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

October 4, 2012

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**Re: Request for Comments – Draft Guidance on Borrowing for Investment Purposes – Suitability and Supervision**

FAIR Canada is pleased to offer comments on the Investment Industry Regulatory Organization of Canada's ("IIROC") request for comments regarding the draft guidance regarding borrowing for investment purposes (the "Proposed Leverage Guidelines").

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 protections in securities regulation. Visit www.faircanada.ca for more information.

## 1. Support for Proposed Leverage Guidelines

1.1. FAIR Canada supports the intention of the Proposed Leverage Guidelines which outline the existing obligations in IIROC rules and securities regulations and provide guidance to dealer members and registered representatives to properly supervise client accounts that employ a leverage strategy, including both "on-book" (margin loans advanced by the dealer member) and "off-book" (loans advanced by third parties) borrowing. **We support the Proposed Leverage Guidelines which clarify the existing obligations and responsibilities of dealer members and their registered representatives and provide best practices.**

## 2. Leverage is a Growing Problem

2.1. 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 IIROC and the Mutual Fund Dealers Association of Canada ("MFDA")).[1] IIROC's Notice dated July 4, 2012 enclosing the Proposed Leverage Guidelines indicates that IIROC's Business Conduct Compliance examination unit has found an increasing number of cases where inappropriate leveraging strategies have been recommended to consumers. It also notes that IIROC Staff have

[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.

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.

2.2. The Proposed Leverage Guidelines are a laudable initiative to make clear the obligations and best practices for dealer members and their registered representatives. However, we do not foresee meaningful improvement in outcomes for investors as a result of their issuance. Current requirements and the level of industry compliance do not provide adequate investor protection from unsuitable advice with respect to borrowing to invest in mutual funds and similar products. **In the absence of further action by the CSA, IIROC and the MFDA, the Proposed Leverage Guidelines will not be sufficient to prevent more consumers from being put into high risk leveraged situations to which they are not suited.**

## 3. FAIR Canada's Recommendations

3.1. 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,
- 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 or 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.

3.2. **We have not seen any meaningful response from provincial regulators to our October 2011 letter and leverage has become an increasing problem in Canada which needs to be addressed urgently.[2] Leverage magnifies volatility increasing downside exposure and the chance of financial ruin for consumers.[3]**

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[2] As noted by the IIROC Notice, there are an increasing number of cases where inappropriate leveraging strategies have been recommended to clients.

[3] "The Danger of Leverage and Volatility", Robert Ferguson in The Journal of Investing, Winter 1994, at 52-56.

## 4. Misalignment of Incentives

4.1. **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.**

4.2. The problem appears to be greatest with “off book borrowing” but also occurs with the use of margin at dealer member firms, which we brought to the attention of IIROC in conjunction with your consultation on proposed changes to the dealer member margin rules.[5]

4.3. 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 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.

4.4. The ease with which registered representatives 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 registrant’s office, is a further cause for concern. These relationships (combined with the misaligned incentives and mistaken belief that registered representatives have an obligation to put the client’s best interests ahead of his or her own personal interests[6]) 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.

4.5. **It is our submission that there is simply no reasonable basis for an advisor 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.**

4.6. **At least one major bank is promoting “3 for 1 No Margin Call Demand Loans” to advisors with the IIROC member of the bank.** We do not see how a 100% loan to purchase investment products makes any economic sense as an “investment” let alone a 3 for 1 no margin call

[4] See supra, at note 1.

[5] Please see our letter to you dated May 3, 2012 in response to the Request for Comment – Plain language rule re-write project – Dealer Member Margin Rules, Rules 5100 through 5800, available online at: http://faircanada.ca/wp-content/uploads/2011/01/120503-FAIR-Canada-comments-re-Dealer-Member-Margin-Rules.pdf.

[6] 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.

demand loan (which on its face is misleading and an oxymoron). It is our view that the bank is promoting irresponsible lending and incentivizing the breach of suitability requirements by advisors. Highly leveraged loans for purchase of investment products promotes gambling with the savings of unsophisticated consumers.

4.7. **Member firms and their advisors 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.**

## 5. Additional FAIR Canada Recommendations

5.1. 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 written policies and procedures, particularly in respect of any "off book" financing. Any representation that the leveraged purchase of mutual funds, structured products and other high fee investment products is a suitable investment strategy should be based on adequate and proper analysis along the lines outlined in IIROC's Guideline on Best Practices for Product Due Diligence. The analysis should demonstrate its suitability in the current environment and with the relevant financial products.

5.2. 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.

5.3. IIROC may wish to consider undertaking reviews of its dealer member firms to determine:

1) the extent and form (i.e. use of margin or off-book) of leveraged investing by the clients of dealer members;

2) the particulars of the relationships regarding off-book loans and, specifically, the contractual arrangements between the investment firms, the financing companies and the registered representatives;
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 dealer member firms from using misleading materials;
4) the prevalence of unsuitable leverage recommendations;
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; and
6) the degree of compliance by dealer member firms with their existing supervisory obligations.

5.4. IIROC would then have valuable data on the extent of leveraged investing to inform regulatory action. Such action should include whether the existing suitability standard is sufficient to adequately protect investors or whether a best interest of the client standard is required.

**6. <u>Applicability of Recommendations</u>**

6.1. Our comments are not solely directed at IIROC or this consultation. We urge all relevant regulators, in particular the CSA, MFDA and IIROC, to consider the recommendations made in this submission.

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

Cc: Attention: Bill Rice, CSA Chair
Cc: Attention: Mark Gordon, President and CEO of the MFDA

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**

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*[1]. 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.

[1] 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[2]. 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[3]. 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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[2] 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.

[3] 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.

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[4].

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.[5]

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[6]. 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[7]. 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.[8] 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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[4] See the decision online at http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=847A551282604C2BB05780A85A2BCE4E&Language=en.
[5] See the decision online at http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=8D4A72A77A624DB9967D4FEEBE5D674E&Language=en
[6] See MFDA Bulletin #0355-C dated January 28, 2009 at page 8.
[7] See MFDA Enforcement Statistics online at http://www.mfda.ca/enforcement/enfStats.html.
[8] 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 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