

# IIROC NOTICE

**Rules Notice**  
**Request for Comment**  
Dealer Member Rules

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**Notice 14-0043**  
**February 19, 2014**

## **Summary of comments received on the draft guidance regarding Borrowing for Investment Purposes – Suitability and Supervision**

On July 4, 2012, the Investment Industry Regulatory Organization of Canada (“IIROC”) issued a draft guidance note for public comment entitled “*Borrowing for Investment Purposes – Suitability and Supervision*” (IIROC Rules Notice 12-0208).

This summary responds to the 12 comment letters we received relating to the draft guidance note. We have considered the comments received and we thank all the commenters for their submissions. The comments specific to the guidance note have been summarized to correspond with the major themes of the guidance note, followed by staff’s response. Guidance Note 14-0044 has been amended as necessary to address the public comments we received.

### **We received the following comments regarding Suitability and Supervision**

One commenter stated that, during these volatile times (and in a period of low interest rates and returns), there is no reasonable basis for an advisor to conclude that a highly leveraged sale of investment product is suitable for any but the most sophisticated investor with a high tolerance for risk. The same commenter indicated that there should be 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.

***IIROC staff response***

Under IIROC Rules, the Dealer Member and its Registered Representatives have an obligation to ensure they comply with their suitability obligations, as set out in the IIROC rules. The suitability requirement is complementary to the statutory duty to act fairly, honestly and in good faith with clients. These duties include 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 are also suitable for the client. The determination of suitability depends on the specific client and the individual circumstances relating to such client. IIROC expects Dealer Members and Registered Representatives to provide proper disclosure of the risks associated with leveraging and to ensure that each client fully understands the risks associated with the use of a leveraging strategy.

One commenter suggested that IIROC prepare and promote an investor brochure on the risk of leveraging, using contemporary communication channels, including social media.

***IIROC staff response***

IIROC is working on a strategy for investor education as a corporate initiative and will be distributing investor education materials in the coming year. Borrowing to invest and other topics that are important and relevant to the investing public will be included in such materials.

Two commenters questioned the need for the best practice of requesting a client provide an acknowledgement that the risks have been explained and are understood, while two commenters were in favour of having registrants and supervisors certify that this has been done.

One commenter requested clarification on whether the acknowledgement by clients is to be in written form.

Lastly, one commenter requested that IIROC create a template for disclosure on the risks of leveraging.

***IIROC staff response***

IIROC Rule 29.26 currently requires that leverage risk information be provided to clients, either in the form of a leverage risk disclosure statement or as part of any margin account agreement entered into with the client. In addition to this written disclosure, IIROC is recommending that Registered Representatives provide their clients with a thorough explanation of the risks of leverage and obtain client acknowledgement that the risks have been explained and that they have understood such risks. IIROC believes that a positive client acknowledgment is more effective than a notation in the client file by the Registered Representative and is consistent with good business practice to ensure that the client is making a fully informed decision before undertaking a leveraging strategy. Examples of positive client acknowledgment include a written client signature, a documented phone conversation or an email or letter from the client, etc.



Several commenters suggested that IIROC prescribe minimum standards for registrants in assessing the suitability of leverage, and provide standardized “know your client” documents which clearly identify criteria in a leveraging to invest section.

***IIROC staff response***

IIROC’s suitability requirement includes an analysis of current “know your client” information any time a leveraged strategy is being considered and/or recommended.

It is IIROC’s expectation that Dealer Members will develop their own risk disclosure statements on leveraged investing, and their own approaches to collecting and documenting “know your client” information, depending on the nature of their business and their business model. IIROC will soon release for comment a separate draft Guidance Note setting out “*Best Practices for meeting your “know your client” obligations*”.

Two commenters requested clarification on the loan procedures and minimum controls that would apply to an order execution only Dealer Member for which there is no suitability assessment obligation.

***IIROC staff response***

The guidance note states “In the case of order-execution service accounts, for which there is no suitability assessment obligation, the amount of on-book borrowing is restricted by IIROC’s margin rules.” Order execution only firms do not provide investment advice and are, therefore, exempt from the suitability requirement. Registered Representatives of order execution only firms who service clients should not be providing advice on leveraged investing strategies. The extent to which order execution only firms promote and/or facilitate “off book” leveraging strategies through their websites (including those of their affiliates) or other means will be subject to a compliance review by IIROC to be undertaken within the next year. The results of the review will identify any gaps in this area and will inform future policy development.

One commenter suggested that IIROC require Dealer Members with high volumes/random peaks to utilize commercially available suitability assessment software.

***IIROC staff Response***

All Dealer Members must have adequate supervision and compliance systems in place to identify, monitor and/or prevent potential violations of IIROC Rules and applicable securities laws. IIROC’s regulatory approach recognizes that there are different ways to implement an effective supervision, compliance and risk management framework depending on the size of the firm, the nature of its business and its business model. It would be inappropriate, therefore, for IIROC to mandate the use of specific policies, processes and/or software.

Several commenters suggested that the guidance note be revised to indicate that a Dealer Member should have policies and procedures that are designed to reasonably detect off book leveraging given that a client may choose not to disclose that the funds are leveraged.



***IIROC staff response***

IIROC believes that Dealer Members who adopt the practice of:

- asking clients whether they have borrowed money in the past or intend to borrow money in the future, to fund the purchase of investment products;
- documenting the client’s responses; and
- providing fulsome disclosures to the client and explanations of the risks of leveraging have adopted best practices.

**We received the following comments regarding Supervisory Framework**

One commenter stated that any representation by a Registered Representative that the leveraged purchase of mutual funds, structured products and other high-fee investment products is a suitable investment be accompanied by adequate and proper analysis along the lines outlined in IIROC’s Guideline on Best Practices for Product Due Diligence. The same commenter expressed concerns about the lending practices of some financial institutions.

***IIROC staff response***

The guidance note indicates that Dealer Members that have 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.

IIROC expects a Dealer Member’s policies and procedures to set out how it will evaluate the risks related to particular recommendations, how suitability will be assessed and how evidence of supervision of the suitability assessment will be documented and maintained.

IIROC does not intend to prescribe the type of analysis to be undertaken by the Dealer Member and/or the Registered Representative in a suitability assessment. The guidance note sets out the factors to be considered, including the proposed loan debt amount, the client’s ability to service the debt, the associated investment product fees, the loan terms and conditions and potential market volatility.

One commenter states that current IIROC Rules allow Dealer Members to use a risk based supervision method which would not necessarily include a review of margin recommendations or of a client’s personal borrowings.

***IIROC staff response***

IIROC’s Client Relationship Model guidance (issued as Rules Notice 12-0108 on March 26, 2012) states: “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.” [emphasis added] This obligation extends to both on-book and off-book borrowing.

It is not IIROC’s intention to prescribe how a Dealer Member implements a supervision



framework. IIROC Business Conduct Compliance Department staff will conduct regular on-site examinations to determine whether the Dealer Member’s supervision framework is effective in detecting, monitoring and/or reporting unsuitable leveraging strategies for clients.

### **We received the following comments regarding Registered Representative Obligations**

One commenter recommended that only Registered Representatives with the necessary education, professional qualifications and a least five years’ experience be permitted to recommend a leveraging strategy.

The same commenter recommended that IIROC adopt a “client first” fiduciary standard for those Registered Representatives authorized to recommend leveraging.

Another commenter suggested that IIROC require independent legal advice be obtained when a home is to be used as security for leveraged investing.

#### ***IIROC staff response***

The guidance note sets out IIROC’s expectations and suggested best practices relating to existing requirements in IIROC Rules, including those recently amended to implement the Client Relationship Model.

All IIROC Registered Representatives must meet high standards of proficiency and conduct. Once satisfied, these proficiencies (which include an education component) qualify the registrant as a financial services professional. The guidance note sets out the expectation that Registered Representatives understand the consequences of recommending leveraged strategies, continually update their knowledge and training, have meaningful discussions with clients in which they discuss both the positive and negative consequences of leverage and properly document any recommendations they make with respect to the use of a leveraged strategy. IIROC does not believe that imposing a minimum experience requirement is appropriate in these circumstances.

### **We received the following comments regarding making specific leverage recommendations**

Three commenters questioned the feasibility of a Registered Representative reviewing a client’s total debt servicing ability, citing lack of expertise or access to required information to determine whether an off-book loan is appropriate for a client.

#### ***IIROC staff response***

All Dealer Members’ policies and procedures should provide that where a registrant is not able, for whatever reason, to adequately assess whether a leveraging strategy is appropriate (which includes a review of the client’s total debt servicing ability), that strategy should not be recommended.

One commenter suggested that requiring a full review of client financial information for loans would also decrease the misuse of this (leveraging) investment strategy.



Another commenter requested that IIROC require Dealer Members analytically assess the risks of leveraged investing within a portfolio context.

***IIROC staff response***

The guidance note provides best practices that may assist Registered Representatives in their review of a client’s debt service costs and debt servicing ability. These, together with the information gathered while satisfying their “know your client” obligations, serves as a basis for understanding the client’s individual situation and satisfying the suitability assessment obligation for leveraging strategies.

One commenter stated that it is critical to carefully review a client’s exposure to leverage by evaluating the client’s leverage-to-liquid net worth ratio, and that it would be beneficial to stipulate minimum margin standards or an alternative measure, such as a minimum allowable debt service ratio, in all situations involving leverage.

This same commenter stressed the importance of mandating and monitoring debt ratios, particularly those involving some mortgage products, such as “all in one accounts”, where a retail client’s assets and liabilities (including credit card debt, mortgages, investment loans, etc.) are bundled into one account.

***IIROC staff response***

We agree with the commenter on the need for the Dealer Member and its Registered Representatives to fully understand each client’s specific financial situation, including the debt levels that client is assuming and the need to explain to each client the consequences of a “borrowing to invest” strategy before it is undertaken.

Three commenters stated that it would be challenging for Registered Representatives to obtain a copy of the client’s completed loan documents as clients would likely not agree to provide such documents.

One commenter indicated the perceived difficulties with the best practice of requesting approved lenders provide reports of the leveraging business on record involving Dealer Member advisors.

***IIROC staff response***

We agree with the commenters that in many cases the Registered Representative may not be able to obtain copies of loan documents or loan reports. We have removed these suggested best practices from the revised guidance note.

It is essential, however, in order to remain informed of the essential facts relevant to each client, for the Registered Representative to obtain sufficient information about any proposed loan. The information collected should include the amount and term of the loan, the loan interest rate and the securities/assets to be used as collateral for the loan. The guidance note has been revised to reflect this expectation.



## **We received the following comments regarding minimum controls**

One commenter indicated the proposed guidance may require a significant and costly system change to identify off-book leveraged accounts.

Another commenter indicated that it could be potentially problematic to properly identify both on-book and off-book leveraged accounts for supervision purposes. In order to comply with this expectation, Dealer Members would need to develop a reliable process to identify these accounts and flag them through the use of unique coding or account number identifiers. It is very likely that this process will need to be manual in nature, and as a result, may not be effective in meeting IIROC's expectations.

### ***IIROC staff response***

It is our understanding that IIROC Dealer Members currently have the capability of identifying on-book loans on an account-by-account basis. While it may be more efficient over time for firms to develop systems to automate the aggregation of client-by-client on-book and off-book loan amounts, other approaches, such as regular updates to the "know your client" information collected from the client relating to client's financial situation, could be used as a reliable method of keeping up-to-date actual client debt and leverage levels. IIROC is flexible in how the Dealer Member implements an effective compliance and supervision framework, depending on the extent of this activity, the nature of its business and its business model.

One commenter stated that current standards for retail account supervision do not require the Chief Compliance Officer to personally conduct any specific review as this can be delegated to a supervisor.

Two other commenters indicated that the guidance note implies the Chief Compliance Officer plays a supervisory role which may not be the case in a larger firm where the Chief Compliance Officer mainly has an oversight role.

### ***IIROC staff response***

We agree that the Chief Compliance Officer is not required to personally conduct client account supervisory reviews and it was not IIROC's intention to imply that the Chief Compliance Officer plays a supervisory role. We have changed the language in the guidance note to refer to the "Supervisor responsible for client account supervisory reviews".

Two commenters stated that IIROC's expectation that all client accounts using a leveraging strategy be identified and subject to a suitability review is worded too broadly. These commenters recommended that this statement not encompass all client accounts.

### ***IIROC staff response***

We have changed the language in the guidance note to clarify that all client accounts using a leveraged strategy should be readily identifiable for supervisory purposes and subject to a suitability review. The guidance note speaks to different supervisory frameworks where leveraging might be recommended and where the Dealer Member may become aware of a





leveraging strategy in a client account.

### **We received the following comments regarding Red Flags**

One commenter requests clarification on whether Dealer Members are expected to have a process in place to identify the red flag of communications from lending institutions to Registered Representatives.

#### ***IIROC staff response***

The “red flags” list included in the guidance note is neither exhaustive nor mandatory.

One commenter suggested that the guidance note be revised to provide a safe harbor for the conservative use of leveraging in clearly defined circumstances. (i.e. the use of “green flags”)

#### ***IIROC staff response***

The suitability of a leveraged strategy is case specific. For that reason, IIROC cannot set out specific scenarios where leveraging is either suitable or unsuitable for all clients.

One commenter suggested that if the referral arrangement was approved by the Dealer Member in accordance with National Instrument 31-103, then the Dealer Member would be aware of it and it would not be a red flag. Further, if a Registered Representative had a referral arrangement in place that was not in accordance with National Instrument 31-103, the Dealer Member would have difficulty discovering it and identifying it as a red flag.

#### ***IIROC staff response***

Staff believes that if a Registered Representative is receiving referral fees from lending institutions, the Registered Representative has the financial incentive to recommend leveraged strategies to his/her clients. This “red flag” should, therefore, be investigated by the Dealer Member to determine whether or not the Registered Representative has recommended a leveraging strategy to his/her clients and, if so, whether the clients have been advised of the risks involved, whether suitability has been properly assessed in each case, and whether the leveraged accounts are properly supervised. The Dealer Member and its Registered Representatives must comply with their suitability obligations in addition to complying with the referral arrangement requirements set out in National Instrument 31-103.

### **We received the following comments regarding Best Practices**

One commenter requested a review of the propriety of contractual relationships between investment fund companies, financing companies and registrants as these relationships may encourage the avoidance of compliance with suitability and other obligations of registrants.

#### ***IIROC staff response***

The guidance note recommends that Dealer Members establish procedures for the approval of Registered Representatives’ outside business activities and referral arrangements in order to identify arrangements that Registered Representatives may have with lenders. In addition, where conflicts of interest arise, IIROC Dealer Member Rule 42 requires that:





- a Dealer Member manage the conflicts of interest in a manner that considers the best interests of its clients; and
- a Dealer Member’s Registered Representatives manage the conflicts of interest in a manner that is consistent with the best interest of its clients.

In the near future, IIROC will be implementing enhancements to its rules that will require that all Registered Representative outside business activities, including referral arrangements, be approved in advance by their Dealer Member. This rule enhancement should assist Dealer Members in identifying “off book” loan referral arrangements initiated by their Registered Representatives.

Two commenters questioned the need for procedures to be developed to periodically assess the financial performance and ongoing suitability of leveraged accounts.

One commenter suggested that the guidance note address a Dealer Member’s responsibility to periodically review the amount of leverage during volatile market conditions.

***IIROC staff Response***

These best practices are offered as guidance to those who must comply with the suitability requirements relating to leveraged accounts.

We have changed the guidance language to indicate that where the leveraged strategy was recommended or where the Dealer Member becomes aware of the use of a leveraged strategy, the Dealer Member should develop procedures to periodically assess the financial performance and the ongoing suitability of the account and note the steps to be followed for leveraged accounts which have become unsuitable (advising the client, etc.) Further, IIROC encourages Dealer Member to adopt processes that would result in the appropriate enhancement of account reviews during volatile market conditions.

One commenter questioned the best practice of reviewing leveraging practices at prior firms as part of the due diligence process performed regarding prospective Registered Representatives.

***IIROC staff response***

Where a Registered Representative is joining a new firm, IIROC is recommending that the new firm conduct appropriate due diligence on whether or not the Registered Representative recommends the use of leveraged strategies to his/her clients in order to determine the extent of supervision that is appropriate for the Registered Representative at his/her new firm.

One commenter expressed concerns with the best practice of including a process for specifically reviewing leveraged accounts as part of the member’s business location examinations and stated that IIROC Dealer Member Rule 2500 sets out a tiered system of post trade activity reviews and describes that the first level review should be conducted by a supervisor at each business location of the firm.



***IIROC staff response***

IIROC Dealer Member Rule 38.1(vi) states that Dealer Members must have procedures for follow-up and review to ensure that supervisory personnel are properly executing their supervisory functions. Where the supervision is conducted and supervisory records are maintained at a business location, the follow-up and review procedures are to include periodic on-site reviews of location supervision and record-keeping, as necessary, depending on the types of business and supervision conducted at each location.

Two commenters stated that IIROC should require Dealer Members to provide monthly/quarterly client statements that provide costs incurred (including loan interest expense) and personal performance rates of return for each account.

***IIROC staff response***

Account performance reporting and account fee/charge obligations have not yet been finalized but will be included in the Client Relationship Model rule amendments in due course. Dealer Members cannot be held responsible for disclosing costs for all loans, given that in the case of “off book” loans, they are not the lender in question and do not possess that information.

**We received the following comments on Advertising**

Three commenters discussed the need to either tighten up the oversight over or have more stringent rules governing the use of marketing materials, advertisements and free lunch seminars with respect to leveraging.

***IIROC staff response***

Review and supervision of these materials and activities is already covered in IIROC Rule 29.7 and IIROC Rules Notice 11-0349.

One commenter stated that IIROC should strengthen the language and prominence of warnings on loan agreements.

Another commenter suggested that IIROC establish a minimum font size and encourage large font and braille formats for loan disclosure documents.

***IIROC staff response***

IIROC does not regulate lending institutions and is, therefore, not in a position to impose either of these suggested requirements.

One commenter suggested that IIROC increase the penalty schedule for unsuitable investments, excessive leverage and false/misleading marketing and sales documents.

***IIROC staff response***

IIROC Rule 1300 .1 requires Dealer Members to use due diligence to ensure that every recommendation is suitable for the client. Rule 29.7 states (among other things) that no Dealer Member shall issue to the public any advertisement, sales literature or correspondence that contains any untrue statement or omission of a material fact or is otherwise false or misleading.



IIROC staff recognizes that unsuitable leveraging strategies can result in serious harm to investors. IIROC enforcement staff will examine the facts in each case before recommending sanctions to an IIROC Hearing Panel. The recommended sanction will reflect a number of factors, which differ in each case.

### **We received the following comments on fines and discipline**

One commenter suggested that IIROC hold Dealer Members accountable for all fines and costs levied on representatives and vigorously collect fines.

This same commenter also suggested that IIROC use penalty money to finance independent research on the best ways to regulate leveraged investing and to study retail investor behavior and finance issues related to borrowing to invest and advised IIROC to include victim impact statements in settlement agreements.

#### ***IIROC staff response***

The collection and use of fines and costs and the settlement agreement process are outside the scope of the guidance note.

### **General Comments**

One commenter indicated that the guidance note did not “go far enough”, while two commenters indicated that the guidance note was too prescriptive and should be more principles based. Two commenters also suggested that IIROC was attempting to effect rule change through the issuance of guidance notes, while one commenter suggested that all the best practices contained within the guidance note should be mandatory.

#### ***IIROC staff response***

The guidance note sets out IIROC’s interpretation, expectations and suggested best practices relating to IIROC’s existing rule requirements dealing with suitability and the supervision of leveraged accounts. We believe that the guidance note strikes an appropriate balance between providing Dealer Members and their Registered Representatives with sufficient detail in order to assist them in meeting their regulatory obligations, while allowing a sufficient degree of flexibility to accommodate differences in business practices and business models.

One commenter indicated that IIROC may wish to consider undertaking reviews of its Dealer Members to determine the extent and form of leveraged investing, relationships with off book loan providers, marketing and advertising.

#### ***IIROC staff response***

As indicated in the guidance note, IIROC’s Business Conduct Compliance Department, as part of its examination process, will focus 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.

One commenter indicated that IIROC should mandate the use of proper representative titles.



***IIROC staff response***

This is outside the scope of this guidance note and has been addressed in a recently issued proposed guidance note entitled “*Use of Business Titles and Financial Designations*” (Rules Notice 13-0005 issued on January 8, 2013).