OSC Updates for Private Client Investment Managers

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Agenda

- What we do and who we regulate
- Overview of 2015 OSC Annual Summary Report
- Common portfolio manager (PM) deficiencies and acceptable and unacceptable practices
- Examples of referral arrangements with improper delegation of KYC and suitability obligations to referral agents
- Examples of inadequate updating of clients' KYC information
- Overview of PMs operating as online advisers ("robo-advisors")
- Guidance for PMs operating as online advisers
- Questions

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What we do and who we regulate

* As of January 6, 2016. Firms can be registered in multiple categories

Registration category	Total firms registered in Ontario	Total firms OSC is principal regulator for
Portfolio managers	721	540
Investment fund managers	504	362
Exempt market dealers	682	523

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2015 OSC Annual Summary Report for Dealers, Advisers and Investment Fund Managers

- Key policy initiatives impacting registrants
- Outreach to registrants
- Registration of firms and individuals
- Info for registrants, including current trends in deficiencies from compliance reviews and acceptable and unacceptable practices
- Examples of registrant misconduct
- Published September 21, 2015 as OSC Staff Notice 33-746
- Available on OSC website http://www.osc.gov.on.ca/documents/en/Securities-Category3/sn_33-746_annual-rpt-dealers-advisers.pdf

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Elements of an effective compliance system

- OSC outreach session from June 2015
- Webinar now available for replay (go to Registrant Outreach section of OSC website, under Registrant Resources, Education Seminars)
- Topics:

1. Key elements of an effective compliance system
2. Roles and responsibilities of the UDP and CCO
3. CCO annual report to the board of directors
4. Key aspects of policies and procedures manual and its
effective implementation
5. Emerging compliance issues

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Outcomes of compliance reviews

- Outcomes of compliance reviews*:

Outcomes of compliance reviews (all registration categories)	Fiscal 2015
Enhanced compliance	40%
Significantly enhanced compliance	47%
Terms and conditions on registration	9%
Surrender of registration	0%
Referral to the Enforcement Branch	3%
Suspension of registration	1%

* - the statistics apply to compliance reviews of firms and does not include action taken involving registration of individuals

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PM-IIROC dealer arrangements

- Arrangements whereby IIROC dealer provides custody, trading, and other services to PM and its clients
- No regulatory framework
- CSA and IIROC staff continue to discuss
- PM must maintain own books and records of client holdings and trades
- Discussing agreement between PM and dealer, and disclosure to clients
- Exploring alternatives to requirement for both PM and IIROC dealer to separately issue account statement to shared clients
- Until this work is complete, PMs are to comply with the existing account/additional statement requirements in s.14.14 and 14.14.1 of NI 31-103
- But may consider interim guidance in section 4.3.3 of OSC Staff Notice 33-742

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High risk compliance reviews

- Background on high risk compliance reviews
  - Risk Assessment Questionnaire – sent in June 2014 to firms for which the OSC is the principal regulator
- Common deficiencies noted during high risk compliance reviews
  - Incomplete and/or inadequate books and records
    - Lack of or inadequate books and records to support compliance with securities law
    - Requested books and records not provided to staff in a timely manner
  - Inadequate referral arrangements
  - Inadequate updating of client's KYC and suitability information
- Repeat Common deficiencies noted during high risk compliance reviews
  - Inadequate written policies and procedures
    - Written policies and procedures manual not tailored to a registrant's operations

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Inadequate referral arrangements

- Continue to be an area of concern for some PM firms
- Issues noted where deficiencies were identified include:
  - *High number of referral arrangements*
  - *Business model reliant on third parties for clients*
  - *Improper delegation of KYC and suitability obligations to referral agents*
  - *Client confusion as to who their advising rep was*
  - *High proportion of management fees paid to referral agent*
  - *Inadequate number of advising reps to service clients*
  - *Inadequate referral agreements*
- Sections 13.8 to 13.10 of NI 31-103 outline the legal requirements
- Further guidance in Part 13 of the Companion Policy to NI 31-103

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Example

- PM firm with over 1600 clients and only 2 registered ARs and 2 AARs
- Managed accounts with model portfolios targeted to retail investors
- Accepted a high level of referrals from financial planners
- Improper use of referral agents to discharge KYC obligations
  - Financial planners collected KYC information and met with clients
- Resulted in terms and conditions being placed on the firm's registration
  - Compliance consultant to develop a remediation plan
  - Remediation plan called for all referred clients to be contacted directly
  - Amendments to referral agreements focusing on enhancing oversight of planners

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Items to consider regarding referrals

1. Agreement
   - Have you entered into an appropriate referral agreement?
   - Does the referral agreement adequately:
     - Identify the roles and responsibilities of each party
     - Identify a non-exhaustive list of activities that the referral agent can engage in
     - Identify how you will monitor and enforce the referral agent's compliance
2. Disclosure
   - Have clients received appropriate disclosure?
     - Referral fees
     - Conflicts of interest
3. Resourcing
   - Do you have appropriate resources to service the referred clients?
     - How will you ensure you meet your regulatory responsibilities?
     - Do you need to hire/register additional ARs and/or AARs?

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Inadequate updating of clients' KYC and suitability information

- 60% of PM firms reviewed were deficient
- PMs required to take reasonable steps to keep their clients' KYC and suitability information current (13.2(4) of NI 31-103)
- Information is current if sufficiently up-to-date to support a suitability determination
- A PM with discretionary authority should update KYC information frequently
- We expect at least annual updates, or more frequently when a material change in a client's circumstances becomes known (for example, marriage, divorce, loss of employment, serious health issue)
- PMs required to maintain records to demonstrate compliance with KYC and suitability obligations (11.5(2)(l) of NI 31-103)

Examples of inadequate KYC updating

- PM relies on client to inform them of any changes in their KYC information
- PM uses referral agent to update client's KYC information
- No process to update client information at least annually, such as part of a client meeting or phone call
- PM only sends a letter/email to client requesting any updates to KYC information, but does not follow-up when no response from client
- No documentation of client's updated KYC information
- No documentation that client's KYC information has not changed

Acceptable practices to update KYC info

- Hold an in-person meeting or telephone call with each client at least annually, which includes a discussion of any KYC changes
- Use a KYC update form or checklist, with examples of trigger events
- Provide client a copy of their latest KYC information so they may inform you of any changes
- Document and date any changes, and consider if new KYC form should be completed and signed by client
- If there are no changes, document that you had the discussion, and when
- If email or letter is sent requesting KYC updates, request client to respond, and follow-up if no response
- If client is non-responsive for KYC updates, document steps taken to contact client

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Other common PM deficiencies

- Inadequate investment management agreements
- Inadequate personal trading policies
- Account statement practices
- No collection of client's insider status
- Inadequate written policies and procedures on portfolio management and trading

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Overview of PMs operating as online advisers

- Relatively new to Canada
- About 9 PMs are online advisers in Canada
- Discretionary portfolio management to retail investors through interactive website
- Hybrid service: Investor primarily interfaces with adviser's website but also has discussion with advising rep (AR) by telephone or online communication
- Investor answers KYC and suitability questions online to generate an investor profile and recommended model portfolio of ETFs or low cost investment funds, subject to discussion with client and AR, and approval by AR
- Client assets held at custodian; online adviser has trading authority over the client's custodial account
- Low fees (e.g. 50 bps of AUM per year plus ETF fees)
- Low account minimums (e.g. $2000 or $5000) = greater access

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Guidance for PMs operating as online advisers

- Guidance for PMs Regarding Online Advice published September 24, 2015 as CSA Staff Notice 31-342
- Same requirements as traditional PMs – no exemptions
- Must be active involvement of AR in reviewing KYC information and approving investments as suitable for client
- Simple investments (portfolio of unleveraged ETFs or low cost mutual funds)
- KYC process should amount to meaningful discussion with client
- Terms and conditions if PM approved to not always contact client
- If PM plans to offer in Ontario, must notify OSC in advance, and be subject to due diligence review
- Materially different business models need to be considered by CSA
- OSC Investor News article published September 2015 https://www.osc.gov.on.ca/documents/en/Investors/inv_news_201500929_robo-advisors.pdf

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Compliance reviews of online advisers

- Compliance reviews after 1-2 years of operation
- Do clients understand nature of services
- KYC and suitability process
- How client identity obligations being met
- Active involvement of AR
- Meaningful discussion with client
- Suitability of investments
- System security
- Ratio of AR/AARs to clients
- KYC updating
- Marketing claims
- Books and records and account statements

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