Mutual Fund Dealers Association of Canada
Association canadienne des courtiers de fonds mutuels

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MFDA Bulletin

Compliance

For Distribution to Relevant Parties within your Firm

Approved Person Targeted Review

In 2018, the MFDA performed a Targeted Review of Approved Persons' books of business. Attached to this Bulletin is a Report which provides a summary of the analysis and work performed and sets out the key findings and recommendations of MFDA staff.

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1. Background

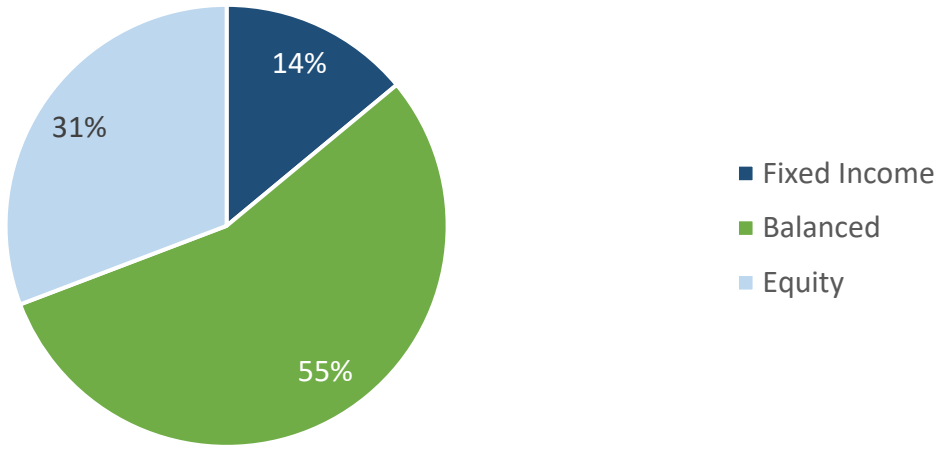
The Client Research Report issued on May 23, 2017 provided the MFDA with valuable information and insight into Members' business, their Approved Persons and their clients. In 2018 we commenced a targeted review of Approved Persons' books of business utilizing information obtained from the Client Research Project. This initiative was part of our continued efforts to enhance suitability testing in our examinations by further utilizing technology and data to help identify patterns or trends and target issues such as concentration risk and potential unsuitable investments for seniors. This report provides a summary of the significant analysis and work performed during the review, our key findings and recommendations.

2. Industry Wide Observations

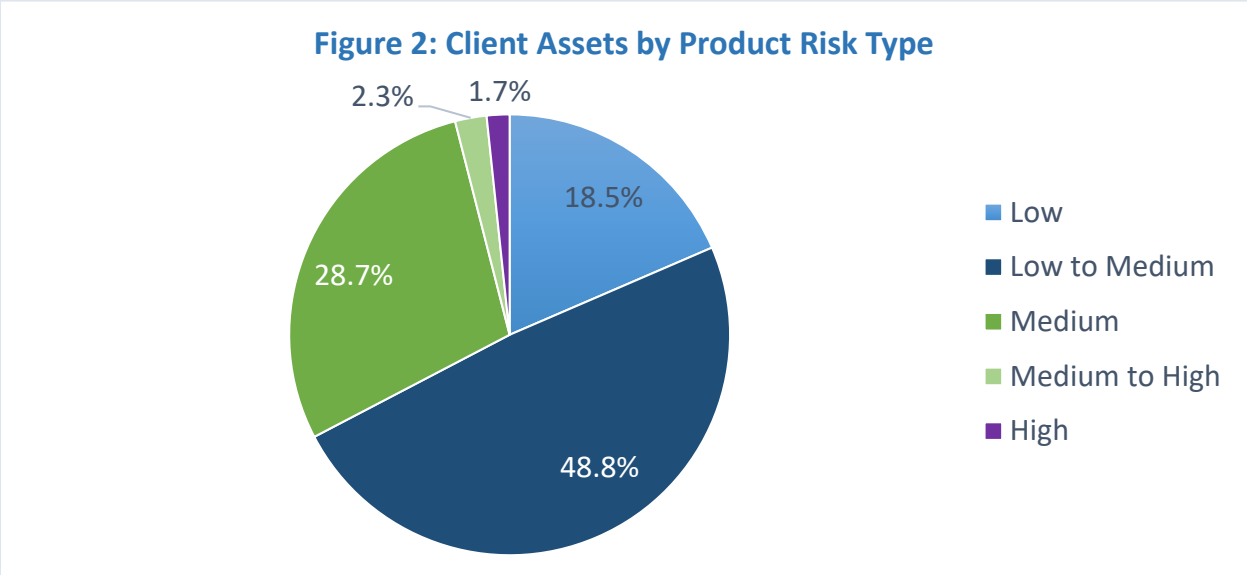
As noted above, we performed our analysis using the information obtained from the MFDA's Client Research Project. This contained complete investment holdings for all client accounts of MFDA Members and therefore covered over 80,000 advisors (Approved Persons) and over 16 million client accounts. Using this information, we analyzed the overall asset allocation for all clients of MFDA Members. We also separately analyzed different client age bands to determine if broad differences exist in the investment holdings and asset allocations.

We found the overall asset allocation to be consistent with widely accepted diversification and asset allocation principles. Approximately, 55% of the assets are in balanced funds or balanced portfolio solutions that provide a mix of fixed income and equity exposure. Approximately 14% of assets are in fixed income funds and 31% in equity funds. (See Figure 1) This translates approximately to an overall asset allocation of 60-65% in equities and 35-40% in fixed income. There were differences as expected amongst age groups, with clients between the ages of 35-44 having the highest equity exposure and clients over age 75 the lowest.

Figure 1: Client Assets by Product Asset Allocation



With respect to the risk ranking of the mutual funds held in client accounts, approximately 75% of the mutual funds had a Fund Facts risk ranking of low-medium or medium. This result is expected and consistent with the asset allocation observations noted above, as the low-medium and medium risk fund classification bands capture balanced funds and many equity funds. Only approximately 5% of total client assets were invested in funds with a risk ranking of medium-high or high. (See Figure 2)



3. Screening and Approved Person Selection Process

Using the overall analysis as context, we sought to identify specific Approved Persons whose books of business were atypical compared to the rest of the Approved Person population. We analyzed the data for all Approved Persons to identify particular Approved Persons who had any of the following significant patterns in the investment holdings in their client accounts:

- Significant concentration in high risk sector funds;
- Most of their client assets in medium-high or high risk ranked funds; or
- All or nearly all of their clients 100% invested in equity funds with no diversification into fixed income investments.

We also considered other information including the Approved Person's history of complaints and enforcement actions, particularly those related to suitability.

We selected a risk-based sample of Approved Persons for further detailed review. These Approved Persons had pronounced examples of the investment patterns noted above. In these cases, we requested complete KYC information and current investment holdings for all their clients to allow for further analysis. We also conducted interviews with the Approved Persons to gather further information on their process for collecting KYC information, their investment philosophy, how they present investment recommendations to clients and their approach to suitability.

4. Findings

As noted above, the Approved Persons selected for detailed review had the most pronounced investment patterns. Accordingly the findings noted below should not be considered to reflect the practices of all Approved Persons generally. However, all Members should ensure their supervisory procedures are adequate to prevent and detect similar findings with their Approved Persons.

i. Concentration in High Risk Sector Funds

Concentration in high-risk sector funds has been an area of focus for MFDA Compliance and Enforcement for several years now. Most commonly, these cases involve an Approved Person recommending that clients put nearly all of their investments in sector specific funds (e.g. precious metals funds). MFDA Enforcement has taken disciplinary action in several of these cases.[1]

When we refer to concentration issues, we are not referring to instances where Approved Persons may have most of their client assets in a small number of mutual funds, provided those mutual funds are well diversified investment products themselves as most mutual fund investments are. However, if an Approved Person has most of their client assets invested in higher risk sector funds then a concentration and suitability concern potentially exists.

We did not identify many instances among the 80,000 Approved Persons where there were significant concentration issues. In the limited instances where we did identify such issues, in most cases the concentration issue had already been identified by the Member or MFDA staff and action was already being taken to address the issue. Appropriate regulatory action is being taken to address the few new concentration cases identified in the review.

ii. KYC Uniformity and Improper Collection of KYC Information

Some of the Approved Persons selected for detailed review had KYC information (risk tolerance, investment objectives and time horizon) that was uniform across all or nearly all of their client accounts. Such patterns raise questions as to whether the documented KYC information accurately reflects the individual client circumstances, particularly where the risk tolerance, objectives and time horizon for clients appear identical despite differences in age and financial situation.

In these cases, there was also insufficient additional documentation to support how the documented risk tolerance, investment objectives and time horizon for the clients was determined beyond simply what was recorded on the KYC form. For example, there were no risk profile questionnaires or notes of client discussions to support the documented risk tolerance, investment objectives and time horizon.

[1] See Equity Associates Inc. File No. 201716, Sun Life Financial Investment Services (Canada) Inc. File No. 201775, IPC Investment Corporation File No. 201659, Hollis Wealth Advisory Services Inc. File No. 2016116

In cases where a clear pattern of uniform KYC information existed, Members implemented an action plan to re-assess the KYC information. The cases of greatest concern involved situations where:

(1) all or nearly all clients had KYC information that was precise and identical (e.g. all clients with a risk tolerance of 80% medium and 20% high), or
(2) the Approved Person's statements suggested that KYC information may have been documented to match the Approved Person's investment philosophy rather than the client's actual risk tolerance, investment objectives and time horizon.

Specific Considerations Regarding Seniors

Seniors may have shorter investment time horizons and less ability to accept investment risk than younger clients, however, each client is different. Seniors are a diverse group and individuals have different investment objectives and different levels of willingness and ability to take investment risk. Some senior clients do have higher risk tolerances, longer investment time horizons and a preference for growth investments. However, as discussed above we are concerned where it appears that an advisor may be attributing the same risk tolerance and investment objective to all their clients, particularly where that includes seniors regardless of their individual circumstances and with little additional supporting documentation to support how the KYC information was determined.

As noted in the recommendations contained at the end of this report, it is important to document how risk tolerance, investment objectives and time horizon are determined. While this recommendation applies to all clients, it can be particularly important when dealing with seniors.

iii. KYC Uniformity and Investment Patterns

In cases where uniformity of KYC was identified, several of the Approved Persons selected for detailed review also had an investment pattern where all or nearly all of their clients were 100% invested in equity funds with no diversification into fixed income investments.

The Approved Persons cited various reasons for this investment pattern. However, we found these explanations to be inadequate to explain how the portfolio recommendations were suitable. For example, an Approved Person explained that his clients, including his senior clients, "didn't need the money" and therefore an equity portfolio was appropriate.

In other cases, the Approved Person explained that they recommend more diversified overall portfolios including fixed income investments or deposit instruments, but these investments were transacted outside of the Member as they were not securities (e.g. GIC's or high interest savings accounts). However, there was generally insufficient documentation in the client files regarding the external assets and the overall asset allocation. Further, there were not adequate notes explaining how the external assets affected the investment objectives and investment recommendations for the investment account at the Member.

5. Key Recommendations and Best Practices

Recommendation 1 – Periodic Reviews for Trends

Members should conduct regular periodic reviews of their Approved Persons' books of business. These reviews should include a review of all client investment holdings and KYC information for the Approved Person to identify trends or patterns of concern. Members should consider working with their back-office system provider to create standard supervisory reports to facilitate these periodic reviews.

Recommendation 2 – Policies and Procedures to Assess Concentration Risk

All Members should have policies and procedures to assess concentration risk for concentration in exempt securities or higher risk sector funds. These policies should include concentration limits that will prompt a supervisory inquiry during daily trade supervision.[2] Members should also include an assessment of concentration in their review of the Approved Person's book of business discussed in recommendation 1 above.

Recommendation 3 –Tools and Documentation to Support KYC Information

Member policies should require sufficient documentation to support how risk tolerance, investment objectives and time horizon are determined. Members should consider providing Approved Persons with standardized tools to support this process such as a well-designed risk profile questionnaire.

Recommendation 4 – Documentation of External Investments

Where external client investments are a significant factor in determining the KYC information and investment recommendations for the investment account at the Member, this information should be specifically documented. The documentation should include details on the external investments and should be readily accessible for review by supervisors.

Recommendation 5- Addressing Instances Where KYC Information was Improperly Collected

Where significant concerns are identified with the accuracy or adequacy of the KYC information collected by an Approved Person, steps need to be taken to reassess the information and re-perform the KYC collection process. Members may wish to consider using a risk-based approach to prioritize vulnerable clients in these situations.

The KYC process should be designed to ensure that the KYC information is collected objectively and accurately. Allowing the Approved Person who originally collected the KYC information to obtain new KYC forms for their clients without significant support and supervision is inadequate. Therefore, the KYC collection process may need to be re-performed using objective tools such as risk profile questionnaires and in some cases with the direct involvement of a supervisor.

[2] See MFDA Bulletin 0678-C Report on 2015 Review of Specific Policies and Procedures: Concentration Criteria

6. Further Steps

We will continue to carefully assess KYC and suitability practices in our compliance examinations. Where we identify uniformity of KYC and significant patterns in investment holdings, we will make further inquiries of Approved Persons and Members and will request supporting documentation to substantiate the KYC assessment and suitability determination.

In order to address specific findings from a compliance examination, Members will be asked to implement action plans to address the findings. Depending on the specific findings, the actions may include any or all of following: (i) additional investigation and documentation; (ii) re-performing the KYC collection process; and (iii) making suitable rebalancing recommendations where necessary.

Members with additional questions or those seeking guidance in enhancing their practices should contact their assigned MFDA Compliance Manager for further assistance.