Comprehensive, but not without controversy on certain topics
- Not to mention the Courts
- Fiduciary/Best Interests Standard discussion

CRM Enhanced Suitability – What?

- Suitability assessment reviews must take into account the following client and client account factors including Rules 1300.1(p)-(r):
 - Current financial situation,
 - Investment knowledge,
 - Investment objectives,
 - Time horizon,
 - Risk tolerance,
 - The account's current investment portfolio composition and risk level, and
 - Other KYC information collected (including age, employment particulars, family circumstances, etc.).
- Rule 1300.1(s): The Dealer Member must use due diligence to ensure that:
 - The suitability of all positions in the client's account is reviewed whenever a suitability determination is required, and
 - The client receives appropriate advice in response to the suitability review that has been conducted
- IIROC Guidance Notice 12-0109 “Know your client and suitability” - Not just investments, suitability also extends to:
 - Order type, trading strategy and method of financing the trade, and
 - Account type (margin, trust, option accounts, etc.)

CRM Enhanced Suitability – When?

- Pre-existing:
 - A trade is accepted (Rule 1300.1(p))
 - A recommendation is made (Rule 1300.1(q))
- New effective March 26, 2013:
 - Securities are received into the client's account by way of deposit or transfer (Rule 1300.1(r)(i))
 - Change in account representative (Rule 1300.1(r)(ii))
 - Material change to the client's life circumstances or objectives has resulted in changes to client's KYC information (Rule 1300.1(r)(iii))
- Relationship disclosure obligations (Rule 3500.5) to disclose other times when a suitability assessment may be made:
 - A description of the process used by the Dealer Member to assess investment suitability
 - Whether or not the suitability of the investments held in the account will be reviewed in the case of other triggering events not described in Rule 1300.1(r) and, in particular, in the event of significant market fluctuations

Case Study - JGK

- JGK - IIROC Enforcement Notice Decision 14-0268 dated November 14, 2014
- Between July 2007 and July 2012 JGK:
 - Failed to use due diligence to learn and remain informed of the essential facts relative to his client, contrary to Rule 1300.1(a); and
 - Recommended the purchase of the securities to a client, without using due diligence to ensure that the recommendations were suitable for the client based on her financial situation, investment knowledge, investment objectives and risk tolerance, contrary to 1300.1(q).
- Penalty:
 - \$10,000 fine,
 - Six months close supervision, and
 - Costs of \$2,000

Case Study Background

- Client:
 - New client to advisor
 - Single 72 year old retiree
 - Investment knowledge was recorded as “Minimal/None”
 - Previous investment experience consisted solely of GICs
 - Net liquid assets of approx. \$290,000 which represented all of her total assets
 - This amount consisted primarily of the proceeds from the sale of her home
 - Looking to invest \$250,000
- Client was categorized as “Balanced” on KYC form
- Advisor presented client with 3 potential investment strategies:
 - An investment in GICs which would provide limited return
 - Primarily bonds with a slightly greater return but only pay interest semi-annually
 - T-series mutual funds with monthly distributions of 8% per annum
- Initial investments made in July 2007

Case Study – What Went Wrong?

- The advisor did not adequately explain that the T-series distribution could include a return of the client's capital
- Though the advisor did make an effort to advise the client of the potential volatility of investing in mutual funds, he did not adequately explain the potential downside exposure and the risks associated with the investment in mutual funds as opposed to the risks associated with either bonds or GICs
- The initial investments were made in all equity mutual funds as opposed to balanced funds which had a component of bond investments
- Queried by Compliance for suitability due to 100% equity holdings and suggested rebalancing to reduce equity to 70%
- Advisor response was instead to obtain updated KYC to “Growth” from “Balanced”
- The advisor did not adequately discuss the increase in the potential downside exposure and risks associated with account holdings consisting entirely of global equities
- Between 2007 and 2010 both the capital in the account and the distributions declined

Case Study – And Then?

- Client expresses concerns about the reduced distributions and the reduced market value of her account
- Mutual funds were sold and proceeds used to purchase trust units of an income trust, REIT and royalty income fund (and a DSC was triggered on one fund sale)
- Within a year some of the distributions were reduced and further portfolio changes were made to seek higher yield
- When queried by Compliance, the advisor responses included “the client has had to give up some security to receive a maximum return with reasonable risk. She cannot live on 1.30% GIC’s and / or 3.493% five year Bell bonds or 3.14% five year BMO bonds.”
- The client complained in July 2012 and received \$41,247.03 in compensation
- It was noted the advisor was “well-intended” in seeking to maximize income for the client, which is what he understood her main and overriding investment goal to be

Case Study – Lessons

- Good intentions do not reduce liability
- Client agreement may not be a defence, particularly if client is unsophisticated
- Heightened standards for vulnerable clients, particularly seniors
- Explaining risk and assessing true risk tolerance (i.e. is the KYC “right”)
- The perils of chasing yield by taking on more risk
- Having “hard” discussions with clients, particularly those with limited financial resources who may not have the retirement they want
- KYP and explaining product attributes such as return of capital
- Appropriate responses to compliance and supervisory queries and concerns
- Documentation, documentation, documentation

Challenges (Opportunities?)

- Is KYC information appropriate and correct?:
 - KYC information gathering process
 - KYC on client statements?
- Identifying Trigger Events when they happen
- Ongoing monitoring of all positions in an account
- Consistent Risk Ratings for all securities:
 - Developing Risk Rating methodology
 - Systematic application
 - Dealing with changes to a security Risk Rating
 - Governance and oversight
- Supervision and Audit Trail:
 - Recorded evidence of suitability assessments
 - Appropriate responses to compliance and supervisory queries and concerns
- Seniors and vulnerable clients:
 - How far do you go to protect them from themselves?
 - Supervisory and Compliance exception reporting

Two Firms

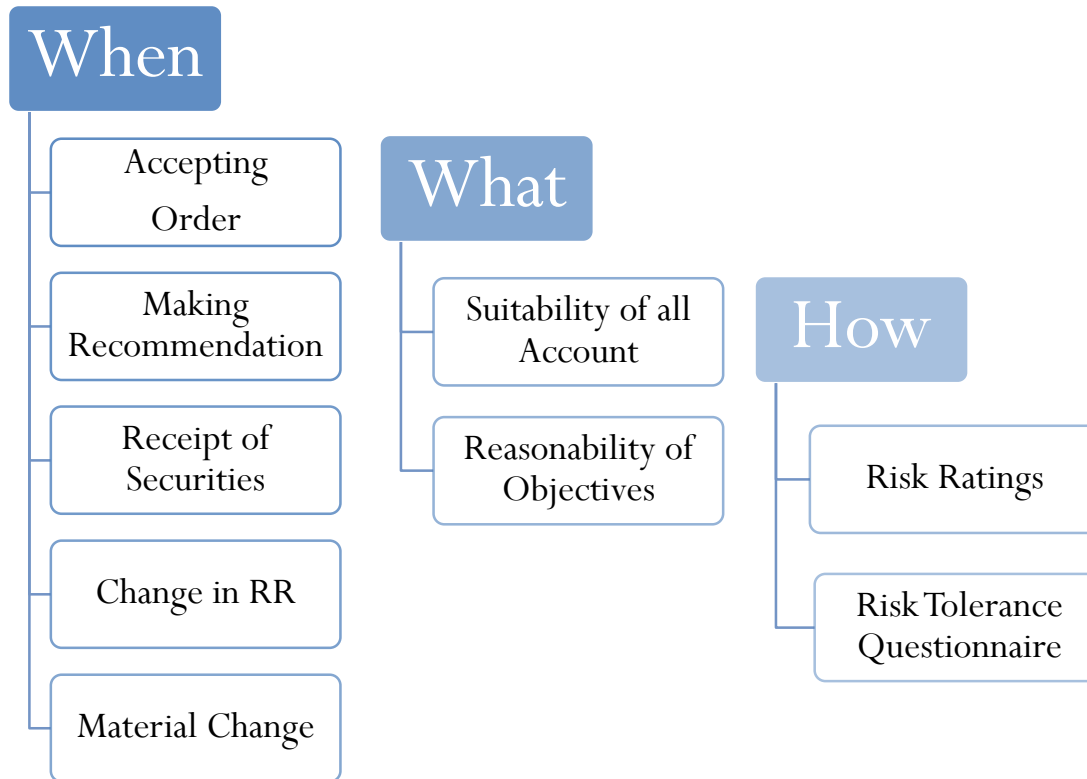
Point - Counterpoint

One Firm's Approach

- Tools at Raymond James
 - Risk Ratings Look Up – Suitability
 - Risk Tolerance Questionnaire – Suitability
- Dataphile Enhancements
 - Risk Ratings of Holdings
 - Financial Advisor (FA) Comments field
 - Pre-Trade Disclosures

CRM – Suitability Rules

- Suitability must be assessed at 5 trigger points



The Risk Ratings Tool

The risk model employs a cascading process, starting with category-level limits.

- Follow regulatory guidelines. For example:
 - All GICs will be LOW
 - All Common Shares will be either MEDIUM or HIGH
 - All ETFs and Mutual Funds will be either LOW, MEDIUM, or HIGH

Each category has its own rules for evaluating various criteria, such as:

- Market Capitalization
- Dividends
- Credit Rating
- Prospectus Rating
- Standard Deviation

Each rule utilizes breakpoints.

- Common Stock – 18 different paths to get to either medium or high. Examples:
 - Market Cap > \$50B, Standard Deviation < 41 = Medium risk
 - Market Cap \$10-50B, Dividend 0.8-5.0%, Standar Dev < 41 = Medium risk.

The Lookup Tool

Allows FAs to quickly look up risk ratings for a list of securities AND create the mandatory AUDIT TRAIL

The screenshot shows a web browser window titled "Online Client Lookup". The page has a dark blue header with the text "Advisor Lookup". Below this is a section titled "Risk & Suitability (Beta Testing)".

Instructions: "Separate multiple Symbols or CUSIPs with commas"

Symbols: RY, TDG, EMA, BCE, MFC

CUSIP: 00126TAB1, 008911AN9, 013051DA2

Listing securities

CUSIP	Symbol	Name	Risk
05534B760	BCE	BCE INC NEW	MEDIUM
290876101	EMA	EMERA INC	MEDIUM
56501R106	MFC	MANULIFE FNCL CORP	MEDIUM
780087102	RY	RYL BK CDA	MEDIUM
893641100	TDG	TRANSDIGM GROUP INC	MEDIUM
896356102	TDG	TRINIDAD DRILLING LTD	HIGH
00126TAB1		TELUS 8.80% 22SEP2025	MEDIUM
008911AN9		AIR CANADA 10.125% 01AUG2015	HIGH
013051DA2		PROV OF ALBERTA 2.75%	LOW

Client ID:

Done

The Lookup Tool.....cont'd

Allows FAs to quickly assess a client's suitability.

★ Favorites Online Client Lookup

Advisor Lookup

Risk & Suitability (Beta Testing)

Separate multiple Symbols or CUSIPs with commas

Symbols: CCM3552

CUSIP:

Listing securities

CUSIP	Symbol	Name	Risk	Reason
CCM3552	CCM3552	IA CLAR STRAT CORP BND FND-LL	HIGH	92.1-MF Fixed Income: default (no risk data available)

Client ID: 2r750

Listing client accounts

As of:	Account #	Client Name	Branch	FA #	FA Name	--STATED--			--CALCULATED--		
						Lo	Me	Hi	Lo	Me	Hi
Oct 17, 2012	2R7500K0					0%	100%	0%	1.7%	73.8%	24.6%
Oct 17, 2012	2R7500E0					0%	90%	10%	8.6%	81.7%	9.6%
Oct 17, 2012	2R7500R0					0%	90%	10%	0.6%	91.4%	7.9%
Oct 17, 2012	2R7500N0					0%	90%	10%	0.1%	99.9%	0.0%

Search Clear

Show All Client's Accounts

The Risk Model.....cont'd

The model will continue to evolve over time.

- We are developing a methodology to reduce the effects of market volatility (to avoid having all stocks become high risk in a 2008-style market).
- We are developing a methodology to reduce the potential for oscillation.

Risk tolerance questionnaire.

- Will provide a consistent method across the firm for assessing client risk tolerance.
- Each client will be assigned to 1 of 5 risk profiles.
- Each risk profile will specify ranges for minimum low% and maximum high%.

Suitability and Reasonability

What's the Difference???

- Reasonability
 - Unrelated to the client's specific holdings
 - Determined at account opening
 - What are the client's goals
 - What are the client's needs
 - What is the client's time horizon
 - What are the client's financial circumstances
 - Does the client have assets elsewhere
 - Are the stated risk tolerance and objectives appropriate for the client

The RTQ?

- 17 Questions designed to reliably and consistently assess a given client's risk tolerance.
 - Psychological pre-disposition
 - Capacity
- The RTQ is client centric, not account centric.
 - One RTQ reflects the client's overall risk tolerance.
 - A client's accounts should collectively align with the RTQ.

RTQ Overview

Client answers 17 questions....

Risk Tolerance Assessment

Your responses to the following questions will be used by your financial advisor to assess your risk tolerance. Your risk tolerance is an important consideration in making investment recommendations that are suitable for you. It is therefore important that your responses be as accurate as possible and that you keep your advisor apprised of any material changes to your financial circumstances or risk tolerance.

Part A – Questions

1. Compared to my friends and associates, my willingness to take financial risks is best described as:

- Very low risk taker
- Low risk taker
- Average risk taker
- Higher risk taker
- Very high risk taker

2. I feel at ease with regard to investing in the stock market:

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly Disagree

3. I tend to choose investments with lower risk even if the returns are lower:

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly Disagree

4. The word "risk" means "opportunity" to me:

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly Disagree

5. I understand investment concepts easily:

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly Disagree

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System generates a risk score....

Part C – Risk Score

Your overall risk score is: 38

Based on your score, we recommend that you pursue an investment strategy that has a risk profile within the minimum and maximum bounds indicated in the highlighted column below:

	Capital Preservation	Conservative	Moderate	Aggressive	Speculator
Risk Score	11 – 34	35 – 45	46 – 53	54 – 64	65 – 84
Minimum Low	60% - 100%	30% - 70%	0% - 40%	0% - 20%	0% - 10%
Maximum High	0% - 5%	0% - 15%	0% - 30%	25% - 60%	50% - 100%

Part D – Client Confirmation of Risk Tolerance

Please select one of the following tick boxes and ensure that the percentages add to 100.

I agree with the results in part C above, in consultation with my advisor, and in keeping with the minimum and maximum limits detailed in part C, my overall risk tolerance (for all investments held at RJL) is as follows:

45 % Low + 45 % Medium + 10 % High

OR

I disagree with the results in part C above and wish to pursue an investment strategy with the following risk profile:

_____ % Low + _____ % Medium + _____ % High

OR

I decline the opportunity to complete this questionnaire because it isn't applicable to my particular circumstances.

_____ % Low + _____ % Medium + _____ % High

If you selected either of the last 2 choices above, please provide a brief explanation below:

Part E – Agreement

I hereby confirm that the information I have provided above is accurate and I understand that my advisor will rely on this information in order to recommend suitable investments to me. I understand that it is my responsibility to communicate any material changes in my risk tolerance or financial circumstances to my advisor.

Name (please print)

Signature

Date

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Our Question?

Industry standard
Risk Ratings?

Your Questions?

Thank you!