



Michelle Alexander
Director, Policy

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Mr. Joe Yassi
Vice-President, Business Conduct Compliance
Investment Industry Regulatory Organization of Canada
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Toronto, Ontario M5H 3T9
Email: jyassi@iroc.ca

DELIVERED VIA EMAIL

Dear Mr. Yassi:

RE: Request for Comments on Draft Guidance Note “Borrowing for Investment Purposes – Suitability and Supervision” (the Notice)

The Investment Industry Association of Canada (IIAC or Association) appreciates the opportunity to respond to the Notice issued for comment by the Investment Industry Regulatory Organization of Canada (IIROC).

The IIAC formed a Working Group to assist in developing this submission and we would like to highlight some areas in the Notice that we recommend should be amended or clarified.

The IIAC appreciates that IIROC has developed guidance and best practices regarding clients of member firms that employ a leverage strategy. However, we have concerns primarily related to the supervision requirements surrounding “off-book borrowing”, whereby clients borrow money from third parties rather than employing margin loans or other financing methods available through the member firm.

In particular, the IIAC has concerns with the following expectations set out in the Notice:

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.

However, IIROC does go on to acknowledge that “these situations can be very difficult to detect and/or supervise.”

The concern arises when one then reviews the Appendices following the Notice, in particular with respect to Appendix B Guidance for Dealer Members regarding supervisory policies and procedures relating to leverage. The IIAC’s issues that we wish to discuss are set out below.

Minimum Controls

In general, with respect to off-book leverage loans, the IIAC finds the Appendix B as drafted to be too prescriptive, reading like a Rule as opposed to Guidance.

For example, Appendix B states that there are minimum controls that IIROC Business Conduct Compliance staff expect members to have in place, including “[p]rocedures to ensure that **all** client accounts utilizing a leverage strategy can be identified and are subject to a suitability review.” This minimum control is worded far too broadly given that IIROC states in the Notice that it recognizes the challenges to detect off-book leverage loans. The IIAC recommends that this statement should not encompass all client accounts.

Furthermore, the detailed supervisory checklist is extremely prescriptive, requiring that all accounts be readily identifiable and that the Chief Compliance Officer (CCO) should either conduct reviews of leveraged accounts personally or receive such reports from his or her delegates. This provision indicates that the CCO plays a supervisory role, which may be contrary to the Compliance mandate in many integrated firms. Compliance in these situations plays an oversight role only.

The Association is of the view that each member should have the latitude to determine how to comply with the Notice and whether it can leverage existing processes or develop new ones.

The need to identify all leverage loans will require significant and costly systems changes to identify both on-book (non-margin) and off-book leveraged accounts. Even if such systems were developed, flagging and capturing any non-margin leveraged arrangements will nonetheless be difficult. There is no reasonable way for members to effectively supervise off-book accounts, which are especially problematic to both detect at the onset and monitor on an ongoing basis. For example, how could an RRSP loan or a client using their personal line of credit be captured?

In addition, it could be potentially problematic to properly identify on-book accounts (other than margin) for supervision purposes. In order to comply with this expectation, 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.

Red Flags

The IIAC requests clarification regarding the red flag relating to communications from lending institutions. Members of our Working Group were not familiar with such an item and were unsure what sorts of communications it was referring to.

With respect to the red flag relating to referral fees paid to an advisor or the member by a lending institution, we found it somewhat problematic. If the referral arrangement was approved and set out in accordance with National Instrument 31-103, then the member would be aware of it and therefore it would be under supervision. As such, it would be not categorized as a "red flag". If, on the other hand, an advisor had a referral arrangement in place that was not in accordance with National Instrument 31-103, the member would have difficulty discovering it and identifying it as a red flag.

The Notice also identifies as a red flag correspondence found in client files suggesting the use of undisclosed leveraging, which suggests that members have a process in place for identifying this type of correspondence.

The Association believes that the Notice should be less prescriptive and we recommend instead that the Notice state that firms should have policies and procedures in place that can assist in detecting off-book leveraging in client accounts.

Best Practices

The IIAC questions the need for the best practice which requires that procedures should be developed to periodically assess the financial performance and ongoing suitability of leveraged accounts. We again reiterate that there is no reasonable or effective means for members to supervise off-book loan arrangements. In addition, firms currently are required to comply with suitability requirements for margin accounts and this is further codified by the requirements under the Client Relationship Model (CRM) and IIROC's Know-Your-Client and Suitability Guidance Note 12-0109 which specifically mentions the requirement to ensure that the method of financing the trade is considered in a suitability review. The CRM Rules require enhanced suitability reviews and suitability assessments upon certain trigger events, so we are unclear why procedures separate and apart from those already being developed under CRM are required in Appendix B.

Further, we question the need for the recommended best practice of requesting that a client provide an acknowledgement that the risks have been explained and are understood. The IIAC seeks clarification from IIROC as to whether clients are expected to provide a written acknowledgement of the risks associated with leveraged accounts. Currently, under Rule 29.26(1), members are required to provide clients with a Leverage Risk Disclosure Statement at the time an account is opened, when a recommendation is made to purchase securities using borrowed money or when the firm becomes aware of a client's intent to purchase securities using borrowed money. Rule 29.26 does not require

an acknowledgement and to include such a statement in the Notice amounts to the imposition of a requirement and not simply guidance.

The Association has some concerns with the best practice of including a process for specifically reviewing leveraged accounts as part of the member's business location examinations. Rule 2500 Minimum Standards for Retail Customer Account Supervision sets out the two-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. If IIROC believes that a specific review of leveraged accounts should occur, then the Association recommends that Rule 2500 be amended accordingly.

Similarly, we have concerns with the proposed best practice of developing supervisory policies that require pre-approval of advisors before permitting them to recommend an off-book leveraging strategy to their clients and requiring all off-book leveraging recommendations to clients to be pre-approved by the firm. The IIAC does not believe that pre-approval should be required as advisors are subject to know-your-client and suitability obligations, which would require an advisor to ensure that the recommendation of an off-book leveraging strategy was appropriate for that particular client.

The IIAC also wishes to raise the potential difficulties with the best practice of requesting that approved lenders provide reports of the leveraging business on record involving firm advisors. Some firms who do use this practice indicate it is extremely challenging to attempt to receive these documents from approved lenders, especially given that these lenders are under no obligation to provide these reports. Members point out that such a requirement can require a significant amount of time for follow-up and thus can be somewhat onerous. Furthermore, is client consent needed to access the reports of approved lenders? Members have indicated that clients would not likely consent to firms obtaining loan documentation from third parties and we have concerns under federal and provincial privacy legislation as to whether or not members would even be in a position to request such information.

Appendix A - Making Specific Leverage Recommendations

The IIAC would like to point out that included in the Appendix A checklist that the advisor should consider when making a recommendation to invest with borrowed funds, is whether the advisor has obtained a copy of the completed loan document. Often, a client may not wish to provide a copy of their loan documents or bank statements. It is not clear of the advisor's responsibilities in those situations or where the client refuses to provide any detail.

In addition, the checklist makes reference to the advisor obtaining an "acknowledgement of receipt of the leverage risk disclosure". Again, we wish to emphasize that there is no acknowledgement requirement contained in Rule 29.26.

We also query the following item contained in the checklist: "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?"

The Association is unsure how feasible it is for a registrant to review a client's total debt servicing ratio. This appears to lend itself more to retail banks where they have the benefit of a formal adjudication process, for example, when extending credit on a credit card/loan/mortgage. Registrants are not equipped with this type of information. Knowing the client's liquid assets and liabilities does not mean that the advisor knows how much the client is paying in monthly bills or the level of other debt obligations the client has. IIROC appears to be imposing expectations that reach well beyond the ability of the registrant to properly assess.

Furthermore, as advisors are subject to know-your-client and suitability requirements, in the event that an advisor recommends a leveraged strategy, the advisor is responsible to ensure that the recommendation is suitable and inform the client of the costs associated with implementing such a strategy. As a result, we do not believe that the Notice should prescribe how an advisor conducts the suitability assessment.

Order-Execution Service Accounts

The IIAC seeks clarification with respect to the off-book leveraged loan procedures and minimum controls outlined in the Notice that would apply to an order-execution only dealer for which there is no suitability assessment obligation.

The IIAC Working Group would welcome an opportunity to meet with IIROC staff to further discuss the Notice and our suggestions for its improvement, as outlined in this comment letter.

Yours sincerely,

A handwritten signature in cursive script that reads "M. Alexander".