FAIR | Canadian Foundation *for* Advancement *of* Investor Rights

November 12, 2012

Mr. Philip Howell
Chief Executive Officer and
Superintendent, Financial Services
Financial Services Commission of Ontario
5160 Yonge Street, Box 85
Toronto, ON M2N 6L9

Delivered via email to: phil.howell@fsco.gov.on.ca

Re: Unsuitable Recommendations to Borrow to Invest

FAIR Canada would like to bring to your attention our concern that borrowing to invest is being recommended to consumers when it is not suited to the consumers' needs and in fact places consumers into inappropriate high-risk investment situations. Current requirements for financial service providers (including insurance agents) and registrant firms who sell mutual funds, segregated funds and other similar investment products and the level of industry compliance do not provide adequate investor protection from unsuitable advice with respect to borrowing to invest.

1. Leverage is a Growing Problem

1.1. Last fall, FAIR Canada identified the widespread inappropriate use of leverage as an emerging issue in need of action by securities regulators. It wrote to the CSA (with a copy provided to the Investment Industry Regulatory Organization of Canada ("IIROC") and the Mutual Fund Dealers Association of Canada ("MFDA")).[1] This followed from our initial letter to the MFDA in support of their proposed amendments to clarify suitability obligations in respect of leverage strategies and codify minimum standards for assessing the suitability of leverage.

1.2. We also brought the issue to your attention at a meeting at our offices on December 19, 2011 and in comments we made in our letter to you dated June 6, 2012 on the Financial Services Commission of Ontario ("FSCO") Draft Statement of Priorities & Strategic Directions (the "Draft Statement").

1.3. Most recently, IIROC's Notice dated July 4, 2012 enclosing Proposed Leverage Guidelines[2] indicates that IIROC's Business Conduct Compliance examination unit has found an increasing number of cases where inappropriate leveraging strategies have been recommended to

[1] A copy of the letter is appended to this submission. FAIR Canada also provided comments to the MFDA regarding its proposed amendments to clarify that the suitability obligations in MFDA Rule 2.2.1 ("Know-Your-Client") and Policy No. 2 Minimum Standards for Account Supervision apply equally to leverage strategies, and codifying minimum standards for Members and Approved Persons in assessing the suitability of client leveraging contained in MFDA Bulletin #0487-P published on July 11, 2011. Available online at http://faircanada.ca/wp-content/uploads/2011/01/111006-FAIR-Canada-submission-re-MFDA-leverage-suitability.pdf.

[2] [insert link to Notice and Guidelines]

consumers. It also notes that IIROC Staff have become aware of situations where consumers were not provided with sufficient information to properly understand the risks associated with such strategies or the details of the debt servicing obligations that the consumers had taken on as a consequence of using leverage.

1.4. There have been two recent class actions involving the use of leverage by clients who were sold mutual funds or segregated funds in Canada.[3]

1.5. In the absence of further action by all regulators, including FSCO, more consumers will be put into high risk leveraged situations to which they are not suited.

1.6. FAIR Canada outlined in its earlier letters (to the MFDA and CSA[4]) some of the underlying motivating factors that often lead to unsuitable recommendations. Issuers, dealer members and registered representatives may push consumers to borrow money to invest by presenting a misleading or incomplete picture of the risks and benefits associated with such a strategy. This results, in part, from the misalignment of the interests of the financial intermediary and those of the consumer. Registrants are incentivized to promote the use of leveraged investments because it generates increased commissions and assets under management. Moreover, contractual relationships between investment fund companies, financing companies and registrants need to be reviewed as they may increase incentives to not comply with suitability and other obligations of registrants. For example, Laurentian Bank, through its subsidiary B2B Bank, completed the acquisition of AGF Trust in 2012, and, according to its press release, appears to have 27,000 "advisors" who, in turn, have 750,000 clients who may be leveraged.[5]

1.7. The same incentives and contractual arrangements are present in respect of segregated funds and the prescriptive requirements that have been developed in respect of mutual funds (including the requirement to deliver a risk disclosure document (MFDA Rule 2.6) and specific criteria to assess the suitability of leverage) are absent in respect of segregated funds.

1.8. We are aware through anecdotal evidence that financial service providers are cognizant of the ease with which they can place clients in leveraged investments on the insurance side with little regulatory requirements or regulatory oversight.[6] Some have given up their MFDA license as a result of the "regulatory burdens" associated with regulation by the MFDA. We believe that this increases the risk that consumers may be sold investment products through

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[3] See *George French v. Investia Financial Services Corp et al* 2012 ONSC Number 1150, available online at http://www.thomsonrogers.com/james-stephenson-money-concepts-class-action; and class action in the amount of $80 million against Brian Malley, see http://www.cbc.ca/news/canada/edmonton/story/2012/10/03/edmonton-lawsuit-brian-malley.html.

[4] See supra, at note 1.

[5] The potential for the financial advisors who distribute B2B Bank's products to recommend a leverage strategy involving the purchase of AGF Trust's fund products is a serious concern. See the news release of Laurentian Bank at http://www.newswire.ca/en/story/1028947/laurentian-bank-reports-a-21-incre.

[6] Globe and Mail article "Terrible financial advice –available at a location near you", by Ted Rechtashaffen published November 14, 2011; available online at http://www.theglobeandmail.com/globe-investor/personal-finance/ted-rechtshaffen/terrible-financial-advice-available-at-a-location-near-you/article2234183/. See also the article in Investment Executive "Contemplating leverage" by Jade Hemeon published October 22, 2012 at http://www.investmentexecutive.com/-/contemplating-leverage?redirect=%2Fsearch.

insurance agents that utilize leverage strategies to which they are not suited, which does not meet their needs and which places them at risk of financial harm.

1.9. We are aware of a practice of investment fund companies having contractual arrangements with financing companies to provide preferential rates on investment loans to investors who purchase their family of mutual funds (and presumably also segregated funds) in order to generate greater sales of their own funds. Some registrants actively promote the use of leveraged investing in order to generate increased commissions and assets under management.

1.10. The ease with which financial service providers can recommend certain investments, including the use of a leveraged strategy and at the same time process the loan application (often within the same day) from the financial service provider's office, is a further cause for concern. These relationships (combined with the misaligned incentives and mistaken belief that financial service providers have an obligation to put the client's best interests ahead of their own personal interests[7]) allow the sales process to take precedence over a careful consideration of the consumer's interest in pursuing a strategy that involves borrowing to invest.

1.11. **It is our submission that there is simply no reasonable basis for a financial service provider to conclude that a highly leveraged sale of investment products is suitable for any but the most sophisticated investor with a high tolerance for risk. In these volatile times (and in a period of low interest rate and returns) the leveraged purchase, particularly of high-fee products, is simply a meritless strategy that will result in significant financial losses to the majority of consumers. This is true regardless of any guarantees associated with the product.**

2. FAIR Canada's Recommendations

2.1. In our letter to the CSA, FAIR Canada made a number of recommendations in order to better protect investors from unsuitable borrowing to invest recommendations, including:

- a presumption that leverage for the purchase of mutual funds, structured products and complex, high fee financial products is unsuitable for consumers, thus placing the onus on the salesperson and firm recommending leverage to prove that leverage is suitable for the consumer;
- implementing 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;
- requiring that independent legal advice be obtained when a home is to be used as security for leveraged investing;

[7] Investor Education Fund: Investor behaviour and beliefs: Advisor relationships and investor decision-making study, written by The Brondesbury Group, 2012 at page 17 and 31. Available online at http://www.getsmarteraboutmoney.ca/en/research/Our-research/Pages/Investor-behaviour-and-beliefs.aspx.

- requiring registrants and supervisors to certify that the risks have been explained and that the client understands the risks; and
- more stringent rules on the marketing and advertising of such a strategy, and a review of the propriety of contractual relationships between investment fund companies, financing companies and registrants in order to address the systemic problem of investors being unsuitably placed in leveraged investment strategies.

2.2. Insurance companies, insurance agencies and their financial service providers should not be permitted to promote leveraged investing unless they can demonstrate through simple examples that leveraged investing is a sensible "investment" strategy given the associated investment product fees, the need to pay loan interest and repay principal and the current "zero interest rate policy" environment and potential market volatility.

3. Additional FAIR Canada Recommendations

3.1. A leveraged sale of an investment product is a "product" in the same way that PPNs, leveraged ETFs and asset backed securities are products. Registrants have gate keeper obligations, including product due diligence, and should have obligations in respect of any "off-book" financing. Any representation that the leveraged purchase of segregated funds, mutual funds, structured products and other high fee investment products is a suitable investment strategy should be based on adequate and proper analysis.

3.2. Specifically, we suggest:

1) The analysis should articulate any assumptions (such as rate of return) and the assumptions used must be objectively reasonable.
2) The analysis should take into consideration the risks of major market corrections and the impact on the client. These risks must be clearly articulated to the consumer.
3) The analysis should reflect the actual financial products being recommended, including all fees and costs (including interest expenses).
4) Any tax assumptions should be relevant to the client's personal tax situation or it should be clearly stated that the tax implications have not been considered and tax advice should be sought separately.
5) The analysis should be readily available and kept on file.
6) The documentation related to the leveraging strategy and any related marketing material should be approved by senior management.

3.3. FAIR Canada recommends that FSCO consider undertaking reviews of its insurance agents (as part of its product suitability review or otherwise) to determine:

1) the extent and form of leveraged investing by the clients of insurance agents;
2) the particulars of the relationships regarding off-book loans and, specifically, the contractual arrangements between the insurance companies, the financing companies and the insurance agents;
3) whether existing marketing and advertising materials that encourage investors to borrow to invest are fair, balanced, and fully disclose the risks of such a strategy, and if not, take steps to minimize harm and prohibit insurance companies and their agents from using misleading materials;
4) the prevalence of unsuitable leverage recommendations; and
5) whether clients who have leveraged investments were provided with sufficient information to properly understand the risks associated with such strategies or the details of the debt servicing obligations that they had taken on as a consequence of using leverage by canvassing a statistically relevant survey of leveraged clients.

3.4. FSCO would then have valuable data on the extent of leveraged investing to inform regulatory action. Such action should include consideration of whether the existing regulatory framework is sufficient to protect consumers or whether specific regulatory requirements are needed.

We intend to post this letter on our web-site. We would be pleased to discuss this letter and our recommendations with you at your earliest convenience. Please contact Ermanno Pascutto at 416-214-3443 (ermanno.pascutto@faircanada.ca) or Marian Passmore at 416-214-3441 (marian.passmore@faircanada.ca).

Sincerely,

Canadian Foundation for Advancement of Investor Rights

Enclosed: FAIR Canada letter to CSA Chair on Leverage Investing

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

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*[8]. 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.

[8] 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[9]. 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[10]. 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.

[9] 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.

[10] Regulatory Affairs Division New Brunswick Securities Commission, "Leverage Sweep Industry Report" (June 2010), online: < 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.

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 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 tolerance4[11].

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[12].

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[13]. 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[14]. 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[15]. 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

[11] See the decision online at http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=847A551282604C2BB05780A85A2BCE4E&Language=en.
[12] See the decision online at http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=8D4A72A77A624DB9967D4FEEBE5D674E&Language=en.
[13] See MFDA Bulletin #0355-C dated January 28, 2009 at page 8.
[14] See MFDA Enforcement Statistics online at http://www.mfda.ca/enforcement/enfStats.html.
[15] See Investment Executive, July 31, 2007 report "Investment loans add oomph to portfolios" (enclosed).

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.

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 or Marian Passmore at 416-572-2728/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