

Know-Your-Product (KYP) – Issues



Adam Hillier, Senior Regulatory Analyst
Matias Pendola, Senior Regulatory Analyst

- Requirements and guidance
- How the requirements apply
- Targeted reforms
- Common issues

- **Duty of care** – must act fairly, honestly and in good faith
- **Registered individuals** – must understand products they recommend – s. 3.4 of NI 31-103 and 31-103CP
- **Registrants** – must take reasonable steps to ensure suitability of trades/recommendations – s. 13.3 of NI 31-103
- **Registered firms** – must oversee compliance of registered individuals
- **You** – gatekeeper of the integrity of capital markets

How do the current requirements apply?

- Client's expectations
- Cannot opt out of KYP
- KYP requirement – in addition to the suitability requirement
- KYP cannot be outsourced
- Ongoing KYP required for all products on shelf

- Consultation Paper 33-404 and CSA Staff Notice 33-319

- No explicit stand-alone KYP requirement

- Amendments being considered to explicitly require
 - Individual KYP knowledge
 - KYP policies/procedures including training
 - Consideration of similar alternative products

Presentation purpose

- Discuss common KYP issues
- Share with you our observations
- Help you in your gatekeeper role

Viability and economic status

Valuation

Background of principals

Use of funds

Product features

Compensation and other costs

Governance

PMs – documenting trade rationale

PMs – mortgage investment entities

Training sales force

- Viability assessment
- Overly simple economic calculations
- Relying on the issuer's assurances

- Conduct meaningful scenario analysis
- Conduct a viability assessment
- Question assumptions and projections
- Review financial statements and question “red flags”

- Trust units vs. Partnership units
- Financial position of underlying operating company
- Issuer price not supported by the current net asset value (NAV)
 - Accumulated losses
 - No recognition of impairments
- Issuer redeeming units at a fixed price regardless of NAV

- Assess and disclose to clients how issue price relates to NAV
- Don't allow complex structures to obscure valuation
- Disclose clearly risks relating to valuation
- Question issuer's ability to make redemptions and distributions

- Track record – management team, directors, advisory group, related parties and promoters
- Regulatory history
- Criminal background



- Thorough assessment
- Conduct a background investigation
- Regulatory investigation – CheckFirst.ca, CSA Disciplined List, and CSA Cease Trade Orders Database
- Criminal background checks
- Social media and other internet searches
- Do not sell the product if necessary

- Material change to core business
 - Change in industry sectors with different risk profiles
 - Change in nature of customer base/revenue sources
 - Change in investment concentration
- Investing in related parties
- Using new investor funds to pay-out existing investors
- Ongoing KYP obligation

- Assessing OM changes not sufficient

- Agreement obligating issuer to provide ongoing information
 - Material financial changes
 - Material changes to “core business”
 - Related party transactions
 - Ongoing financial reporting

- Stop selling the product if necessary

- Features that adversely affect risk profile
- Hurdle rate
 - Low hurdle rate
 - Resets every year
- Substantial carried interest (e.g. issuer or related parties receive >50% up to 90% of profit)
- Impact on risk profile and investor returns

- Thorough KYP assessment of features
 - Feasibility of projected/targeted returns
 - Holistic assessment of investors' share of return
 - Is the risk worth the reward?
- Are the features clearly understood by DRs?
- Are the features and risks disclosed to investors?
- Are the features and risks taken into account in suitability assessments?
- Marketing – adequate description of product, including risk?

- Selling commissions and other offering costs
- Salaries and management fees paid to related parties
- Equity participation by dealers and related parties at nominal cost
- Effect on viability

- Prominent and clear disclosure of all fees and compensation
- Assess how costs and compensation may affect returns and whether they are reasonable
- Don't sell if costs and compensation are excessive



- Voting rights held by IFM/PM or captive dealer insiders
- Investors having no or limited voting rights
- No conflicts of interest protections
 - No independent directors or trustees
 - No other controls
- These structures create significant conflicts of interest
 - Redemption requests
 - Selection of management of issuer or IFM/PM
 - Related party transactions
 - Potential wind-down

- Prominent disclosure to investors
- Significant risk factor
- Material conflicts of interest
- Does issuer have conflicts controls?
 - Independent directors and trustees
 - Independent approval of conflicts transactions
 - Investor voting or veto rights
- Do not sell product if necessary

- No documentation supporting how specific trades are suitable
- Trade within managed account mandate parameters, but PM cannot demonstrate
 - Why trade is suitable at purchase price paid
 - Up-to-date due diligence on the security
- PMs must maintain documentation supporting suitability of all trades in addition to compliance controls

- Demonstrate suitability of each trade – principles based requirement

- Best practice examples
 - Up-to-date due diligence research for every security purchased or sold – subject to suitability within managed account investment parameters
 - Memoranda with rationale for each trade

- Maintain up-to-date documentation for securities that are held for a long term

- PMs managing mortgage funds – demonstrating suitability of each mortgage is required

- Suitability failures
 - Investing outside mandate
 - Non-qualifying mortgages
 - No due diligence performed
 - Simply supporting syndicate decisions

- Related parties sourcing mortgages
 - Due diligence requirements apply in the same manner
 - Consider conflicts of interest

- Demonstrate suitability of each mortgage funded – including renewals, additional advances, and syndicate votes
- Evaluate sufficient mortgage criteria according to mortgage fund investment parameters
- Provide fair and complete disclosure of investment criteria and risks to investors
- Address conflicts of interest

- Product training required for registered individuals
- Risks
- Conflicts of interest
- Costs and compensation
- Liquidity and redemption rules
- Management and financial strength
- Revocation or rescission timelines

- Comprehensive training sessions
 - Present independent KYP information
 - Mandatory completion prior to selling
 - Test and quizzes
- Provide up-to-date information based on ongoing KYP process
- Obtain feedback from clients

Contact information

Adam Hillier

Senior Regulatory Analyst

adam.hillier@asc.ca

Matias Pendola

Senior Regulatory Analyst

matias.pendola@asc.ca