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Dear Mr. Yassi:

RE: Draft Guidance regarding Borrowing for Investment Purposes - Suitability and Supervision

We are writing in response to the Investment Industry Regulatory Association of Canada's (IIROC's) Request for Comment on its draft guidance regarding Borrowing for Investment Purposes – Suitability and Supervision.

Advocis: Who We Are

Advocis, The Financial Advisors Association of Canada, is the oldest and largest voluntary professional membership association of financial advisors in Canada. Through its predecessor associations, Advocis proudly continues a century of uninterrupted history of serving Canadian financial advisors, their clients, and the nation. With over 11,000 members organized in 40 chapters across Canada and almost 6,200 in Ontario, Advocis serves the financial interests of millions of Canadians.

As a voluntary organization, Advocis is committed to professionalism among financial advisors. Advocis members adhere to an established professional Code of Conduct, uphold standards of best practice, participate in ongoing continuing education programs, maintain appropriate levels of professional liability insurance and put their clients' interests first.

Across Canada, no organization's members spend more time working one-on-one on financial matters with individual Canadians than do ours. Advocis advisors are committed to educating clients about financial issues that are directly relevant to them, their families and their future. Almost all Advocis members are regulated under provincial securities commissions, and many are employed by IIROC members.

Comments

Advocis welcomes IIROC's attempt to articulate guidance for its Member Dealers and their representatives that is aimed at ensuring that leveraging practices and investments that are made with borrowed funds are suitable for the client.

We believe that borrowing for the purposes of investment can be entirely appropriate and beneficial for the client, facilitating suitable investments. However, borrowing can increase the client's "downside" as well as their "upside."

Borrowing that is recommended by the representative tends to increase the representative's compensation while increasing the client's risks (and potential benefits), and leads to the representative's personal interest and the best interest of the client being out of alignment. Abuses may occur because the representative's recommendation to implement a leveraging strategy is influenced by the representative's self-interest. As well, some suitable leveraging strategies may be adopted in circumstances where the client has not been informed of and does not understand the risks of the leveraging.

Dealer representatives should make sure that recommended leveraging strategies and the investments that their clients make with borrowed money are suitable, and that their clients understand the risks and the conflict of interest.

Dealers should supervise their representatives with the goal of ensuring suitability in mind: to make sure that recommended leveraging strategies and the investments that their clients make with borrowed money are suitable, and that their clients understand the risks.

Three categories of leveraging

We note that client borrowing to invest can be usefully categorized as follows:

1. "On book" leveraging that is recommended by the representative;

2. "Off book" leveraging that is recommended by the representative; and

3. "Off book" leveraging that is not recommended by the representative and not necessarily disclosed by the client.

The Dealer and their representative have a duty to make sure that the borrowing that their client engages in for the purposes of investing through the Dealer is suitable. The Dealer and the representative also should take into account any "off book" borrowing by the client that they become aware of, even if it is not recommended by the Dealer or the representative and is not expressly disclosed to them by the client.

We note in our comments below that the first two categories of leveraging are more amenable to oversight and to consistent application of the guidance than the third.

Our comments below under the headings "Undisclosed off-book leverage" and "Appendix B: Procedures to identify red flags" outline some of our concerns with regard to the third category of leveraging.

Impact on client access to leveraging

The draft guidance could have the effect of limiting client access to suitable, conservative leveraging strategies. (We note that we do not mean by "conservative leveraging", leveraged investment in products that are described as "conservative investments.") No matter how suitable and potentially useful some leveraging strategies might be in helping clients to achieve their financial goals, the guidance could result in leveraging being too much trouble and bringing too much potential liability for the Dealer to implement with all but the wealthiest clients. The guidance may send the message to Dealers and to representatives, that recommending leveraging strategies to clients is a potential source of regulatory risk to the Dealer and to the representative. Helping clients to use leveraging strategies could put a black mark on a representative's employment record, and hiring representatives who have experience with leveraging strategies could magnify a Dealer's risk of regulatory problems and lawsuits.

We presume that deterring the use of leverage is intended, and is "a feature, not a bug" of the guidance. If it is the aim of IIROC or of the senior securities regulators that help to shape SRO regulatory policy to deter the use of leveraging strategies generally, on the basis that the risks exceed the benefits, we believe that should be acknowledged and the merits of deterring the use of leverage as a goal of the guidance should be discussed openly.

"Green flags" and safe harbor

We suggest that the guidance should be revised to provide a safe harbor for the conservative use of leveraging in clearly defined circumstances. This might be done by listing conditions or situations that may generally be taken as indicating that leveraging is likely to be suitable; "green flags" that permit the Dealer and the representative to proceed with a suitable, conservative leveraging strategy without having to worry unduly that an IIROC auditor or a client's lawyer will demand that they justify the leveraging after a market decline.

What might amount to "green flags"? Here are plausible "conservative" green flag criteria for establishing a safe harbor for leveraging:

- Where the client's borrowing for investment
    a. Is fully disclosed;
    b. the investments are moderate or low-risk; and
    c. does not exceed the lesser of $50,000 or 20% of the client's net investible assets (excluding real estate).

Undisclosed off-book leverage

Advocis agrees with the direction of the draft guidance with regard to undisclosed off-book leverage that places an onus on the Dealer and the representative to be on the lookout for such leverage.

Suitability of investment recommendations is at the core of the Dealer's obligation to the client, and borrowing for the purposes of investing multiplies the risks to the client as well as the potential benefits - to the Dealer, the representative and the client - of an investment decision. It makes no difference to the issue of suitability, whether the funds are lent to the client by the Dealer or by a third party, nor whether the client has disclosed the leveraging to the Dealer or has not done so. If the Dealer is aware of the leveraging, they are reasonably expected to take

that into account in assessing suitability. The borrowing will be relevant to the assessment of suitability, whether or not the borrowing is disclosed to the Dealer.

Thus we agree with the following draft guidance:

> Whether or not the borrowing is through margin loans advanced by the dealer or third party loans, "(i)n 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."

However, the draft guidance begs the question as to how far the Dealer should be expected to go in order to ferret out information about borrowing by the client from third partie, for the purposes of investment that the client has not voluntarily disclosed.

The draft guidance states:

> 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

We agree that the Dealer and its representatives should be alert to red flags that suggest the possibility of undisclosed off-book leverage.

We think it would be unfortunate and excessive and even unfair if a client were to sue their Dealer and representative or pursue a claim through the Ombudsman for Banking Services and Investments or analogous complaint resolution mechanisms, arguing that the Dealer should have had better controls and should have minded red flags that would have enabled them to identify the client's undisclosed off-book leverage that made their investment through the Dealer unsuitable. We are concerned that the draft guidance could lead to such a perverse result.

Instead of imposing a vague requirement of vigilance, it may be more effective to simply require the Dealer and their representative to ask the client whether they have borrowed any of the funds that they propose to use to purchase an investment, and to document the client's response in writing. Thus, if the client does disclose the borrowing, the Dealer will be able to assess suitability in light of the borrowing, and if the client fails to disclose the borrowing in response to a direct question, the Dealer may be afforded some protection from legal and regulatory liability.

We also would suggest that if IIROC is concerned about the possibility that clients may be leveraging their home equity in the course of their dealings with a financial intermediary without advising the IIROC dealer they deal with, that concern should be addressed explicitly. Perhaps the Guidance should recommend that clients be asked whether they have borrowed pursuant to a HELOC.

Appendix B: Procedures to identify red flags

The question that we raised above about how far the Dealer should be expected to go in its due diligence also arises with regard to Appendix B, Guidance for Dealer Members regarding supervisory policies and procedures relating to leverage.

The Guidance states that "Dealer Members should have in place procedures to identify red flags that may indicate off-book leverage." This suggests that the Dealer should constantly be engaged in forensic investigation of the client and of their own representatives. For example the Guidance cites the following examples of "red flags":

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- 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.

There seems to be no question that any of the above situations could raise red flags that the Dealer should pay attention to.

However, the question remains: How far should the Dealer be expected to go, to investigate possible undisclosed off-book leverage? Does guidance of this nature potentially open the Dealer and the representative to liability for failing to find out about and take into consideration off-book leverage that the client did not disclose?

We think it is excessive to expect the Dealer, at a supervisory level, to constantly monitor account activity quite so closely in order to ascertain whether the client has engaged in borrowing for the purposes of investment that the client has not disclosed.

Appendix B: Best Practices

Appendix B sets out "some best practices that Dealer Members should consider in developing and implementing supervisory controls."

The suggested best practices include the following that involve investigating the representatives' activities:

- Developing procedures for the approval of Registered Representatives' outside business activities with a view to capturing activities involving third party lenders
- 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.).

Once again, we believe the expectation that the Dealer at a supervisory level should constantly be in “investigation mode” with regard to its Registered Representatives’ involvement in leveraging that has not otherwise been disclosed, including such involvement in prior employment, is excessive.

It is not difficult to imagine circumstances where a client whose leveraged investment has suffered a loss, would seek to have the Dealer held liable to compensate them for the loss due to the Dealer’s inability to establish that they undertook an adequate review of a representative’s leveraging practices at a prior firm.

Advocis appreciates this opportunity to provide comments on IIROC’s Request for Comment on its draft guidance regarding Borrowing for Investment Purposes – Suitability and Supervision. Should you have any comments or questions, please do not hesitate to contact the undersigned, or contact Ed Skwarek, Vice President Regulatory and Public Affairs at eskwarek@advocis.ca, or by calling 416-342-9837.

Sincerely,

Greg Pollock, M.Ed., LL.M., C.Dir., CFP
President and CEO

Dean Owen, CLU, CH.F.C.
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