



Canadian Foundation *for*  
Advancement of Investor Rights

October 26, 2011

Mr. Bill Rice  
Chair and CEO, Alberta Securities Commission  
& Chair, Canadian Securities Administrators  
Alberta Securities Commission  
Suite 600, 250–5th St. SW  
Calgary, AB T2P 0R4

Sent by E-mail and Mail

Dear Mr. Rice:

**Re: Regulators Need to Act on Leveraged Investing**

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We are writing to you in your capacity as Chair of the CSA to recommend that the CSA enhance protection for investors who are persuaded to borrow money in order to invest in mutual funds and other investments. Leveraged investing is not suitable for most retail investors and current requirements do not provide adequate investor protection from unsuitable advice with respect to borrowing to invest. FAIR Canada believes that this is a systemic problem that regulators must address or investors will continue to be placed into unsuitable investments with resulting financial losses and an increasing number of investor complaints.

Please find enclosed a copy of FAIR Canada's submission to the Mutual Fund Dealers Association of Canada (the "MFDA") on Proposed Amendments to MFDA Rule 2.2.1 ("Know-Your-Client") and Policy No. 2 *Minimum Standards for Account Supervision*<sup>1</sup>. FAIR Canada provided comments on these amendments proposed by the MFDA which intend to clarify that suitability obligations apply equally to leverage strategies and to codify minimum standards for Members and Approved Persons in assessing the suitability of client leveraging.

FAIR Canada urges the CSA to consider our recommendations with a view to revising section 13.13 ("Disclosure when recommending the use of borrowed money") of National Instrument 31-103. To better protect investors, we suggest the CSA amend the requirements in order to:

1. Prevent registered firms and individuals from pushing investors to borrow money to invest by presenting a misleading picture of the risks and benefits of leverage.
2. Institute a presumption that leverage is unsuitable for retail investors, thus placing the onus on the salesperson and firm recommending leverage to prove that leverage is suitable for the client.

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<sup>1</sup> Also available online at <http://faircanada.ca/wp-content/uploads/2011/01/111006-FAIR-Canada-submission-re-MFDA-leverage-suitability.pdf>.

3. Implement minimum standards for registrants in assessing the suitability of leverage, which would include the following criteria: client investment knowledge; risk tolerance; net worth; gross income; employment status; and ability to withstand loss.
4. Develop a certification requirement, which would oblige registrants to certify, at the time of a leverage recommendation, that they have explained the risks associated with leverage 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 risk and preventing problems down the road than boilerplate language. This certification requirement would provide a meaningful method of fulfilling the current requirement that registrants deliver “a description of the risks to a client of using borrowed money to finance a purchase of a security” pursuant to paragraph 14.2(2)(d) of NI 31-103.
5. Require that independent legal advice be obtained when a home is to be used as security for leveraged investing.
6. Mandate supervisory requirements and reviews for leveraged trades and leverage recommendations for all accounts including RRSPs and RESPs.

Amending a national instrument will take a significant period of time. In the interim, we urge the CSA and its members to issue notices to registrants cautioning them: (1) on the use of leverage and the need for proper supervision of leveraged investments; and (2) that any advertising and marketing must be fair and balanced, and fully disclose the risks, including the statement that leveraged investing in mutual funds and similar products is only suitable for investors with a high risk tolerance.

The use of leverage often results in significant losses for investors and also generates complaints regarding the suitability of the advice provided by the registrant. Such losses are particularly harmful when they involve borrowing against a person’s home in order to invest and when they are incurred by seniors or individuals nearing retirement<sup>2</sup>. We cite a report by the New Brunswick Securities Commission (“NBSC”) on leverage practices which found that there was a high correlation between leveraged investing, unsuitable investments and losses to consumers<sup>3</sup>. The NBSC found that 68 percent of cases where the use of leverage was aggressive were in a loss position.

#### *Leverage is an Emerging Issue*

A review of enforcement actions on IIROC’s website reveals two recent examples of the inappropriate use of leverage.

The first example is the recent Settlement Agreement between IIROC and Berkshire Securities Inc. (now Manulife Financial Securities Incorporated (“Manulife”). Berkshire failed to adequately supervise its registered representative who made recommendations to a group of five clients to use leveraged investment loans to

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<sup>2</sup> See, for example, a media report at <http://nslegal.com/mutual-fund-dealer-faces-lawsuit> and the Nova Scotia Securities Commission decision of Mr. John Allen dated June 29, 2011 at <https://www.gov.ns.ca/nssc/docs/Allendec29062011.pdf> where Mr. Allen, a registrant, was found to have forged client information and encouraged and clients to invest in highly leveraged strategies involving clients borrowing and investing over \$14 million.

<sup>3</sup> Regulatory Affairs Division New Brunswick Securities Commission, “Leverage Sweep Industry Report” (June 2010), online: <<http://www.nbsc-cvmnb.ca/nbnc/docs/2010-08-03-Sweep-Report-FINAL-EN-web.pdf>>. Note that this review covered both MFDA and IIROC member firms.

fund their investment accounts, recommendations which were not suitable for the respective clients. A group of five clients (some of whom were in their 50s, 60s and 70s) received leveraged investment loans through AGF Trust Company and B2B Trust at prime plus 0.5 percent or 0.75 percent in order to purchase equity-based mutual funds on a deferred sales charge basis. At the time of the latest loan each client was paying interest at a rate of 6.5 percent. The amount of money each of the clients borrowed to invest was not suitable for the clients because the loan was higher than would be appropriate based on their age, income, net worth and risk tolerance<sup>4</sup>.

The second example is the October 19, 2011 decision regarding Kenneth Gareau who failed to ensure recommendations were suitable, including the \$100,000 purchase of a hedge fund on margin and the purchase of \$170,000 in limited partnerships, some of it on margin, and inaccurately recorded “know your client” information, including that two clients had not borrowed money to make investments when they in fact had.<sup>5</sup>

MFDA members and Approved Persons also are frequently found to have failed to establish, implement and maintain policies and procedures to supervise leveraging recommendations and ensure the suitability of leveraging recommendations leading to the issuance of an MFDA Compliance Bulletin dealing with, among other things, the Suitability of Leveraging<sup>6</sup>. For the period from July 1, 2010 to July 30, 2011, the MFDA had 33 out of 453 enforcement cases dealing with problems with the suitability of leverage or 7.28 percent of its total enforcement actions<sup>7</sup>. The Ombudsman for Banking Services and Investments (“OBSI”) data indicates that in the first ten months of 2011 there has been, a 56 percent increase in complaints where the main issue was seen by OBSI to be leverage over the previous year.

FAIR Canada recommends that the existing contractual relationships between the mutual fund companies, financing companies and registrants need to be reviewed in order to address the systemic problem of investors being unsuitably placed in leveraged investment strategies. Some mutual fund companies have contractual arrangements with financing companies to provide preferential rates on investment loans to investors who purchase their family of mutual funds in order to generate greater sales of their own funds. Some registrants actively promote the use of leverage investing in order to generate increased commissions and assets under management. Registrants can recommend a leverage strategy to the client, process the loan application at their own office, and have the client invest in the mutual fund company’s mutual funds, all within the same day.<sup>8</sup> This is cause for concern and requires examination from a retail investor protection perspective.

Accordingly, FAIR Canada urges the CSA to consider our recommendations and revise NI-31-103 and the related Companion Policy (the latter is currently silent on suitability obligations with respect to leverage) in order to protect investors. We encourage IIROC to follow the MFDA’s lead and implement rules that will apply to its Dealer Members and their representatives to clarify that the suitability obligations apply to leverage strategies and that set minimum supervisory standards. We urge IIROC to incorporate our recommendations into any new proposed rules. We are copying the Commissions which are recognizing regulators for IIROC and the MFDA with this letter and propose to publish this as an open letter.

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<sup>4</sup> See the decision online at <http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=847A551282604C2BB05780A85A2BCE4E&Language=en>.

<sup>5</sup> See the decision online at <http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=8D4A72A77A624DB9967D4FEEBE5D674E&Language=en>

<sup>6</sup> See MFDA Bulletin #0355-C dated January 28, 2009 at page 8.

<sup>7</sup> See MFDA Enforcement Statistics online at <http://www.mfda.ca/enforcement/enfStats.html>.

<sup>8</sup> See Investment Executive, July 31, 2007 report “Investment loans add oomph to portfolios” (enclosed).

We would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-572-2282/[Ermanno.pascutto@faircanada.ca](mailto:Ermanno.pascutto@faircanada.ca) or Marian Passmore at 416-572-2728/[marian.passmore@faircandaa.ca](mailto:marian.passmore@faircandaa.ca).

Sincerely,



Canadian Foundation for Advancement of Investor Rights

Cc: Brenda Leong, Chair and CEO, BSCS  
Howard Wetston, QC, Chair and CEO, OSC  
Mario Albert, Président-directeur générale, AMF  
Susan Wolburgh Jenah, President and CEO, IIROC  
Larry Waite, President and CEO, MFDA

Enclosed:

- 1) FAIR Canada submission regarding MFDA Leverage Suitability
- 2) Investment Executive article – Investment loans add oomph to portfolios