Mr. Robert Day, Senior Specialist Business Planning

ONTARIO SECURITIES COMMISSION

NOTICE 11–780 – 2018 – 2019 STATEMENT OF PRIORITIES

REQUEST FOR COMMENT ON STATEMENT OF PRIORITIES FOR FINANCIAL YEAR TO END MARCH 31, 2019

Mr. Robert Day, Senior Specialist Business Planning,

David Jenkins, HBA, ICD.D, author of TheAnswerIs.ca, and Dr. Radha Maharaj, PhD (Economics), author and Adjunct Professor at the University of Toronto, are pleased to submit our comments in response to the OSC Notice 11-780 – *Statement of Priorities – Request for Comments Regarding Statement of Priorities for Financial Year to End March 31, 2019.*

Background

We have reviewed the draft for comment version of the OSC 2018 – 2019 Statement of Priorities (SoP) and understand the OSC has five regulatory goals. Our comments focus on the OSC's goal to deliver strong investor protection; more specifically, the OSC's goal to champion protection especially for retail investors. The OSC will publish regulatory reforms that address the best interests of the client and advance retail investor protection, engagement and education.

We have also reviewed the National Instrument 31–103 *Registration Requirements, Exemptions, and Ongoing Registration Obligations*, including the areas of Know Your Client (KYC), Know Your Product (KYP), and Suitability. We have focused our comments on KYC. We note that these provisions are designed to help protect the client, the registrant and the integrity of the capital markets.

Proposed Addition to the SoP for the Year to End March 31, 2019

Asymmetric information exists between most clients and their financial institutions. Our proposal is to mitigate the asymmetric information that exists between clients and their financial institutions to reduce the risk of mis-selling, i.e., the act of selling something that is unsuitable to the buyer, or the act of selling something about which the buyer is poorly informed.

Asymmetric information increases the risk that a client:

1) May invest too little or too much with respect to achieving their investment goals.
2) May accept an asset allocation that assumes too much or too little risk with respect to their investment goals, and/or
3) May choose a service, product or fee option that compromises their ability to reach their investment goals.

We propose that the KYC onboarding process be amended to include:

1) A Standardized Financial Literacy Test and Risk Profile Questionnaire. To date, institutions have followed no standardized practice to determine a client's risk tolerance. This can be mitigated by providing a standardized Risk Profile Questionnaire that accommodates low, moderate and high levels of financial knowledge. This would require institutions first to ask clients to take an initial Financial Literacy Test, so they can determine which Risk Profile Questionnaire is best for each client. Having a process that includes a standardized Financial Literacy Test and Standardized Risk Profile Questionnaire will boost the institutions' tendency to act the client's best interest.

2) Mandatory Portfolio Sensitivity Analysis[1]. The introduction of a mandatory Portfolio Sensitivity Analysis will ensure that clients understand the impact of key investment inputs and decisions on their future portfolio value and long-term investment goals.

These two changes will ensure that investors are protected against the risk of mis-selling associated with asymmetric information. The reduction of asymmetric information may prompt clients to revise their investment decisions and could result in the creation of portfolios that are more consistent with their best interests and investment goals.

To make a verifiable, substantive case for these two amendments, we propose an OSC-funded, collaborative research study be added to the OSC's Statement of Priorities for the year to end March 31, 2019.

The research study would provide data to test the hypothesis that:

> A: Modifying the investor onboarding process to include:
>
> > (1) The introduction of a Financial Literacy Test and Standardized Risk Profile Questionnaire prior to investing on a client's behalf, and
> >
> > (2) A Mandatory Portfolio Sensitivity Analysis
>
> will result in clients making different decisions than they would make without the benefit of these two onboarding process modifications, and
>
> B: These revised client decisions will result in the creation of investment portfolios that are more consistent with the clients' best interests and investment goals.

In short, the goal of the proposed research would be to provide the OSC with sufficient data to drive an alteration to improve the clarity and transparency of the existing investor onboarding process.

Rationale for Our Proposed Revisions to the Investor Onboarding Process

There is no common definition of what risk means in the context of the Canadian investing industry. Additionally, there is insufficient consideration of a client's financial knowledge across this industry. Financial institutions all have their own definitions of risk and importantly also have their own risk profile questionnaires. This results in clients receiving inconsistent risk profile questionnaires, some of which are more detailed, technical and relevant than others. The inconsistency of risk profile questionnaires impacts the way portfolios are designed and the service or advice that is provided. These findings are corroborated by the 2015 Annual Report of the Ontario Securities Commission Investor Advisory Panel (April 2016).

Clients with limited financial knowledge may not clearly understand the intent behind the risk profile questions and may answer in a vacuum. This is a concern because financial institutions use this information to create their clients' portfolios. Although the resulting recommended asset allocations and portfolio recommendations may meet the OSC guidelines for the clients' risk tolerance levels, they may be incorrectly constructed in the first place because of the client's inherent misunderstanding the risk tolerance questions.

Financial Literacy in Canada

The Government of Canada identified a Canadian financial literacy problem in 2009 and assembled a Task Force on Financial Literacy. Results of the 2009 Canadian Financial Capability Survey were analyzed under five themes: making ends meet, keeping track, planning ahead, choosing products and staying informed. The results were sobering: *only one-quarter of Canadians* scored high in all five areas.

The Government of Canada subsequently appointed Canada's first Financial Literacy Leader: Jane Rooney of the Financial Consumer Agency of Canada (FCAC), and established the National Steering Committee on Financial Literacy, both in 2014.

In 2014 the Government of Canada made financial literacy a priority. It committed annual resources to the FCAC to enable it to undertake initiatives, conduct research and develop consumer-friendly programs and tools. The FCAC released The National Strategy for Financial Literacy – Count me in, Canada on June 9, 2015. This financial literacy strategy was a call to action for all Canadians and raised awareness of the value of financial literacy.

On March 23, 2016, Statistics Canada released the Canadian Financial Capability Survey, indicating that only 31% of women and 43% of men considered themselves to be financially knowledgeable.

On June 27, 2017, a survey commissioned by LowestRates.ca (conducted by Ipsos[2]) showed that Canadians overestimate their financial literacy skills. The majority of Canadians (78 percent) said they are financially literate, but when tested on their knowledge via a series of questions, nearly six in ten failed to make the grade.

Notwithstanding the significant effort and resources committed by the Federal Government and others, financial literacy remains a significant issue for Canadians. Many investors may think they are financially literate but may not be. Clients that have low or limited investment knowledge **do not know what they do not know**, **and therefore are *unable* to ask their advisors good questions**.

In the current KYC risk-profiling process, financial institutions survey people using inconsistent risk profile questionnaires. Many of these people have low or limited investment knowledge. Then the financial institutions knowingly accept and use these uninformed answers to their inconsistent risk

profile questionnaires to formulate their clients' asset allocations and product mixes. While this practice is legally consistent with current rules and regulations, we ask: **Is this process serving Ontarians' best interests?**

Also missing from this KYC process is the provision of information that clients can use to help formulate their investment decisions, such as key facts about asset allocation and product mix. Clients with low or limited investment knowledge are operating in a vacuum and, even if certain facts are disclosed to them, they do not have the benefit of knowing what impact those disclosures will have on their future portfolio value. They are unable to determine the significance, or ask good follow-up questions regarding, those disclosures. ***By leveraging a clients' low or limited financial knowledge, the current KYC process permits financial institutions to effectively hide behind their disclosures, because most clients can not figure out the significance of a disclosure.***

Proposed Investor Onboarding Process

Our proposed investor onboarding process is as follows:

1) The financial institution performs a brief, standardized Financial Literacy Test to determine a client's investment knowledge, i.e., low, moderate or high.
2) Based on a client's investment knowledge, the financial institution would give the client one of three brief, standardized Risk Profile Questionnaires (based on their low, moderate or high investment knowledge).
3) Based on the client's Risk Profile Questionnaire results, the financial institution would provide the client with an initial asset allocation and services/products for a fee, along with a Target Portfolio Value. The Target Portfolio Value would be based on the client's investment goal, (e.g., retirement), the initial amount invested plus a proposed periodic amount to be invested, and their investment horizon, together with the financial institution's own assessment (not guaranteed and excluding alpha) of future returns for equity, fixed income and cash over the client's investment horizon.
4) The financial institution would then present the client with a Portfolio Sensitivity Analysis (see the attached sample), clearly indicating the impact on the Target Portfolio Value if the:
    1) Initial amount invested increased or decreased by 5%.
    2) Periodic amount to be invested increased or decreased by 5%.
    3) Number of years to initial drawdown increased or decreased by one year.
    4) Assets were allocated to increase equity holdings by 10% or decrease fixed income holdings by 10%, and vice versa.
    5) Total advisor and product fees increased or decreased by 50%.
    6) Volatility information would also need to be provided for the various asset allocations

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5) Armed with the results of their initial Target Portfolio Value and Portfolio Sensitivity Analysis, the client would be in a better position to make *informed* choices. The client might request changes to the initial amount invested, periodic amount to be invested, years to initial drawdown, asset allocation or total advisor and product fees, and a new Target Portfolio Value and Portfolio Sensitivity Analysis summary would be generated. This process may be iterative.

6) Only after items 1-5 above, can the client then proceed to authorize (via mandatory documentation) the *actual* initial amount invested, periodic amount to be invested, years to initial drawdown, asset allocation, total advisor and product fees, Target Portfolio Value and corresponding Portfolio Sensitivity Analysis.

The first three items on the Portfolio Sensitivity Analysis are unlikely to be controversial, i.e., the initial amount to be invested, periodic amount to be invested and years to initial drawdown.

Items 4 and 6, i.e. asset allocation sensitivity combined with the volatility information would be highly constructive to a client's decision-making process. Long-term portfolio values are very sensitive to asset allocation and a client needs to clearly understand the volatility associated with various asset allocation choices. Armed with this understanding, even a person with low or limited financial knowledge would be in a better position to make an *informed* asset allocation decision.

Item 5 deals with investment costs. The Total Fees section of the Portfolio Sensitivity Analysis will be embraced by value-add financial institutions and advisors. The fee sensitivity is designed to open the discussion between the financial institution and client regarding advice levels and investment products (i.e., what people can expect to pay for an advised stock/bond portfolio versus mutual funds versus ETFs or direct investing, etc.). A client may ask how they can get their fees 50% lower. The financial institution/advisor will have to explain other product offerings and the reasons why they earn the fees they are charging, perhaps by talking about their proven historical alpha, or other advisory services they offer, such as monthly reporting; mortgage, tax, insurance and estate advice; or simply good old-fashioned hand-holding.

The 50% fee sensitivity raises the issue of the advice spectrum, from do-it-yourself direct investing brokerages to robo-advisors to full-service wealth managers to mutual fund salespeople. No matter where a client starts on this advice spectrum, they can move across it based on the perceived value that an advisor will now need to explain to them. They will be educated enough to opt intelligently for the level of services they want to receive for the fees they are willing to pay. Some investors with limited knowledge and investment interest will be happy to pay for additional advice and services, while others may choose to open the discussion on different product and service combinations.

Conclusion

To ensure that the financial institution investor onboarding process addresses the best interests of retail investors and advances their protection, engagement and education, it is critical that financial literacy is considered as part of a standardized Financial Literacy Test and Risk Profile Questionnaire, and that a client receives a mandatory Portfolio Sensitivity Analysis.

This revised investor onboarding process will ensure that all clients, including those with limited investment knowledge, will receive the key information they need to begin to ask questions that will help them make *informed* choices that are in their best interest and consistent with their investment goals. The result will be better alignment of the clients' and financial institutions' expectations. This goal alignment is important as it increases a client's confidence that the investment process is *fair*, which in turn supports long-term capital formulation. It will also protect financial institutions by documenting their compliance with KYC regulations and best practices.

[1] A Portfolio Sensitivity Analysis reveals how a client's portfolio will be affected by specific changes to the amount invested (initial and periodic), asset allocation, fees and market volatility.

[2] Ipsos poll conducted between May 18 and May 23, 2017, on behalf of LowestRates.ca. For this survey, a sample of 1,001 Canadians aged 18+ from Ipsos' online panel was interviewed online. The precision of Ipsos online polls is measured using a credibility interval. In this case, the poll is accurate to within ±3.5 percentage points, 19 times out of 20.