

# IIROC NOTICE

**Rules Notice**  
**Guidance Note**  
Dealer Member Rules

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## **Borrowing for Investment Purposes – Suitability and Supervision**

Borrowing-to-invest is a strategy that may be employed to enhance potential returns in investment portfolios, but it involves more risk than paying for an investment outright with cash. The use of borrowed money will magnify losses in situations where the value of the investments decline. Whether the investment makes money or not, the investor must still pay back the money plus interest. The use of borrowed money in retail investor accounts is, therefore, an important investor protection issue for IIROC and we remind dealers to ensure that clients are made aware of all of the potential risks and costs before borrowing-to-invest.

IIROC's Business Conduct Compliance examination unit has found an increasing number of cases where inappropriate borrowing-to-invest strategies<sup>1</sup> are being used by 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 on-book and off-book debt servicing obligations that clients had taken on as a consequence of borrowing money to invest.

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<sup>1</sup> For the purposes of this guidance "borrowing-to-invest strategies" includes any strategy where the client borrows money to invest, including strategies where other client assets are used to secure the client loan.



## **Suitability**

Any time a borrowing-to-invest strategy is recommended by a Registered Representative or a Dealer Member, or the Registered Representative or Dealer Member becomes aware that borrowed money is to be used or is being used by a client, that recommendation or usage is subject to the supervision and suitability requirements under IIROC rules.

As noted in IIROC's Guidance Note on the "know your client" and suitability obligations<sup>2</sup>, issued in conjunction with the implementation of the Client Relationship Model:

"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 borrowing-to-invest strategy is suitable for the client, based on their individual needs and financial objectives, the Dealer Member must fully disclose the risks associated with using borrowed money to invest. To ensure that a client fully understands both the positive and the negative aspects of the borrowing-to-invest 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
- use of a borrowing-to-invest strategy could result in far greater losses than an investment strategy that does not involve the use of borrowed money.

## **On-book and off-book borrowing**

Clients may engage in borrowing-to-invest 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, or that a client has used a borrowing strategy, the Registered Representative and the firm have a responsibility to ensure that suitability and supervision 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 (IIROC Dealer Member Rule 100). In the case of

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<sup>2</sup> IIROC Rules Notice 12-0109 issued on March 26, 2012.



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. Firms approved to provide order-execution only services must not advise on or promote the use of borrowing-to-invest strategies, nor engage in referral activities to lenders. In the case of advisory accounts, on-book client borrowing must be determined to be suitable for the client before a margin account is opened and any loans are extended. 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 borrowing-to-invest strategy where the loan is to be obtained from a third party. Such off-book borrowing situations 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 loans 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 loans not recommended by the Registered Representative. IIROC staff are aware that where an off-book loan is instigated solely by the client, these situations can be very difficult to detect and/or supervise, particularly in cases where the client denies the existence of the loan. IIROC staff are not expecting a Dealer Member to have an expansive compliance framework in place to identify and monitor off-book loans where no recommendation is made and the loan is instigated solely by the client and not disclosed to the Registered Representative and/or the Dealer Member. Dealer Members and their Registered Representatives should not, however, ignore situations where the existence of:

- an off-book loan comes to light during a communication with the client, including when the client's "know your client" information is being collected/updated; or
- a "red flag"<sup>3</sup> indicates that the client may be using borrowed money to invest.

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

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<sup>3</sup> This Guidance Note sets out best practices to identify these "red flag" situations and the questions to ask clients when "red flags" are identified.



- written disclosure of the essential terms of the agreement as required in NI 31-103 (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 for borrowing-to-invest strategies***

#### *Where the strategy is recommended*

IIROC expects all Dealer Members to have sound policies and procedures for 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 client lending supervision policies and procedures address all aspects of suitability: loan 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 borrowing-to-invest strategies where a recommendation is made, 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 lending activity of their Registered Representatives.

#### *Where the strategy is not recommended*

IIROC staff are not expecting a Dealer Member to have an expansive supervisory framework in place to identify and monitor off-book loans where no recommendation is made and the loan is instigated solely by the client and not disclosed to the Registered Representative and/or the Dealer Member. Supervisors and other individuals with supervisory responsibilities should not, however, ignore situations where the existence of:

- an off-book loan comes to light during a supervisory review of the client account, including any during any review of the client's "know your client" information; or
- a "red flag"<sup>4</sup> indicates that the client may be using borrowed money to invest.

### ***Compliance and supervisory regime objective***

Having sound policies, procedures and controls together with an effective supervisory regime will create an environment where borrowing-to-invest strategies are properly assessed and approved,

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<sup>4</sup> This Guidance Note sets out best practices to identify these "red flag" situations and the questions to ask clients when "red flags" are identified.



where appropriate, and where unsuitable borrowing-to-invest strategies are detected and prevented.

Further guidance for Registered Representatives and for Dealer Members, respectively, is set out in Appendices “A” and “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 lending practices. In particular, staff will be examining situations where off-book lending is being recommended, 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 a client using borrowed money to invest.
- Registered Representatives must continually update their knowledge and training to ensure a sufficient understanding of the products, borrowing-to-invest strategies and the associated risks.
- Registered Representatives should apply their education and training in a thorough and meaningful discussion with the client about borrowing-to-invest strategies.
- Registered Representatives should properly document any recommendations they make regarding the use of a borrowing-to-invest strategy.

#### Making Specific Leverage Recommendations

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

- Has the Registered Representative:
  - collected sufficient information about the proposed loan, including amount and term of the loan, loan interest rate and the securities/assets to be used as collateral for the loan?
  - determined on a pro-forma basis the impact on the proposed loan on the client’s financial situation?
  - determined that the loan arrangement is suitable, and, if not, informed the client that they do not believe the loan arrangement to be suitable for the client and/or, in the case of a proposed Dealer Member loan, refused to advance the loan to the client?
  - provided the client with and received client acknowledgement of receipt of the leverage risk disclosure statement or equivalent margin account agreement disclosure pursuant to Dealer Member Rule 29.26?
- In determining the impact of the proposed loan on the client’s financial situation and in determining the suitability of the proposed loan, has the Registered Representative considered:
  - how the client’s total monthly debt service costs (taking into account the proposed loan), combined with the client’s other monthly expenses, compares to the client’s monthly income?



## **Appendix “A”**

- how much the client’s total debt level (taking into account the proposed loan) will impact on the client’s overall debt to net worth leverage ratio?
- whether the resultant client’s overall debt to net worth leverage ratio (taking into account the proposed loan) is appropriate for the client?
- whether other client assets are to be used to secure the loan and, if so, whether the client fully appreciates the encumbrance placed on these other client assets?
- in the case of a proposed third party or “off-book” loan, whether the proposed loan involves higher leverage than is permissible “on-book” under IROC margin rules?



## Appendix “B”

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

#### *Minimum Controls*

The following are minimum controls that Dealer Members should have in place to identify and supervise the use of borrowing-to-invest strategies:

- Procedures designed to reasonably ensure that client accounts with positions financed by loans, can be identified and are subject to an account supervisory review:
  - Accounts with investment product positions that are financed by on-book and/or off-book loans (including situations where the Dealer Member or Registered Representative subsequently becomes aware of the use of an off-book borrowing-to-invest strategy), should be readily identifiable for supervisory review purposes.
  - The applicable Supervisor responsible for client account supervisory reviews should conduct specific reviews of accounts where investment product positions are financed by on-book and/or off-book loans.
- Procedures for the maintenance of the evidence of supervisory review.
- Procedures to ensure that accounts that include positions financed by any disclosed or identified third-party loans 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 leveraged strategies*

With respect to undisclosed off-book loans, Dealer Members should have in place procedures to identify red flags that may indicate the existence of off-book client loans 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 the client’s “know your client” information, 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 loans.
- Client complaints relating to the use of a borrowing-to-invest strategy.





## Appendix “B”

### Best Practices

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

- Developing a borrowing-to-invest suitability checklist, or a similar document, to detail the appropriate client circumstances that might support the use of a borrowing-to-invest strategy.
- Developing procedures to periodically assess the financial performance and the ongoing suitability of accounts that use a borrowing-to-invest strategy and noting the steps to be followed for borrowing-to-invest accounts that have become unsuitable (advising the client, etc.). This should include a more enhanced/frequent review during periods of volatile market conditions.
- Developing detailed guidance for Registered Representatives to help ensure that they explain all risks before recommending or accepting the use of a borrowing-to-invest strategy and requesting that clients provide an acknowledgement that the risks have been explained and are understood.
- Including a process for specifically reviewing borrowing-to-invest 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 the use of an off-book borrowing-to-invest strategy by their clients; and/or
  - requiring that all off-book borrowing-to-invest strategies (new loans or re-financings) be pre-approved by the firm.
- Including a review of lending practices at prior firms as part of the due diligence process performed regarding prospective Registered Representatives.
- Requesting that approved lenders provide reports of the lending business on record involving firm Registered Representatives.
- Reviewing third-party remuneration captured in Dealer Member records for trends indicative of lending practices.