Risk Profiling Roundtable Discussion Guide
September 28, 2016

PURPOSE

On September 28th, the Ontario Securities Commission's Investor Advisory Panel (IAP) convenes invited representatives from …

- Regulators and Government
- Industry and industry associations
- Academia
- Investor advocate organizations
- OBSI; and
- Legal profession

… to participate in a Roundtable on the subject of Risk Profiling.

The Roundtable is to:

- provide an opportunity for key stakeholders to share information and views, and engage in discussion about the findings of PlanPlus Inc.'s research report, *Current Practices for Risk Profiling in Canada and Review of Global Best Practices,* commissioned by the IAP, and
- provide insights about:
  - the nature of change needed
  - the challenges of successful change, and
  - recommendations on possible next steps to improve the risk profiling used in the retail investment advice process.

The Roundtable will be moderated by an independent third party facilitator.

The discussion outcomes will form the basis of a summary report without attribution, which will be distributed to participants and made available on the IAP's website.

CONTEXT

Establishing an investor's risk profile is crucial to an advisor's ability to make appropriate investment recommendations for the client.

Practices employed by Canadian dealers and investment advisors during the Know Your Client (KYC) process varies widely. The most common investor complaint in Canada today is unsuitable investments, due in part to an inadequate risk profiling assessment.

The IAP, an independent committee of the Ontario Securities Commission (OSC), commissioned independent and objective research regarding Canadian risk assessment processes. In November 2015, the Panel published the research report, "Current Practices for Risk Profiling in Canada And Review of Global Best Practices" http://www.osc.gov.on.ca/documents/en/Investors/iap_20151112_risk-profiling-report.pdf, prepared by Shawn Brayman, President and CEO of PlanPlus Inc., along with co-authors Ellen Bessner, Babin Bessner Spry LLP; Dr. Michael Finke, Texas Tech University; Dr. John Grable, University of Georgia; and Dr. Paul Griffin, Humber Institute of Technology & Advanced Learning.

The research focussed on the practices of investment and mutual fund dealers and portfolio managers in determining a client's risk profile. It included a survey of investment advisors' use of a standard risk assessment questionnaire, a similar survey of firms and their compliance departments, and an analysis of 36 risk profile questionnaires currently in use across the industry. The report offers examples of best practices in other jurisdictions and recommendations for regulators, industry and the academic community. The research report has been broadly disseminated[1], and PlanPlus has provided briefing opportunities for regulators, industry and other key stakeholders.

The Current Regulatory Environment in Canada

The Canadian Securities Administrators (CSA) are currently seeking feedback on proposed targeted regulatory reforms which would involve changes to the KYC obligation, including requirements regarding client risk profiles.

In the CSA's Consultation Paper 33-404 - *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward their Clients*, they note that the current KYC obligation includes "no explicit requirement around developing risk profiles for clients". There is "no explicit requirement to collect certain key elements of investment needs and objectives and financial circumstances (e.g., amount and nature of debts)." In the absence of explicit regulatory requirements, regulators have provided direction and guidance (see PlanPlus report regarding different approaches among Canadian regulators).

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[1] Academy of Financial Services, October 15, 2015 (academic conference for peer review discussions); Canadian Institute of Financial Planners Conference, May 18th, 2016; Confederation of Financial Planners, Bangalore, India July 12th 2016,"A Review of Risk Profiling Practices", Brayman, Grable; Financial Planning Association Conference Academic Track, September 15, 2016.

The CSA's proposed targeted reforms would require dealers, advisors and representatives to gather more client-centred information in respect of each of the three key elements of the KYC obligation including investment needs and objectives, financial circumstances and risk profile "based on concepts including risk attitude, risk capacity and loss aversion (terms to be defined for client)". The proposal states that: "Firms should ensure that, in particular: they have a thorough process for assessing the level of risk a client is willing and able to take including: assessing a client's capacity for loss", among other factors.

ROUNDTABLE DISCUSSION QUESTIONS

The questions that follow will guide participant discussions in small breakout groups, which will be followed by plenary sessions where the breakout group findings will be discussed and debated.

In the interests of time, and to ensure that participants in the Roundtable have sufficient time to do justice to these important topics:

- each participant will discuss some topics at greater length than other topics, and
- all participants will have an opportunity to comment on every topic.

We would ask you to review and consider your responses to these questions prior to attending the Roundtable.

Topic 1: SCOPE OF A RISK PROFILE

Regarding the current state, the research paper says:[2]

a. Risk profiling often considers factors such as:

   <u>Risk Assessment</u>

   - Risk tolerance
   - Risk capacity (pensions, debt, flexibility)
   - Loss aversion
   - Risk preference
   - Risk need

   <u>Demographic and Factual</u>

   - Age
   - Annual income
   - Net worth
   - Stability of employment

   <u>Knowledge and experience</u>

   - Investment knowledge
   - Investment experience
   - Level of education
   - Current and prior vocation

   <u>Goals or use of funds</u>

   - Investment objectives
   - Time horizon
   - Specified goal
   - Other uses of funds

b. There is widespread conflicting understanding and use of such terms by every stakeholder – regulators, advisors, solution providers and academics.[3]

c. The application of these factors is inconsistent and there is no academic consensus on consistent methodologies.

d. Almost all regulators are principles-based and provide little guidance on how a firm or advisor should arrive at the determination of risk, although all agree that an advisor's professional judgment is critical.

[2] The following are excerpts, in some cases paraphrased, chosen for discussion purposes

[3] The research report established definitions for key terms used in the report

DISCUSSION QUESTIONS

1.1 To develop a reliable risk profile, what factors or information ought to be collected and considered (e.g., compared to those listed in section "a" on the previous page)?

1.2 Describe the challenges that will be faced in gathering and analyzing such information.

1.3 In achieving change and overcoming such challenges, what should be the roles and responsibilities if any, of:

Law	
Regulators	
Firms	
Advisors	
Academics/Researchers	
Advocacy organizations	
Clients	
Others	

Topic 2: USE OF TOOLS IN THE RISK PROFILING PROCESS

Topic 1 addresses the scope of a risk profile. This section addresses various tools that can be used to assist in the development of a risk profile. The following topic addresses the process by which a risk profile is developed.

Regarding the current state, the research paper says:[4]

a. A number of tools have been developed to assist in risk profiling, such as risk profile questionnaires (automated or non-automated)

b. A “fit for purpose” questionnaire or other tool, when required, encourages transparency, consistency and accountability for all concerned

c. There are situations where a skilled advisor can determine their client’s risk profile without using a risk-profiling tool

d. A related issue is proportionality (“one size doesn’t fit all”), such as:
   - Whether the size of a client’s portfolio should influence the nature or amount of information gathered
   - Whether the frequency of transactions for a client should influence how frequently the advisor should update the client’s risk profile

e. Regardless of whether a tool is used, the advisor must keep detailed records to show that they have received their client’s consent about the level of risk required to achieve their objectives

f. Risk questionnaires are most widely used in retail channels using mutual funds and less so in wealth management and portfolio manager channels

g. Over 53% of respondents to an advisor survey indicated that between 76% and 100% of clients had completed a risk questionnaire, creating a strong dependency on the fitness of these tools

h. 48% of firms indicated that risk questionnaires are developed in-house; 36% said advisors could choose their own risk profiling methodology; only 11% who have questionnaires said they were “validated” in some way

i. While a good advisor uses “professional judgement”, only one questionnaire reviewed for the research paper provides the advisor with the opportunity to modify the questionnaire or add additional information that, in the opinion of the advisor, is material to the assessment of risk

j. 16.7% of questionnaires reviewed are “fit for purpose”

k. A poor tool is worse than no tool at all.

[4] The following are excerpts chosen for discussion purposes

DISCUSSION QUESTIONS

2.1 What improvements are required in the use of questionnaires and tools in the process of risk profiling? To what extent can or should they be mandated, standardized, etc?

2.2 To what extent should proportionality be considered? What guidance should be provided on proportionality?

2.3 What other tools or uses of technology should be considered?

2.4 Item “b” above describes the benefits of questionnaires and other tools, while item “c” indicates that they are not required in all circumstances. When should they not be required?

2.5 In achieving change, what should be the roles and responsibilities if any, of:

Law	
Regulators	
Firms	
Advisors	
Academics/Researchers	
Advocacy organizations	
Clients	
Others	

Topic 3: PROCESS TO DEVELOP A RELIABLE RISK PROFILE FOR A CLIENT

Regarding the current state, the research paper says[5]:

a. Academic research has shown that clients are not bad, but not great, at predicting their own behaviour with respect to risk

b. In Canada … advisors cannot delegate responsibility for determining risk to clients or to anyone else

c. A good advisor uses “professional judgement” to combine [objective and subjective or emotional] factors to determine a client’s risk profile

d. It is often difficult for a client to truthfully and completely answer the questions in a questionnaire

DISCUSSION QUESTIONS

3.1 To achieve effective risk profiling, what should be the elements of the risk profiling *process* between client and advisor, including the consideration of the results of a questionnaire or other assessment tool? What is the role of the firm in this process, if any?

3.2 How might changes in technology improve, or alternatively threaten, the effectiveness of the process?

3.3 What changes can/should be made to improve the process for risk profiling?

3.4 Describe the challenges that will be faced in trying to make such changes.

[5] The following are excerpts chosen for discussion purposes

3.5 In achieving change, what should be the roles and responsibilities if any, of:

Law	
Regulators	
Firms	
Advisors	
Academics/Researchers	
Advocacy organizations	
Clients	
Others	

Topic 4: HOW CAN WE IMPROVE RISK PROFILING IN CANADA TODAY?

4.1 Overall, describe a path forward, in the short and long term, to achieve successful change.

4.2 Consistent with that path, what should be the role and responsibilities of each of the following in the change process?

Law	
Regulators	
Firms	
Advisors	
Academics/Researchers	
Advocacy organizations	
Clients	
Others	