Client Focused Reforms (CFRs) – Phase II: What You Need to Know for Implementation

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Agenda

- Introduction
- Overview
- Key Principles
- Q&A

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Introduction

Introduction

- The Client Focused Reforms ("CFRs") were introduced to enhance the registrant conduct requirements and ensure registered firms and individuals are putting the **interests of their clients first**.
- The CFRs primarily apply to registered advisers, dealers, and their registered representatives.
- Phase I - Conflicts-related amendments took effect on **June 30, 2021**.
- Phase II - Remaining amendments take effect on **December 31, 2021**.

Overview: Phase II

Overview

- Know Your Product (KYP)
- Know Your Client (KYC)
- Suitability
- Misleading Communications
- Training
- Books and Records
- Relationship Disclosure Information (RDI)

Know Your Product (KYP)

- CFRs include new KYP requirements for both firms and individuals
  - assess (firm) and understand (adviser) structure, features, risks, and costs of securities that are *made available* to clients
  - making securities available by a firm includes purchasing, selling, recommending, adding to shelf, advertising/promoting in any medium
  - firms must *approve* securities made available to clients
- No duplication of KYP review process – determined at the level the securities are made available or recommended to clients (i.e., investment funds, sub-advisers, model portfolios)
- No requirement to compare and understand other securities in the market with those *made available* by the firm
- Transfers and self-directed trades
  - assess and understand these securities within a reasonable amount of time
  - firms not required to *approve* transferred or self-directed securities if not made available

Know Your Product (KYP) (cont'd)

- Firms must have a robust KYP process that will vary depending on the specific circumstances (e.g., universe vs, product shelf, adjusted for risk and complexity)
- Individuals must take reasonable steps to understand securities sufficiently to make the *suitability* determination
  - includes general understanding of all securities available through the firm to be able to consider a *reasonable range of alternatives*
  - the fact that a security is approved by the firm does not discharge KYP obligations for individual advisers
- Assessing and understanding securities includes:
  - structure, complexity, transparency, *basis of return*, *likelihood of achieving objectives*, time horizon, liquidity, use of leverage
  - conflicts of interest such as compensation, related parties
  - consider parties involved: management, portfolio adviser, fund manager, sponsors, guarantors, counterparties
  - risks
  - impact of costs on performance: commissions, sales charges, trailer fees, management fees incentive fees, redemption fees, as well as expenses
  - exempt securities require special considerations

Know Your Product (KYP) (cont'd)

- Independent due diligence is not required in all cases but may be necessary where there are reasons to question the validity of an issuer's information or where information provided is not sufficient
- Process for periodic monitoring for *significant changes* to the securities that have been *approved* and *made available* by the firm
  - firms determine form and frequency of monitoring (i.e., periodic suitability determinations)
  - when there are *significant changes* firms should revisit approval of the security
  - includes monitoring for significant changes in business environment or market conditions

Know Your Client (KYC)

- Additional enumerated categories:
  - Personal circumstances
  - Risk profile
  - Investment knowledge
  - Investment time horizon
- Confirming KYC information and “significant changes”
- Reviewing KYC information:
  - Managed accounts – no less frequently than once every 12 months
  - EMDs – within 12 months before a trade / recommendation
  - All other cases – no less frequently than once every 36 months

Suitability

- CFRs have enhanced the *suitability* obligations of registrants with two pronged test:
  - (1) *investment action* is reasonably *suitable* for the client based on KYC of the client, KYP of security, concentration within the *account*, liquidity, impact of costs on returns, and reasonable range of alternatives *made available* at the firm
    - registrants should use their professional judgement to determine weight to put on each factor
  - (2) *investment action* puts client interest first (i.e., ahead of registrant)
- Suitability assessment must be made when:
  - new responsible individual is designated
  - registrant *becomes aware* of a change in security
  - registrant *becomes aware* of a change in KYC information
  - at time of annual KYC review (periodic suitability review)
- Suitability determination extends to type of client account (i.e., fee options, leverage/margin)

Suitability (cont'd)

- Client directed actions may be executed provided the registrant informs the client of the suitability determination, recommends alternative actions, and documents the instructions
- Transfers: suitability can be determined within a reasonable time after account opening provided there is a process to restrict investment actions
- Reasonable range of alternative actions
  - suitability determination may result in a range of investment actions
  - registrants must put client's interest first
  - options available through the firm (limited number of options)
  - registrants must exercise their *professional judgement* in deciding between suitable options

Suitability (cont'd)

- Periodic suitability assessments
  - annual suitability determinations include review of continuing to hold securities and how much *cash* to leave uninvested
  - periodic review may not require reassessment of client's account and registrants should exercise their *professional judgement* based on the nature of any particular change
- Focus on impact of costs on returns
  - registrants must assess the relative costs of multiple suitable actions including all direct and indirect fees and expenses
  - lowest cost is not always best
- Suitability must be determined on the basis of all the client's accounts at the firm, but a registrant is not required to inquire about a client's *outside investments* to make a suitability determination

Suitability (cont'd)

- Registrants should monitor thresholds for portfolio concentration and liquidity
  - issuer, industry, asset class, illiquid securities
- Suitability waiver: (1) non-individual permitted clients with managed accounts; (2) individual permitted clients *except* managed accounts
- Regulatory review: *reasonable registrant with similar business model in same circumstances*
  - Not review subsequent events
  - Multiple suitable investment actions
  - Reasonable basis for conclusion subject to best interest of client

Misleading Communications

- Specific prohibitions with respect to misleading communications, including with respect to:
  - Proficiency, experience, qualifications, or category of registration
  - Nature of relationship / potential relationship
  - Products or services
- Titles / designations / awards / recognitions

Training

- Registrants are expected to have a compliance training program for registered individuals in relation to their KYC, KYP, suitability, and conflicts of interest obligations
- Scope of a firm's compliance training program will depend on the nature, size, and complexity of its business
  - formal compliance training programs may not be necessary for small firms
  - training materials do not have to be in writing
  - firms should exercise their *professional judgement* in determining and evaluating appropriate compliance training programs
- Training may be outsourced but the responsibility remains with the firm

Books and Records

- Enhanced recordkeeping and documentation
- Policies and procedures
- Oversight
- Key requirement to assist in demonstrating compliance

Relationship Disclosure Information (RDI)

- Additional categories and requirements:
  - General description of products and services
  - Limitations on products and services (e.g., proprietary products)
  - Fees, charges, costs, and expenses
  - General description of benefits received or expected to be received
  - Statement with respect to suitability and putting the client's interest first
  - Potential impact on a client's investment returns

Don’t Forget!

Waivers

Conflicts of Interest

Protection of Older and Vulnerable Clients

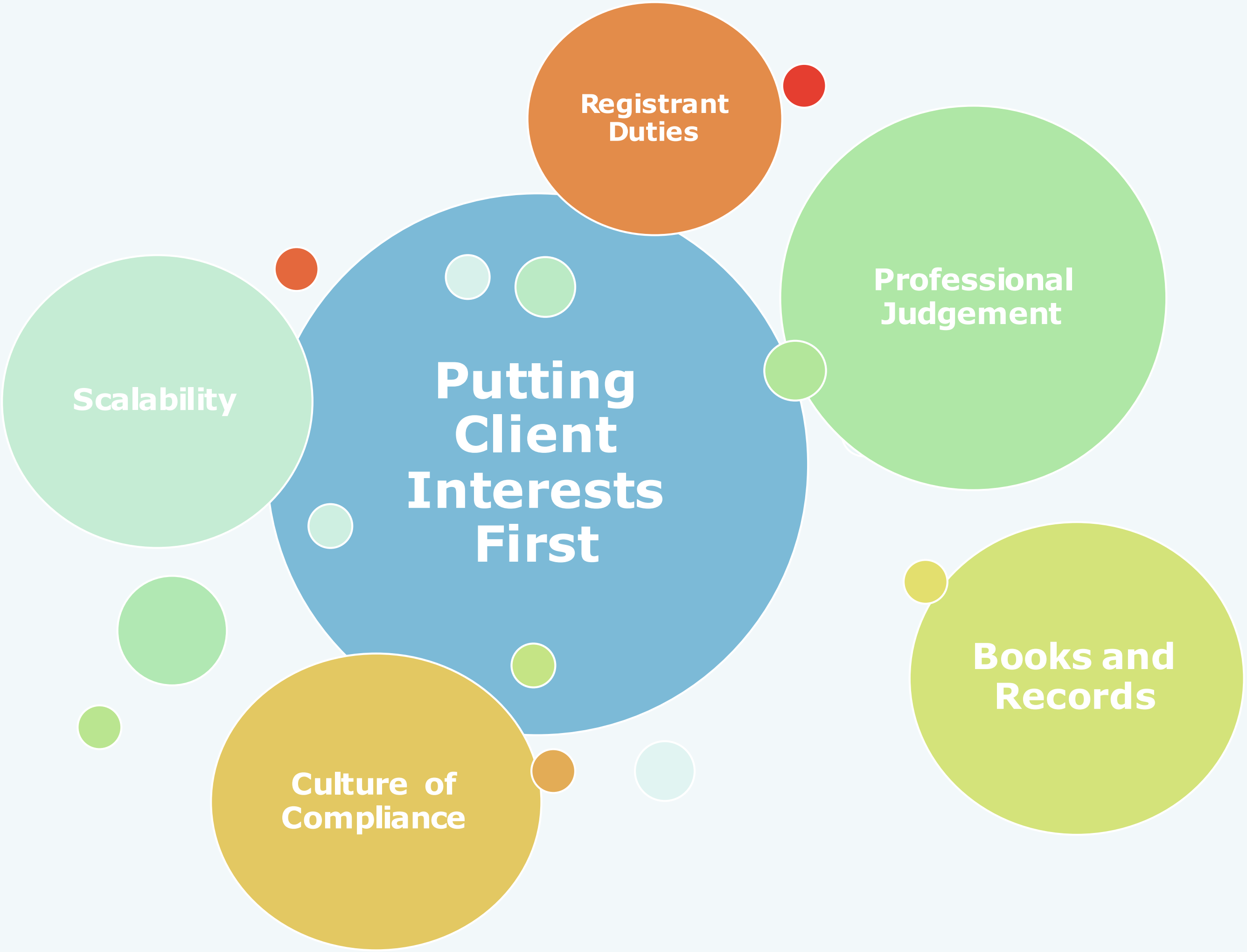
Referral Arrangements

Referral Arrangements

- CFRs did not proceed with the proposed restriction on referral fees to non-registrants, but some changes have been made
  - enhanced disclosure to clients
  - enhanced recordkeeping, monitoring, and supervision to ensure compliance with securities laws
- Registrants must satisfy themselves that the other party to the referral arrangement is appropriately qualified and, if applicable, registered
  - assess the appropriateness of the referred services for the client
  - assess the qualification of the referral party including civil actions, regulatory and professional discipline, client complaints
- Registrant is required to maintain records including name of referred client, amount of fee, party paying or receiving fee, party responsible for client disclosure
- Registered individuals cannot enter into referral arrangements independent of their firm

Key Principles

Key Principles



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Q&A

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What are the new title requirements? What titles are permitted / prohibited?

What does “significant change” mean?

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How can KYP responsibilities be allocated within a registered firm for portfolio managers of funds?

What are acceptable ways to document a client’s confirmation of KYC information?

What recordkeeping considerations should registrants be aware of?

Thank You

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If you have any questions about McMillan, or how we may help you with your legal needs, please get in touch with us.