

# FAIR

Canadian Foundation *for*  
Advancement of Investor Rights

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**RE: Request for Comment – Plain language rule re-write project – Dealer Member Margin Rules, Rules 5100 through 5800**

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FAIR Canada is pleased to offer comments on the Investment Industry Regulatory Organization of Canada's ("IIROC") request for comment regarding the proposed 5000 series of plain language rules regarding margin (the "Proposed Rules").

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit [www.faircanada.ca](http://www.faircanada.ca) for more information.

FAIR Canada supports the intention of the Proposed Rules which aim, among other things, to provide a set of rules that are clearer and more concise and organized, clarify IIROC expectations of certain rules and ensure that the rules reflect industry practice and are consistent with other dealer member rules.

FAIR Canada is pleased to offer specific comments on proposed Rule 5111 which is a new provision setting out the steps a dealer member must take in deciding whether to allow a client to trade on margin. FAIR Canada provides suggestions to improve the proposed Rule 5111, in order to strengthen investor protection.

We are of the view that securities regulators need to enhance protection for investors who are persuaded to borrow money in order to invest. Leveraged investing is not suitable for most retail investors and requirements in existing securities regulation are not adequate to protect investors from unsuitable advice with respect to borrowing to invest, whether through the use of a margin account or otherwise. We believe that some registered representatives and their dealer member firms push consumers to borrow money to invest by presenting a misleading picture of the risks and benefits. This results, in part, from the misalignment between the interests of the financial intermediary and those of the investor.

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Proposed Rule 5111 provides:

(1) In deciding whether to allow a client to trade on margin, a Dealer Member must:

- (i) Ensure that the client is aware of the risks and benefits associated with trading on margin; and
- (ii) Assess whether trading on margin is appropriate for the client.

FAIR Canada supports IIROC's efforts to ensure that a client is aware of the risks and benefits involved in the use of margin and to assess whether it is appropriate for a client to trade on margin. FAIR Canada recommends that Rule 5111(1) be strengthened as follows:

(1) Ensure that the client is not only aware of the risks and benefits associated with trading on margin but also fully understands those risks by:

- a. Requiring a minimum level of investment knowledge regarding financial markets and the risks associated with trading on margin. This knowledge could be independently certified, or certified by dealer members. Meeting a minimum knowledge requirement will protect investors by ensuring that those who use this investment strategy are aware of the inherent risks.
- b. Obliging the registered representative to certify, at the time of a margin trade recommendation, in respect of a transaction that
  - 1) invests primarily in mutual funds, hedge funds, structured products or similar collective investment securities; or
  - 2) that is outside the normal trading pattern for that client and which represents a significant portion of the net assets or income of that of the client (i.e. more than 10%),

that the registered representative has explained the risks associated with such trading to the client and certify their belief that the client understands the associated risks. The client would acknowledge that the risks have been explained and are understood. Certification signed by the client will be more effective at communicating the associated risks and preventing problems down the road than boilerplate language.

- c. Requiring that dealer members assess whether trading on margin is suitable for the client and do this by instituting minimum standards for registered representatives and their dealer members in assessing the suitability of using margin to trade. The Mutual Fund Dealers Association of Canada (the "MFDA") in its Proposed Amendments to MFDA Rule 2.2.1 ("Know-Your-Client") and Policy No. 2 Minimum Standards for Account Supervision<sup>1</sup> set out minimum standards for registrants in assessing the suitability of leverage which included such criteria as: client investment knowledge; risk tolerance; age; time horizon; net worth; and gross income. FAIR Canada provided comments on the proposed amendments in which it added the criteria employment status (since the suitability of borrowing to invest for retired individuals or those within 5 years of retirement should be subject to further supervisory review and investigation) and ability to withstand loss (since retail investors want to know how much money they stand to lose and need to be able to

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<sup>1</sup> Available online at <http://www.mfda.ca/regulation/bulletins11/Bulletin0487-P.pdf>.

determine whether they can afford to lose the collateral they put up before trading on margin)<sup>2</sup>, and

- d. Requiring that registered representatives disclose to the client, prior to the certification in respect of a transaction referred to in paragraph (b) above, the amount of additional commissions, interest and other remuneration that they (and any other entity, if relevant) will be paid as a result of trading on margin.
- (2) Ensure that there is adequate supervision and review for trading on margin and recommendations to utilize margin for all accounts in the situations identified in item 1(b) above.

In our letter dated October 26, 2011<sup>3</sup> (a copy of which was provided to IIROC), we urged the Canadian Securities Administrators and its members to issue notices to registrants, cautioning them on the use of leverage and the need for proper supervision of leveraged investments and stating that any advertising and marketing must be fair and balanced and fully disclose the risks, including that borrowing to invest is only suitable for investors with a high risk tolerance. We urge IIROC to provide similar notices to its members.

#### *Inappropriate Use of Margin by Registered Representatives*

A review of enforcement actions on IIROC's website reveals two recent examples of the inappropriate use of margin accounts. The September 26, 2011 Decision and Reasons in the matter of Kenneth Gareau found that Gareau had failed to ensure recommendations he made to clients were suitable when he recommended that the retiree clients purchase \$100,000 of a hedge fund on margin and purchase \$170,000 in limited partnerships, which were speculative investments, some of it on margin, as well as recommending the extensive use of margin accounts and failing to take positive steps to reduce the margin once it reached excessive amounts. Gareau had also inaccurately recorded "know your client" information, including that the retiree couple had not borrowed money to make investments, when in fact they had done so.

The IIROC Panel found that "...more likely than not a margin account was never addressed by Mr. Gareau with the Howdens in a manner that clearly set out its negative risk factors, which were numerous."<sup>4</sup> The Howden couple who had invested almost \$1.2 million with Gareau, lost 60% of their investment as a result of the unsuitable recommendations to invest in 100% equities and the use of margin, and received a \$500,000 (with \$100,000 contributed by Gareau) in settlement of any claim they may have had with the Regina sub-branch of Dundee Securities Corporation.

In the Penalty Decision dated January 2, 2012, the ruling notes that Gareau had testified that the "...disciplinary process had caused him to re-evaluate and actively work to reduce the use of margin accounts and leverage generally."<sup>5</sup> However, the Panel also noted that at the time of the penalty hearing many of Gareau's clients "...were still investing on margin yet investment sophistication of the clients who were called as witnesses to support the Respondent appeared to be very fundamental. They were unsophisticated investors and, if they are representative of his overall clients, the use of margin

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<sup>2</sup> Available online at <http://faircanada.ca/wp-content/uploads/2011/01/111006-FAIR-Canada-submission-re-MFDA-leverage-suitability.pdf>.

<sup>3</sup> Available online at <http://faircanada.ca/wp-content/uploads/2011/10/111026-letter-to-CSA-re-Leverage-final.pdf>.

<sup>4</sup> *Re Garreau* [2011] IIROC No. 53 at paragraph 149.

<sup>5</sup> *Re Garreau* [2011] IIROC 72 at paragraph 23.

accounts continues to be unsuitable for them.”<sup>6</sup> . The decision also notes that “...the Panel does not have confidence that the Claimant, *or his firm*, understood the inappropriateness of creating investment portfolios for the two client families that were composed entirely of equity investments...none were suitable because all were equity products and some were very high risk.”<sup>7</sup> (emphasis added).

FAIR Canada believes that dealer member firms must have placed upon them a greater responsibility to adequately supervise the use of margin so that investors are not convinced to borrow to invest when it is not suitable for them to do so given their age, risk tolerance or other relevant criteria. FAIR Canada notes that the Gareau decision indicates that other retail investors remain at risk of significant losses given the registered representative’s recommendations to other clients and the apparent lack of any remedial action upon the firm to correct matters for those clients who have likely been provided with unsuitable advice, including the use of margin.

The October 6, 2011 decision in respect of Carolann Steinhoff in which the panel found that, among other things, Ms. Steinhoff had purchased securities using approximately \$120,000 borrowed on margin when use of margin was not suitable for the client and constructed a portfolio using margin which was not suitable for the client. In this case, a young married couple who were inexperienced investors, sold their first home and while waiting for their second new home to be constructed placed \$125,000 with Ms. Steinhoff clearly stating that they could only stand to lose, if anything, \$10,000. Ms. Steinhoff created a portfolio for the couple using extreme margin which the panel found to be completely unsuitable, given that they could not afford to lose any of the down payment on their home. She failed to explain margin, or leverage to her clients and, upon inquiries from the client, failed to inform him of the potential consequences of the use of margin in their portfolio. The panel found that the portfolio (including the use of margin) was inconsistent with the client’s investment objectives and risk tolerance.

The Panel also noted that if the clients had been told about the commissions that would be charged on the buy and sell of the portfolio she put in place and that the rate of return on the account would have to cover off not only margin interest, but the commissions charged to show any kind of gain, the couple would have understood that they could easily lose money<sup>8</sup>. We understand that the penalty decision has been reserved<sup>9</sup>.

FAIR Canada believes that the unsuitable use of leverage strategies and margin accounts is an ongoing problem which needs to be addressed. We note that OBSI’s 2011 Annual Report reported that it had received 9 out of 453 complaints where the main issue was seen by OBSI to be the use of margin. It is quite likely that many cases where there is an unsuitable use of margin, the matter will be classified under “suitability” complaints. A report by the New Brunswick Securities Commission (“NBSC”) on leverage practices found that there was a high correlation between leveraged investing, unsuitable investments and losses to consumers.<sup>10</sup>

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<sup>6</sup> *Re Garreau*, Penalty Decision, at paragraph 45.

<sup>7</sup> *Re Garreau*, Penalty Decision, at paragraph 49.

<sup>8</sup> *Re Steinhoff* [2011] IIROC No. 54 at paragraph 228.

<sup>9</sup> Broker calls accusations overzealous by Andrew A. Duffy, Times Colonist, available online at <http://www.timescolonist.com/news/topic.html?t=Person&q=Carolann+Steinhoff>.

<sup>10</sup> Regulatory Affairs Division New Brunswick Securities Commission, “Leverage Sweep Industry Report” (June 2010). Available online at < <http://www.nbsc-cvmnb.ca/nbsc/docs/2010-08-03-Sweep-Report-FINAL-EN-web.pdf>>. Note that this review covered both MFDA and IIROC member firms.

We therefore encourage IROC to follow the MFDA's lead and implement specific rules that will apply to its dealer members and their registered representatives to ensure that the use of margin is only recommended when it is suitable to do so and the risks and benefits of such a strategy are clearly and fully explained and understood by clients.

We would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-214-3443 ([ermanno.pascutto@faircanada.ca](mailto:ermanno.pascutto@faircanada.ca)) or Marian Passmore at 416-214-3441 ([marian.passmore@faircanada.ca](mailto:marian.passmore@faircanada.ca)).

Sincerely,



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