CSA Staff Notice 31-342
Guidance for Portfolio Managers Regarding Online Advice

September 24, 2015

Purpose of this Notice

Some Canadian registered portfolio managers and restricted portfolio managers (**PMs**) have recently begun operating as "online advisers". They include new registrants as well as portfolio managers that were already registered and have changed their operating model to provide advice using an online platform. These firms provide discretionary investment management services at a low cost to retail investors through an interactive website.

This Notice describes the operations of these online advisers and provides guidance from staff of the CSA (**CSA staff** or **we**) about the ways in which a PM can provide advice using an online platform, while complying with regulatory requirements.

The guidance in this Notice is directed only at PMs planning to undertake online advice. A brief discussion of the use of online platforms by registered dealers appears at the end of this Notice.

Key Points

- There is no "online advice" exemption from the normal conditions of registration for a PM. The registration and conduct requirements set out in *Regulation 31-103 respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**Regulation 31-103**) are "technology neutral". The rules are the same if a PM operates under the traditional model of interacting with clients face-to-face and if a PM uses an online platform.

- The online advice platforms that we have seen so far are hybrid services that utilize an online platform for efficiency, while registered advising representatives (**ARs**) remain actively involved in decision-making. These platforms use electronic questionnaires for the know-your-client (**KYC**) information gathering process, but an AR is responsible for determining that sufficient KYC information has been gathered to support investment suitability determinations for a client. Clients' managed accounts are invested in relatively simple products, including unleveraged exchange traded funds (**ETFs**), low cost mutual funds or other redeemable investment funds, cash and cash equivalents. Often, model portfolios are created using algorithmic software although, again, an AR has responsibility for the suitability of each client's investments.

- Prior to implementing an online advice operating model, a PM or an applicant for registration as a PM will be asked to file substantial documentation, including their proposed KYC questionnaire and information about the processes relating to its use. The documents will be reviewed by CSA staff to assess how the firm will meet its obligations under Regulation 31-103.

- CSA staff would need to carefully consider whether a PM would be able to fully comply with its obligations under Regulation 31-103 if the PM sought to conduct operations using an online advice platform that is materially different from the model described in this Notice.

Online Advice by PMs with Active Involvement of an AR

The online advisers that have been approved to carry on business in Canada are not “robo-advisers” of the kind that are operating in the United States, which may provide their services to clients with little or no involvement of an AR. By comparison, Canadian online advisers can be seen as providing hybrid services, in that they use an online platform for the efficiencies it offers, while ARs remain actively involved in (and responsible for) decision-making.

KYC Process and Suitability Determination

In the hybrid model, an interactive website is used to collect KYC information, which is then reviewed by an AR. The AR is responsible for determining that sufficient KYC information has been gathered to support investment suitability determinations for the client or prospective client. In most cases, the firm’s policy is that an AR will always communicate directly with a client or prospective client before its KYC information gathering is completed. Less often, a firm will only require an AR to have direct communications with a client or prospective client if the AR has questions or concerns about the information gathered through the online platform. In such cases, the software for the KYC questionnaire will include mechanisms to identify inconsistencies in responses and other triggers for the AR to contact the client or prospective client. In either model, the AR may communicate with the client or prospective client by telephone, video link, email or internet chat. A client or prospective client always has the option of initiating contact with an AR.

Effectively bringing on clients in these ways depends on the quality of the online questionnaire and the availability of helpful explanations and other relevant information on the PM’s website. An online adviser’s KYC process must amount to a meaningful discussion with the client or prospective client, even if that discussion is not in the form of a face-to-face conversation. A well-designed online KYC questionnaire and system will:

- use a series of behavioural questions to establish risk tolerance and elicit other KYC information
- prevent a client or prospective client from progressing further until all questions have been answered
- test for inconsistencies in the answers (for example, answers that indicate both low risk tolerance and a maximum growth objective), and will not let the client or prospective client complete the questionnaire until the conflict is resolved
- flag inconsistencies or conflicts in the client or prospective client’s responses that would trigger a call from the AR to the investor
- offer investor education about the terms and concepts involved, and
- remind the investor that an AR is available to help them throughout the process.

The system should also prompt clients to update their personal information online at least annually, and more often if there has been a material change in their circumstances (for example, marriage, divorce, birth of a child, loss or change in employment). An AR must review all changes to KYC information and consider whether the selected model portfolio is still suitable.

See CSA Staff Notice 31-336 *Guidance for Portfolio Managers, Exempt Market Dealers and Other Registrants on the Know-Your-Client, Know-Your-Product and Suitability Obligations* for more information about these obligations. This guidance is applicable regardless of whether a PM uses a traditional operating model or an online platform to provide advice to clients.

Investment Portfolios

To-date, online advisers' client portfolios have consisted of ETFs, low-cost mutual funds or other redeemable investment funds, or cash and cash equivalents. There is no use of leveraged strategies or short selling. Some online advisers rely entirely on an AR to determine the asset allocation and selection of products in a client's portfolio. However, in most cases, after the KYC process is completed, software is used to make a preliminary determination of:

- the client's investor profile, and
- a model portfolio that is suitable for a client with that investor profile.

An AR will review the investor profile generated by the software to ensure it accurately reflects the information gathered in the KYC process. The AR is also responsible for ensuring that the model portfolio that the software proposes for the client is in fact suitable for them. Going forward, the PM will ensure that the client's investments are consistent with the model portfolio that the AR has approved for the client. This includes rebalancing the client's portfolio to its target asset allocation mix at appropriate intervals. This is usually done by the client authorizing the PM to direct trading in an account opened for the client at a member firm of the Investment Industry Regulatory Organization of Canada (**IIROC**).

Notification to CSA Staff

The registration and ongoing conduct requirements for PMs as set out in Regulation 31-103 are "technology neutral". This means the KYC and suitability obligations of PMs that provide their services through online platforms are the same as for any other PM. This is also true for other requirements applicable to a registered adviser under securities law.

PMs conducting operations using an online platform in the manner described in this Notice have not been granted exemptions from any of the conduct requirements for a registered adviser.

There is no special application process for PMs wishing to conduct operations using an online platform. Any firm applying for registration must provide a business plan and other information about its proposed business activities as part of its Form 33-109F6 *Firm Registration* (**F6**) filing. For firms wishing to conduct operations using an online advice operating model, this information should include their proposed online KYC questionnaire, investor profiles, model portfolios and details of related processes. This will be reviewed by CSA staff as part of our usual pre-registration due diligence.

Existing registrants are required to submit a Form 31-109F5 *Change of Registration Information* if they change their primary business activities, target market, or the products and services they provide to clients to something different than what is described in their current F6 filing. This would include adopting an online advice platform or making a significant change in the way an existing online advice platform operates.

Firms contemplating online advice operations are encouraged to contact CSA staff at an early stage, particularly if they propose to conduct them in a manner materially different from the model described in this notice.

Due Diligence Review by CSA Staff

In reviewing a PM's plans for online advice, CSA staff will give particular attention to the firm's KYC and suitability determination processes. Like any other PM, an online adviser must gather its own KYC information and make its own suitability determinations – it cannot rely on information provided under a referral arrangement or otherwise delegate its obligations to someone else. A KYC questionnaire used with an online platform cannot be just a "tick the box" exercise. The KYC process must be designed and then conducted so that it will amount to a meaningful discussion between the firm and the client or prospective client. Clients should have the opportunity to initiate a live interaction with an AR by telephone, video link, email or internet chat.

As the number of its clients grows, an online adviser, like any PM, must ensure that it has a sufficient number of ARs to service clients and continue to operate effectively. Also like any other PM, an online adviser must document the KYC information gathered for each client and update it regularly (this is generally built into an internet-based system). Other areas where CSA staff will focus attention, given the characteristics of online advice, include reviewing the composition of the different investor profiles and model portfolios that will be used for clients.

System security and the integrity of client information are obvious concerns related to online advice platforms. However, these concerns are not unique to online advisers, since many registrants have some online interaction with their clients, such as providing electronic account statement delivery or online access to account information. All registrants operating online must comply with laws and regulatory requirements relating to client identification, privacy of information and the prevention of money laundering, among other things. At a minimum, we expect online advisers to follow the practices that have already been developed by the industry for these purposes and accepted by regulators.

CSA staff may conduct compliance reviews of online advisers within one or two years after they commence operations in order to ascertain that all regulatory requirements are being met.

To-date we have only approved online advisers with the relatively simple product offerings described in this Notice. We believe portfolios with uncomplicated asset allocation models, made up of relatively basic ETFs or mutual funds, are readily understood by most investors and determining whether they are suitable for a given investor is a comparatively straight-forward exercise for a registrant. If a PM or applicant for registration as a PM proposes to use more complex investment products in an online platform, CSA staff will carefully assess whether it can meet its regulatory obligations.

The due diligence review conducted by CSA staff in no way diminishes any registrant's ongoing responsibilities under applicable securities laws.

Terms and Conditions on Registration

To-date, we have not imposed terms and conditions on online advisers who contact each prospective client during the on-boarding process. If a PM or applicant for registration that is planning to operate as an online adviser does not intend to have an AR initiate contact with every prospective client (but will have an AR available to respond to every client initiated contact) CSA staff:

- will ask it to demonstrate to us that it has a satisfactory system for identifying circumstances when an AR *will* initiate contact with a prospective client, and
- may recommend that terms and conditions be imposed limiting it to using the relatively simple investment products described in this Notice and registration in the restricted portfolio manager category.

We will consider whether terms and conditions will be appropriate for different operating models as they develop over time.

Use of Online Platforms by Registered Dealers

Registered dealers may utilize online platforms in different ways, which may have different regulatory implications. The same general principle will apply as for online advice by PMs: the obligations of registrants using new business models for registerable activity are the same as for registrants using established business models. Members of IIROC or the Mutual Fund Dealers Association of Canada will also have to comply with any requirements imposed by their self-regulatory organization.

Questions

If you have questions regarding this Notice, please refer them to any of the following:

Julie Politi
Analyste aux pratiques de distribution
Direction de l'encadrement des intermédiaires
Autorité des marchés financiers
418 525-0337, ext 4828 and
1 877 525-0337
julie.politi@lautorite.qc.ca

Jason Alcorn
Legal Counsel, Securities
Financial and Consumer Services Commission
(New Brunswick)
Tel: 506 643-7857
jason.alcorn@fcnb.ca

Christopher Jepson
Senior Legal Counsel
Compliance and Registrant Regulation
Ontario Securities Commission
416 593-2379
cjepson@osc.gov.on.ca

Denis Silva
Senior Legal Counsel
Capital Markets Regulation
British Columbia Securities Commission
604 899-6511 and
1 800 373-6393
dsilva@bcsc.bc.ca

Steven D. Dowling
General Counsel
Consumer, Labour and Financial Services Division, Department of Environment, Labour and Justice,
Government of Prince Edward Island
902 368-4551
sddowling@gov.pe.ca

Craig Whalen
Manager of Licensing, Registration and Compliance, Office of the Superintendent of Securities
Government of Newfoundland and Labrador
709 729-5661
cwhalen@gov.nl.ca

Thomas W. Hall
Associate Director, Legal Registries
Department of Justice
Government of the Northwest Territories
867 873-7490
tom_hall@gov.nt.ca

Rhonda Horte
Deputy Superintendent
Office of the Yukon Superintendent of Securities
867 667-5466
rhonda.horte@gov.yk.ca

Brian W. Murphy
Deputy Director, Capital Markets
Nova Scotia Securities Commission
902 424-4592
murphybw@gov.ns.ca

Navdeep Gill
Manager, Registration
Alberta Securities Commission
403 355-9043
navdeep.gill@asc.ca

Liz Kutarna
Deputy Director, Capital Markets, Securities Division
Financial and Consumer Affairs Authority of Saskatchewan
306 787-5871
liz.kutarna@gov.sk.ca

Chris Besko
Director, General Counsel
The Manitoba Securities Commission
204 945-2561 and 1 800 655-5244
(Toll Free (Manitoba only))
chris.besko@gov.mb.ca

Shamus Armstrong
Acting Director, Legal Registries
Department of Justice,
Government of Nunavut
867 975-6598
sarmstrong@gov.nu.ca