

IIROC NOTICE

Rules Notice Request for Comments

Dealer Member Rules

Please distribute internally to:

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Institutional
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Contact:

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12-0208

July 4, 2012

Request for Comments on draft guidance regarding Borrowing for Investment Purposes— Suitability and Supervision

This Notice requests comments on draft guidance with respect to the responsibilities of Dealer Members and Registered Representatives where a recommendation to use borrowed money to invest has been made or where the Dealer Member or Registered Representative becomes aware that a client intends to make an investment with money borrowed from third party sources.

The attached draft guidance outlines the obligations contained in IIROC rules and other securities regulations and provides some guidance as to best practices that may be adopted to help ensure that Dealer Members are able to properly supervise client accounts that employ a leverage strategy.



Dealer Members and other interested parties are requested to provide comments on the attached draft Guidance Note. Comments should be made in writing and delivered by October 4, 2012 (90 days from the publication date of this Notice).

Comments on the draft Guidance Note may be delivered by mail, fax or e-mail by October 4, 2012 to:

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Those submitting comment letters should be aware that a copy of their comment letter will be made publicly available on the IIROC website (www.iiroc.ca under the heading “IIROC Rulebook - Dealer Member Rules – Proposed Policy”).

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Guidance Note
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12-xxxx
July 04, 2012

Borrowing for Investment Purposes – Suitability and Supervision

IIROC's Business Conduct Compliance examination unit has found an increasing number of cases where inappropriate leveraging strategies have been recommended to clients. Staff has also noted several situations where clients were not provided with sufficient information to properly understand the risks associated with such strategies or the details of the debt servicing obligations that clients had taken on as a consequence of using leverage.

Suitability and other obligations

Any time a leveraging strategy is recommended by a Registered Representative or a Dealer Member, the recommendation is subject to the suitability requirements under IIROC rules. As noted in IIROC's Know-Your-Client and Suitability Guidance Note, included as part of the IIROC Client Relationship Model proposals:



“the regulatory obligation to ensure that orders and recommendations are suitable includes not only an obligation to ensure that the specific investment product is suitable for the client but also that the order type, trading strategy and method of financing the trade recommended and/or adopted are also suitable for the client.”

In addition to performing an assessment as to whether the strategy is suitable for the client based on their individual needs and financial objectives, where a recommendation is made, the Dealer Member must provide proper disclosure of the risks associated with leveraging. To ensure that a client fully understands both the positive and the negative aspects of the leveraging strategy, he or she should be made aware that:

- using money borrowed from others to purchase investments involves greater risk than a purchase using the client’s own money;
- the client has a continuing obligation to repay principal and interest even if the value of the investment goes down; and
- a leveraging strategy could result in far greater losses than an investment strategy that does not involve leverage.

On-book and off-book borrowing

Clients may engage in leveraged strategies either through margin loans advanced by the Dealer Member (“on-book” borrowing) or through loans advanced by third parties (“off-book” borrowing). In either case, where a recommendation is made, or the firm becomes aware of a client’s intent to use a leveraging strategy, the Registered Representative and the firm have a responsibility to ensure that suitability obligations and other responsibilities under IIROC rules are satisfied.

IIROC has margin rules that restrict the amount of money that a Dealer Member may lend to a client to finance the purchase of an investment product (Dealer Member Rule 100). In the case of order-execution service accounts, for which there is no suitability assessment obligation, the amount of on- book client borrowing is restricted by IIROC’s margin rules. In the case of advisory accounts, on-book client borrowing must be determined to be suitable for the client before any loans are extended and a margin account is opened. Even if client borrowing is determined to be suitable, Dealer Members must make a determination as to an appropriate loan amount to extend to the client, within the maximum amount permissible under IIROC’s margin rules.

Additional issues arise when Registered Representatives make recommendations for the use of a leveraging strategy where the loan is off-book. These can be more difficult to detect and/or supervise. Dealer Members must have adequate systems and controls to flag accounts that involve recommended off-book leverage and ensure they are properly supervised. In



addition, Dealer Members should have controls designed to identify accounts that may be funded through the use of undisclosed off-book leverage not recommended by the Registered Representative. IIROC staff are aware that where the off-book leveraging is instigated solely by the client, these situations can be very difficult to detect and/or supervise. Dealer Members and their Registered Representations should not ignore “red flags” and this Guidance Note sets out best practices to identify these situations and ask the client questions in these circumstances.

IIROC staff are aware of some cases where Dealer Members or Registered Representatives seek to put in place referral arrangements with off-book leverage providers or other outside business activities involving third party lenders. Firms are reminded of their obligations under National Instrument 31-103, which require that:

- the terms of the referral arrangement be set out in a written agreement between the Dealer Member and the other party;
- the Dealer Member maintain records of all referral fees paid; and
- written disclosure of the essential terms of the agreement as required in NI 31-1-3 (including conflicts, calculation of fees; registration category and authorized activities of the parties, etc.) be provided to clients before account opening, or before services are provided.

In addition, proposed amendments to Dealer Member Rule 18.14, which are pending approval by the provincial securities commissions, will also impose specific requirements regarding the approval and supervision of outside business activities carried on by Registered Representatives.

IIROC requirements for a supervisory framework on leveraging strategies

IIROC expects all Dealer Members to have sound policies and procedures on borrowing-to-invest strategies recommended by the firm and its Registered Representatives. These policies and procedures must detail how it will evaluate the risks related to particular recommendations, how suitability will be supervised and how evidence of supervision will be maintained. Dealer Members are expected to demonstrate that their leveraging supervisory policies and procedures address all aspects of suitability: leverage amount, debt servicing ability and suitability of investments and strategy.

The Dealer Member’s supervisory framework must capture margin account loans as well as off-book leveraging strategies, including new and existing client accounts. Dealer Members need to consider whether limits or other controls will need to be established to monitor and supervise the leveraging activity of their Registered Representatives.

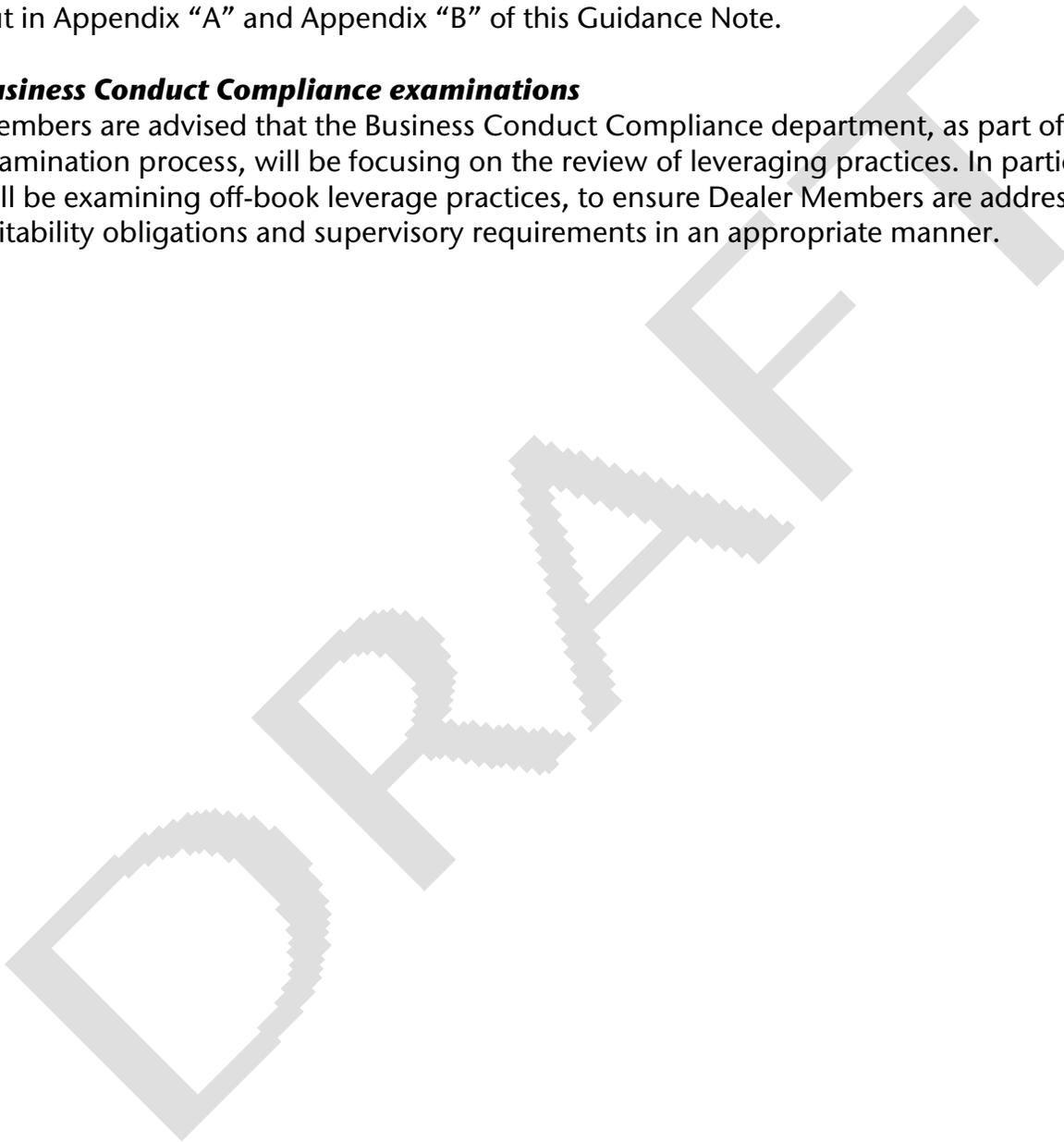


Having sound policies, procedures and controls together with an effective supervisory regime will create an environment where leveraging strategies are properly assessed and approved, where appropriate, and where unsuitable leveraging strategies are detected and prevented.

Further guidance for Registered Representatives and for Dealer Members, respectively, is set out in Appendix “A” and Appendix “B” of this Guidance Note.

Business Conduct Compliance examinations

Members are advised that the Business Conduct Compliance department, as part of its examination process, will be focusing on the review of leveraging practices. In particular, staff will be examining off-book leverage practices, to ensure Dealer Members are addressing their suitability obligations and supervisory requirements in an appropriate manner.





Appendix “A”

Guidance for Registered Representatives on leveraged strategies

Registered Representative Obligations

IIROC rules set out several requirements relating to minimum standards for business conduct. The following points provide a reminder of some of these obligations, along with some best practices that should be considered:

- Registered Representatives must fully understand the consequences of leveraging recommendations to clients. Registered Representatives must continually update their knowledge and training to ensure a sufficient understanding of the products, leveraging strategies and the associated risks.
- Registered Representatives should apply their education and training in a thorough and meaningful discussion with the client about leveraging strategies.
- Registered Representatives should properly document any recommendations they make regarding the use of a leveraging strategy.

Making Specific Leverage Recommendations

The following checklist lists some issues that Registered Representatives should consider before making a specific recommendation to invest with borrowed funds:

- Has the Registered Representative obtained complete documentation for proposed leveraged accounts and transactions? This includes:
 - Complete and accurate Know Your Client information;
 - Copy of the completed loan documents;
 - Acknowledgement of receipt of the leverage risk disclosure (Dealer Member Rule 29.26)
- How does the combined client debt service costs of a leverage strategy compare to the client’s monthly gross income? Has the Registered Representative performed an evaluation of the client’s total debt servicing ability?
- Does a recommendation to a client to borrow money off-book involve higher leverage than is permissible on-book under IIROC margin rules?
- How does the client’s total debt compare to his or her total net worth? Has the Registered Representative evaluated whether or not the recommended leverage would cause the client’s leverage-to-liquid net worth ratio to go below a specified conservative percentage?
- Are there other client assets to be used to secure the loan and does the client fully appreciate the encumbrance placed on these?



Appendix “B”

Guidance for Dealer Members regarding supervisory policies and procedures relating to leverage

Minimum Controls

The following are minimum controls that IIROC Business Conduct Compliance staff expect all Dealer Members to have in place:

- Procedures to ensure that all client accounts utilizing a leveraging strategy can be identified and are subject to suitability review :
 - All accounts employing a leveraging strategy (whether on-book or off-book) should be readily identifiable for supervisory purposes.
 - The Chief Compliance Officer (CCO) should either conduct reviews of leveraged accounts or receive leveraging reports from his or her delegates.
 - Dealer Members must not rely on the approval of loans from lending institutions as being determinative of suitability of a proposed leveraged strategy.
- Procedures for the maintenance of the evidence of supervisory review.
- Procedures to ensure any disclosed third party loans deposited to margin accounts fall under this supervisory framework.
- Procedures to ensure compliance with the requirements relating to permitted referral arrangements under NI 31-103.

Red flags to identify undisclosed off-book leveraging strategies

With respect to undisclosed off-book leverage loans, Dealer Members should have in place procedures to identify red flags that may indicate off-book leverage and should follow up any such situations with questions and/or more testing, as appropriate. Examples of such red flags may include:

- Large investments or transfers in to client accounts (including deposits into margin accounts), where such amounts are inconsistent with information provided on Know Your Client forms, and inconsistent with the Registered Representative’s or the firm’s knowledge of the client’s individual circumstances or profile.
- Communications from lending institutions regarding the value of the client’s portfolio, or requests for duplicate statements.
- Referral fees paid to a Registered Representatives or the Dealer Member by a lending institution or an affiliate of the institution.
- Correspondence found in client files suggesting the use of undisclosed leveraging.
- Client complaints relating to borrowed funds or leveraging recommendations.



Best Practices

The following are some best practices that Dealer Members should consider in developing and implementing supervisory controls:

- Developing a leverage suitability checklist, or a similar document, to detail the appropriate client circumstances that might support a leveraging recommendation.
- Developing procedures to periodically assess the financial performance and the ongoing suitability of leveraged accounts and noting the steps to be followed for leveraged accounts that have become unsuitable (advising the client, etc.).
- Developing detailed guidance for Registered Representatives to help ensure that they explain all risks before recommending a leveraging strategy and requesting that clients provide an acknowledgement that the risks have been explained and are understood.
- Including a process for specifically reviewing leveraged accounts as part of the Dealer Member's business location examinations.
- Developing procedures for the approval of Registered Representatives outside business activities with a view to capturing activities involving third party lenders
- Developing supervisory policies:
 - requiring pre-approval of Registered Representatives before permitting them to recommend an off-book leveraging strategy to their clients; and/or
 - requiring all off-book leveraging recommendations to clients (new loans or re-financings) to be pre-approved by the firm.
- Including a review of leveraging practices at prior firms as part of the due diligence process performed regarding prospective Registered Representatives.
- Requesting that approved lenders provide reports of the leveraging business on record involving firm Registered Representatives.
- Reviewing third party remuneration captured in Dealer Member records for trends indicative of leveraging practices (e.g. compensation for sale of products with embedded leverage; compensation from referral arrangements, etc.).