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VALEURS MOBILIÈRES
DU NOUVEAU-BRUNSWICK



Leverage Sweep Industry Report

Regulatory Affairs Division
New Brunswick Securities Commission

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Contents

Executive Summary	3
Purpose of the Report	5
1.0 Phase One	5
1.1 Firm Policy and Procedures for Leverage Accounts	6
2.0 Phase Two	7
2.1 New Leverage Account Review Procedures	8
2.2 Suitability of Leverage Accounts.....	10
3.0 Leveraging Strategies	14
3.1 Tax Planning	14
3.2 Systematic Withdrawal Plan (SWP).....	15
3.3 Aggressive Investors.....	16
4.0 Know-Your-Client.....	16
4.1 Accurate and Complete Know-Your-Client Information (KYC).....	16
4.2 Consistent Net worth, Liquid Assets and Fixed Assets Calculations	18
4.3 Accurate Client Investment Knowledge	18
4.4 Additional information.....	19
5.0 Resolving Unsuitable Leveraged Investments	19
6.0 Self Regulatory Requirements and Guidelines for Leveraging	20
6.1 MFDA Requirements and Guidelines	20
6.2 IIROC Requirements and Guidelines	21



Leverage Sweep Industry Report

Executive Summary

The Regulatory Affairs Division of the New Brunswick Securities Commission (NBSC) is responsible for conducting compliance reviews on registrants and market participants to verify that their activities are carried out in compliance with the New Brunswick *Securities Act*, Rules and Regulations.

NBSC staff recently completed a review of leverage practices within New Brunswick. Staff conducted this review because staff discovered, during routine compliance reviews, a number of firms registered in New Brunswick appeared to be overly aggressive and in some cases careless with the use of leverage for their clients. The findings from the routine reviews are not included in the results of this report, but are simply referenced to provide the context for our leverage sweep.

The purpose of the review was to assess the firms' policies and procedures regarding the practice of borrowing to invest, to determine whether leverage was being appropriately used as an investment tool and to determine the suitability of the investments that were made with borrowed money. Staff also reviewed supervision and client Know-Your-Client (KYC) information. During the site visits, staff attempted to determine the strategies and the reasons why leverage was chosen as an investment strategy for New Brunswick Investors.

NBSC staff chose, at random, ten Mutual Fund Dealers Association of Canada (MFDA) member firms and ten Investment Industry Regulatory Organization of Canada (IIROC) member firms with branches in New Brunswick. During the first phase of the review, in the fall of 2009, staff requested information from these firms. We requested information pertaining to the amount of leverage on the clients' books, the firms' policies and procedures relating to leverage, and the firms' total assets under management. All firms responded to our request, thereby allowing staff the opportunity to determine which firms required additional testing.

Of the 20 firms chosen, six firms did not have leverage accounts¹ on their books. Therefore, staff only reviewed the remaining 14 firms. Of these firms, three had pledge accounts² only and three had an immaterial amount of leveraged assets. Therefore, only the results of the remaining eight firms, of which a total of 11 branches were reviewed, are discussed in our phase two analysis.

¹ In this instance we mean an account where borrowed money was used to purchase an investment.

² Pledge Account is defined in this instance as an investment account held as collateral at a financial institution against an existing loan at a lending institution or bank. No money was borrowed to invest in the investment account at the financial institution. Even though pledge accounts were not the focus of this review, these accounts were reviewed by staff to ensure that any lending restrictions were being adhered to by the firm and that asset thresholds required by the lending institutions were being met. Staff did not observe any deficiencies with the pledge accounts reviewed at these three locations. These results are not included in the report.



Leverage Sweep Industry Report

The second phase of our review began in early 2010, where staff reviewed 93 files at the 11 branches. Staff reviewed individual client files and discussed these files with the dealing representative or the branch manager. This report summarizes staff's findings in relation to the 11 branches, including the following key observations:

- All firms included in the sweep had a "leverage loans to assets under administration" ratio of less than 3%;
- The majority of client files reviewed had appropriate sign-off by clients on the risks relating to leverage;
- The average age of an investor who held a leverage loan was 51;
- 41% of the files reviewed exceeded *MR-0069 "Net Worth"* guidance provided by the MFDA;
- 36% of leveraged files were in a loss position;
- 70% of files, where client objectives did not match their current investment portfolio, were in a loss position;
- 68% of files where staff deemed the use of leverage as aggressive³ were in a loss position;
- There were instances where supervisory staff, when approving new leveraged accounts, were not provided all relevant Know-Your- Client (KYC) information; and
- The loan sizes ranged from less than \$10,000 to over \$3,000,000.

Throughout the report, staff also provides recommended business practices to assist firms in improving their procedures regarding leveraging practices.

Conclusion

We have concluded that the majority of firms appear to be using leverage in an effective and reasonable manner. The extent leveraging was used as an investment tool ranges significantly from firm to firm and from dealing representative to dealing representative. However, the overall use of leverage appears appropriate. In addition, staff determined that the policies and procedures currently in place appear to be adequate for most firms, and the rationale firms used for recommending the use of leverage, though at times aggressive, appeared to be well thought through by the firms.

Several firms did have systemic deficiencies in this area, however, and will be subject to additional follow-up by the New Brunswick Securities Commission (NBSC).

Follow up

Staff conducted these reviews to evaluate compliance with applicable legislation and to identify weaknesses in the dealers' practices. Staff will send correspondence directly to firms with significant or repetitive deficiencies outlining such deficiencies.

³ Aggressive – in this report we are referring to leveraged accounts where staff of the NBSC would question the merits of allowing a particular client to use leverage as part of their investment strategy.



Purpose of the Report

The purpose of the review was to assess firms' policies and procedures regarding the practice of borrowing to invest, to determine whether leverage was being appropriately used as an investment tool and to determine the suitability of the investments that were made with borrowed money. Staff also reviewed supervision and client KYC information. Finally, staff attempted to determine the strategies and the reasons why leverage was chosen as an investment strategy for New Brunswick investors.

1.0 Phase One

NBSC staff chose, at random, ten MFDA member firms and ten IIROC member firms with branches in New Brunswick. During the first phase of the review, in the fall of 2009, staff requested information from these firms. We requested information pertaining to the amount of leverage on the clients' books, the firms' policies and procedures relating to leverage, and the firms' total assets under management. All firms responded to our request allowing staff the opportunity to determine which firms required additional testing.

In September of 2009, staff sent each of the 20 firms a letter requesting the following information:

1. A list of branches and sub-branches located in New Brunswick, including address, telephone number, designated branch manager, and a list of registered salespersons, licensed assistants and total Assets under Administration (AUA) at each location.
2. An internal organizational chart (reporting structure) for NB Branches-including compliance staff, branch managers, administration staff.
3. List of all pledge/leveraged accounts opened between 15 September 2007 and 15 September 2009, including:
 - client name
 - account number
 - date the account was opened
 - registered salesperson of record
 - initial loan amount and with what institution the loan was financed through
 - market value of the account as of 15 September 2009
 - book value of account
 - amount and date of first transaction
4. A list of total pledged/leveraged assets under administration by registered salesperson, including the salesperson's name, code and summaries of commissions and trailing commissions for each person for the period of 15 September 2007 to 15 September 2009.



Leverage Sweep Industry Report

5. Total AUA for pledged/leveraged accounts for all New Brunswick branches and sub-branches.
6. A list of all lending institutions, affiliates or any other 3rd party your firm currently used to finance investment loans, including copies of pledge/leverage documentation for each entity.

Staff was able to use this information to determine which firms would be included in the second phase of our sweep.

Of the 20 firms chosen, six firms did not have leverage accounts on their books. Therefore, staff only reviewed the accounts of the remaining 14 firms. Of these firms, three only had pledge accounts and three firms had an immaterial amount of leveraged assets. Consequently, staff chose the remaining 8 firms for the second phase of our review.

Results of Phase One

- All firms included in the sweep had a “leverage loans to assets under administration” ratio of less than 3%;
- The most commonly used lending institute was B2B Trust.

The following provides details on the registration requirements, our findings regarding policy and procedures, and recommended business practices.

1.1 Firm Policy and Procedures for Leverage Accounts

Rules

National Instrument 31-103 – Registration Requirements and Exemptions

11.1 Compliance system

A registered firm must establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to

- (a) provide reasonable assurance that the firm and each individual*
 - i. acting on its behalf complies with securities legislation, and*
- (b) manage the risks associated with its business in accordance with*
 - i. prudent business practices.*

Written Policies and Procedures

Findings

Staff observed instances where firms had minimal written policies and procedures for internal staff to follow when completing leveraged investments for a client.



Recommended Business Practices

Firms are required to establish and maintain written policies and procedures for dealing with clients and ensuring compliance with securities legislation and applicable Self Regulatory Organizations (SROs). These policies and procedures should incorporate a firm's written leveraging policies and procedures which must be distributed to all dealing representatives in order to provide guidance on the firm's leveraging criteria. This will provide dealing representatives with clarification of when leveraging is suitable or perhaps not suitable for clients. Firms must also develop policies and procedures for:

- Head office and branch supervisory staff relating to the supervisory requirements for assessing and approving the suitability of leverage recommendations;
- Delivery of risk disclosure documents to clients;
- Appropriate client circumstances for recommending the purchase of investments by borrowing; and
- Required information to be maintained in the client file.

2.0 Phase Two

The second phase of our review began in early 2010, where staff reviewed 93 files at the 11 branches. Staff reviewed individual client files and discussed these files with the dealing representative or the branch manager. The remainder of the report discusses the results of our Phase Two review, which includes expectations for new leverage accounts regarding supervision and compliance, the quantitative results of our testing and expectations for KYC information. We have provided suggestions for resolving unsuitable leveraged investments, and have also provided applicable IIROC and MFDA references.

This report presents the quantitative results by branch; however, much of the information throughout the report has been consolidated, and does not necessarily apply to each dealer. Staff also provided recommended business practices to assist the dealers in improving their procedures regarding leveraging practices. The recommended business practices encompass both requirements under existing legislation and recommended best practices, but are not meant to be an exhaustive list of practices and procedures that could be incorporated by the dealers.

During the review, we also discussed with branch managers and dealing representatives the strategies used and reasons why leverage was recommended for individual clients. We outline in Section 3.0 the most common strategies and reasons for recommending leverage to a client.



2.1 *New Leverage Account Review Procedures*

Rule

National Instrument 31-103 – Registration Requirements and Exemptions

11.1 Compliance system

A registered firm must establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to

- (c) provide reasonable assurance that the firm and each individual
 - i. acting on its behalf complies with securities legislation, and**
- (d) manage the risks associated with its business in accordance with
 - i. prudent business practices.**

Supervision and Compliance

Staff noted instances where supervisory staff, when approving new leveraged accounts, were not provided all relevant KYC information, thus making it challenging for them to make a well-informed assessment. For example, staff noted instances where an account application was presented to the supervisor which did not include any information relating to the fact that the client had existing leverage loans or the fact that the client was applying for two separate loans at the same time.

Staff also identified additional concerns with respect to the supervision of leveraging conducted by dealing representatives, including the following:

- Consistent procedures were not being followed with respect to criteria requirements to assess suitability; and
- Leveraged accounts being approved by supervisory staff for clients that, according to the KYC information on file, would not appear to be ideal candidates for a leveraged investment. However, upon querying the file, we noted the candidate was actually appropriate. In some cases, these clients had unique circumstances (for example, lottery winner or large inheritance) which explained why they were granted a leveraged plan. However, staff did not see documented evidence of the changes to the clients' circumstances or notes that provided evidence the account was queried by supervisory staff.

Recommended Business Practices

It is imperative for a dealing representative to provide accurate documentation when opening a new leverage account as it allows the supervisory staff to conduct a thorough suitability review which helps ensure that recommendations made for any account are appropriate and the firm is meeting the clients' investment objectives. It is also critical to maintain these records and update them accordingly to ensure ongoing objectives are being met.



Leverage Sweep Industry Report

Criteria that should be considered when assessing leveraging suitability include:

Investment Knowledge:

A leveraging strategy is not recommended for clients who have indicated that their investment knowledge is low or poor.

Risk Tolerance:

A leveraging strategy should only be recommended where a client has a medium risk tolerance or higher. A leveraging strategy is normally not suitable for investing in low risk investments as the cost of borrowing may be greater than the returns from the investment.

Net Worth:

A general guideline provided by the MFDA notes that an investment loan should not exceed 30% of a client's net worth and 50% of a client's liquid net worth. For example, a client with a liquid net worth of \$100,000 should not have a loan that is more than \$50,000.

In some instances it may be acceptable to exceed these thresholds but these instances should be reviewed and assessed for suitability on a case by case basis by supervisory staff and evidence of this assessment should be documented.

Client's Income:

A client's income must be sufficient to service the debt payments on all of the client's loans. A general guideline provided by the SROs states the debt payments should not exceed 35% of the client's gross income, not including income generated from the leveraged investments.

Age:

A leveraging strategy, to be effective, should have a long-term time horizon of growth investments. Most clients who are 60 years or older should have a portfolio that is designed for income generation and capital preservation as opposed to long-term growth.

Also, when clients are at or nearing retirement, their earning potential and ability to withstand investment losses decreases, therefore leveraging is generally not considered suitable. If supervisory staff receives a request for approval of an individual who is within this age bracket, they should expect a written explanation as to the appropriateness of the investment strategy. Staff recommends keeping such notes and discussions on the client's file.

Time Horizon:

A leveraging strategy is generally more appropriate for clients with a long-term time horizon. This is due to the fact that investing over the long-term has the potential to reduce the risk of short and medium term market volatility. If a client is leveraged and has a time horizon of less than 5 years, this should be questioned by supervisory staff.



2.2 *Suitability of Leverage Accounts*

Rules

National Instrument 31-103

13.3 (1) Suitability

A registrant must take reasonable steps to ensure that, before it makes a recommendation to or accepts an instruction from a client to buy or sell a security, or makes a purchase or sale of a security for a client's managed account, the purchase or sale is suitable for the client.

Findings

Staff conducted a suitability review of 93 leveraged client accounts and noted the following:

- 36% of the client accounts reviewed were in a loss position;
- 9.6% of the client accounts reviewed were considered to be invested in unsuitable investments according to their investment objectives on file; and
- 23.7% of the client accounts reviewed were considered aggressive and possibly unsuitable for leverage investing.



Leverage Sweep Industry Report

Quantitative Results of Leverage Files Reviewed at Individual Branches

The following analysis relates to the 11 branch reviews completed and has been reported by the individual branch. The first column of the chart shows how each file compared to MFDA guideline MR-0069⁴. The second column shows staff's view on whether or not the loan was aggressive or possibly unsuitable given the client's circumstances, at the time the loan was granted.⁵ The third column shows the number of leverage files where the clients' objectives matched their current portfolio holdings. For example if we reviewed ten files and nine were within the MFDA guideline the result would read 9/10 (9 out of 10).

Location	Number of Files within Guidance Provided by MR - 0069	Number of Files Deemed "Not" Aggressive	Number of Files with Suitable Investments
Branch A	15/16	16/16	16/16
Branch B	2/3	3/3	3/3
Branch C	1/5	5/5	5/5
Branch D	1/9	4/9	6/9
Branch E	5/6	6/6	6/6
Branch F	7/16	9/16	13/16
Branch G	7/17	15/17	17/17
Branch H	4/6	4/6	5/6
Branch I	4/9	6/9	7/9
Branch J	2/3	3/3	3/3
Branch K	0/3	0/3	3/3

Branches D, F and I will be receiving a follow up letter based on the results of our review and will be asked to complete an internal review of the files that were determined to be aggressive or not suitable. These findings must be submitted to the NBSC with an explanation for why these files were approved and what corrective action will take place if it is determined that the account has not been appropriately managed.

⁴ **MR-0069 "Net Worth"**- A general guideline is that an investment loan should not exceed 30% of a client's net worth and 50% of a client's liquid net worth. For example, a client with a liquid net worth of \$200,000 should not have a loan that is more than \$100,000.

In some instances it may be acceptable to exceed these thresholds and this will require judgment. For example, it may be appropriate in some circumstances for a young client with very little liquid net worth but with a high income to be leveraged. As always this factor must be considered in conjunction with all others.

⁵ For consistency we presented column two as files that were deemed not aggressive, therefore 16 out of 16 would be a positive result throughout the chart.



Leverage Sweep Industry Report

MR-0069

The SROs do not have rules or regulations that restrict leverage based purely on financial characteristics; however, as noted above the MFDA provided some guidance as to what they deem appropriate for firms to consider when approving a leverage loan strategy for a client.

Staff of the NBSC recognizes that MR-0069 provides guidance only and is not a requirement for IIROC dealers. Nonetheless, staff believes this guidance is an appropriate standard to evaluate firms. We did not consider files that exceeded the suggested thresholds as inappropriate investments; however, the results demonstrate that many firms allow leverage to reach a significant portion of a client's net and liquid worth.

Aggressive Files

Staff assessed the clients' age, income, net worth, liquid net worth, investment objectives, current employment and any unique circumstances. We determined that 23.6% of leverage files were aggressive. The findings do not mean that the loan should not have been granted, but that the file raised a red flag for staff.

Staff noted a very interesting correlation between files that we considered aggressive and files that were noted in a loss position. Of those files considered aggressive, 68% of the clients suffered a loss in their leveraged portfolio. This is much higher than the overall 36% of leveraged files that are in a loss position. This fact should remind firms of how risky leverage can be, and in many cases these losses could have a detrimental effect on their clients.

Suitability of the Investment

Staff reviewed clients' investment objectives and then compared them to the clients' most recent investment statement. Staff used this information to assess whether clients' leveraged funds were being invested suitably. We determined 90.4% of files to be suitable.

There is also an interesting correlation between unsuitable investments and loss experienced. Staff noted 70% of clients' leverage files where client objectives did not match the actual investment had lost money for the holders. This statement also highlights the risk involved in leveraging accounts. These statistics suggest that when a client account is not being reviewed appropriately for suitability, clients will most likely experience consequences of inappropriate asset allocation.

These statistics highlight the need for firms to establish and implement adequate internal controls which are designed to flag leveraged accounts that are in a loss position. Staff recommends firms complete an internal review on all leveraged accounts that are in a loss position.



Recommended Business Practices

A client's risk tolerance, investment objectives and time horizon give direct information regarding what is suitable for a client. These three elements must be compared against the assets in the client's account to verify that the investments are suitable. The other categories of KYC including investment knowledge, annual income, net worth and age are used in assessing the suitability of any leveraged loans and they can be used as a check against the three categories that give direct information regarding whether the investments are suitable for a client.

The following two scenarios demonstrate situations which warrant a follow up by supervisory staff:

Scenario 1: An older client that is shown as having a high risk tolerance and no investment knowledge would be a situation that would warrant follow up by supervisory staff.

Scenario 2: A younger client with a low annual income and good investment knowledge would also warrant follow up by supervisory staff.

It is staff's opinion that unsuitable leverage accounts also occur and issues arise in some cases because of a client's failure to fully understand key considerations before borrowing money to invest. Dealing representatives are required to provide clients with appropriate information regarding the available options and the risks associated with the use of leverage including:

- The value of the leveraged investments may fall below the value of the loan;
- There is a magnification of the investment risk where a leverage strategy is used;
- Even where returns on leveraged investments are positive, interest costs may exceed the returns received;
- Whether investment returns are positive or negative, clients must still pay back the loan plus the agreed interest, which may cause client hardship;
- The clients may be forced to realize losses as a result of the loan terms;
- Any loans secured against a client's home can put the client's equity interest in the home at risk;
- If a client is relying on investment returns to cover borrowing costs and the investment falls in value, the client could default on the loan; and
- A lender's assessment of a client's ability to repay an RRSP loan may be based on the presumption that the client will use the tax refund to pay back the loan.

It is important that a leverage strategy only be used by individuals that are comfortable with the universal risks associated with leveraging.

Firms should ensure that their dealing representatives provide this information to all clients to whom leveraging recommendations are offered.



3.0 Leveraging Strategies

Staff reminds firms and their dealing representatives that simply because a leverage strategy is effective "in theory", it does not mean that strategy is appropriate for all clients. A firm or dealing representative cannot hide behind a strategy because of its benefits, without a thorough review of all factors especially the risks if an investment loses money.

The following section discusses the leverage strategy most commonly found in clients who use leverage as an investment tool.

3.1 Tax Planning

The most common strategy noted during our visits relating to why leverage was used as an investment tool was the use of leveraged money for tax planning purposes. In some cases this strategy was used as a primary investment objective for the investor.

Tax Deduction

Using leveraged money to obtain a tax deduction

This was the most basic and direct method used to sell and promote the use of leverage. Throughout the province, when dealing representatives were asked why they chose to use leverage in a particular case, they often cited the ability to tax deduct the interest paid on a leveraged loan.

Though we agree that the interest is tax deductible this is not reason enough to recommend a leverage strategy, and careful consideration must be given to all factors.

To compound the risk, we noted instances where clients obtained an interest only payment leverage loan. This strategy increases the chance that significant losses could occur as the amount of leveraged money exposed to risk does not diminish as long as the client holds this particular investment. We remind firms that using leveraged money to purchase investments and maintaining the full balance of the loan throughout the investment period keeps a client at an elevated risk throughout the time the loan is held.

Recommended Business Practice

We recommend firms consider only allowing the use of leverage loans that require a repayment of interest and principal.



Registered Retirement Income Fund (RRIF) or Registered Retirement Savings Plan (RRSP) reduction

A RRIF meltdown⁶ or RRSP reduction requires the use of a leverage loan of sufficient size to generate a tax savings equal to the tax burden being generated by the money being removed from a client's RRIF or RRSP account. The desired result would be a complete offset of tax payable and tax refund for the client.

We came across two distinct reasons for using a RRIF meltdown to achieve a client's investment objective. The first and most traditional method used related to investors that were of retirement age that had relatively high taxable income and expressed an interest in lowering their tax burden. The dealer representative would suggest a RRIF Meltdown in order to reduce their tax burden.

The second method we noted was using RRIF meltdowns on clients with limited income who were earning too much money to qualify for a particular government benefit. The intent is to use a RRIF meltdown to reduce their annual income thereby allowing the client to remain or become eligible for this particular government benefit.

Both of these strategies may prove effective. However, these individuals can least afford to lose their investment savings so caution must be used when considering this strategy. Supervisory staff need to complete a thorough review of these types of strategies.

We noted in some cases advisors were starting to discuss the overall effectiveness of RRSPs as an investment plan. They disclosed to staff that clients no longer saw the benefit of having RRSP savings, due to the future tax burden.

Recommended Business Practices

We recommend advisors disclose to clients that unless they have a strong understanding of the long-term consequences of this strategy they consult a tax professional regarding a collapse of a registered plan.

3.2 Systematic Withdrawal Plan (SWP)

Staff found SWPs in a limited number of circumstances. The strategy requires all gains, dividends or interest earned from a leverage investment to be deposited directly into the client's bank account. This type of account is traditionally used as a source of income, however when matched with an interest only leveraged loan, we believe that this strategy is extremely risky.

⁶ RRIF Meltdown refers to a client's ability to remove money from their RRIF account by using a leverage loan to offset the taxes that will be triggered by removing money from the RRIF.



Recommended Business Practices

Clients should not be relying on the growth within their portfolio to make payments on the leveraged loan. If a client cannot afford to make payments that include a principal reduction then it is unlikely that leverage of any kind would be an appropriate strategy.

3.3 Aggressive Investors

A common explanation provided by the registrant for recommending a leverage strategy was “the investor is aggressive”, they understand the markets, they understand the risk and they want to use “other peoples’ money” to help them make the maximum return possible. This can result in a client investing their money inappropriately as their actual circumstances may not align with the risks they are willing to take.

Recommended Business Practices

Regardless of the client’s personal risk tolerance, dealer representatives must consider all relevant KYC information when determining if a leveraged investment is appropriate or suitable for a client. Supervisory staff should question any file where a high risk tolerance appears to be the overriding reason a dealer representative recommends a leverage loan as part of an investment strategy.

4.0 Know-Your-Client

4.1 Accurate and Complete Know-Your-Client Information (KYC)

Rules

National Instrument 31-103 – Registration Requirements and Exemptions

➤ 13.2(2) Know your client

A registrant must take reasonable steps to

- (a) establish the identity of a client and, if the registrant has cause for concern, make reasonable inquiries as to the reputation of the client,*
- (b) establish whether the client is an insider of a reporting issuer or any other issuer whose securities are publicly traded,*
- (c) ensure that it has sufficient information regarding all of the following to enable it to meet its obligations under section 13.3 or, if applicable, the suitability requirement imposed by an SRO:
 - (i) the client’s investment needs and objectives;*
 - (ii) the client’s financial circumstances;*
 - (iii) the client’s risk tolerance, and**
- (d) establish the creditworthiness of the client if the registered firm is financing the client’s acquisition of a security.*



Leverage Sweep Industry Report

Findings

During the review staff observed instances where:

- KYC information was either missing or incomplete;
- KYC forms had investment objectives that were too broad or vague to relate to any specific trade or investment;
- KYC documents did not contain sections for net worth, liquid assets and fixed assets calculations;
- Joint account calculations for annual income, liquid assets, fixed assets and net worth were calculated per joint account holder and in other cases, they were calculated per account. It was unclear to staff if the KYC information collected was per account or per client which made suitability assessment difficult;
- KYC information was inconsistent. For example, a client with an aggressive investment objective, but a low risk tolerance; and
- Loan documentation submitted to the financial institutions varied from the KYC information on file for the client.

Recommended Business Practices

When reviewing a client account, the KYC categories of risk tolerance, investment objectives and time horizon offer direct information regarding what is or is not suitable for a client. Firms must have policies and procedures in place to make sure that this information is recorded accurately and completely, and consistently prepared by dealing representatives. The information in these categories should be compared by supervisory staff against the assets in the client's account to ensure that the investments are suitable.

The other categories included in the KYC - investment knowledge, annual income, net worth and age are also used in assessing the suitability of a leveraged loan and should be used in conjunction with risk tolerance, investment objectives and time horizon to provide a complete picture of the client when assessing the suitability of the investment for the client.

- A firm should either have controls to prevent such inconsistencies or have detective controls to identify and follow up where inconsistencies are identified.
- For joint accounts, certain KYC information such as age and investment knowledge should be collected for each individual account holder. Annual income and net worth can be collected for each individual or on a combined basis as long as it is clear which method has been used. Investment objectives, time horizon and risk tolerance should relate to the account and should not be collected separately for each individual account holder.

Staff would also like to remind firms that they cannot rely on the approval by the lending institution of the loan as an indication of suitability.



4.2 Consistent Net worth, Liquid Assets and Fixed Assets Calculations

Staff observed significant ranges being used for indicating annual income and net worth on KYC documentation. For example we noted the following options - Annual Income Under \$25,000 and in some cases annual income greater than \$100,000. There is a significant difference in making \$10,000 a year as opposed to \$25,000 a year or making \$500,000 a year as opposed to making \$100,000. These types of ranges do not provide an accurate reflection of a client's financial position for supervisory staff to assess suitability.

Recommended Business Practices

All firms should review the ranges they are using within their KYC documents. Staff recommend using ranges that are small enough to capture the client's true financial position and annual income. Best practice would be to use the approximate values instead of ranges whenever possible.

4.3 Accurate Client Investment Knowledge

While reviewing KYC information staff made an observation that the majority of the client's investment knowledge indicated on the KYC documents was either "good" or "excellent" regardless of the client's employment, education or circumstances. In these cases, it appears the KYC information is being determined based upon trading practices used by the dealing representative rather than on clients' actual circumstances.

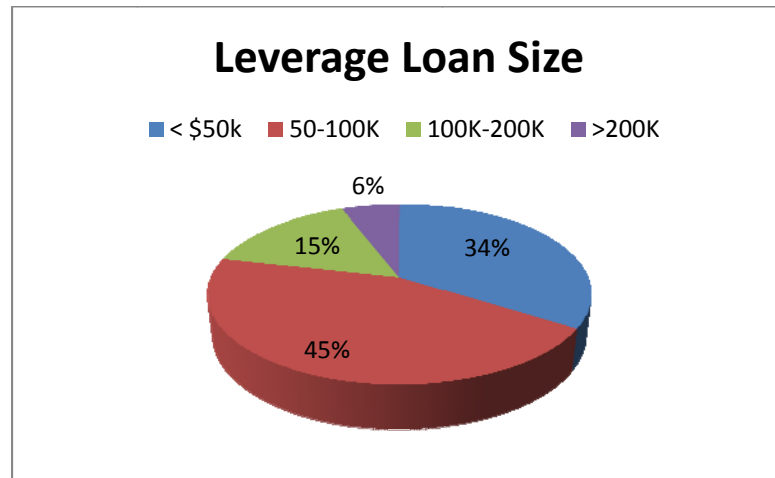
Recommended Business Practices

Supervisors need to challenge situations where a dealing representative has a significant portion of clients with the same or similar KYC information.



4.4 Additional Information

The following chart shows the number of loans in each category expressed as a percentage of the total number of files reviewed.



5.0 Resolving Unsuitable Leveraged Investments

When firms identify concerns with leveraging practices, we would expect corrective action to be taken by supervisory staff. Depending on the circumstances, corrective action might include:

- Prohibiting further leveraging recommendations by a dealing representative;
- Prohibiting marketing of leveraging by problematic dealing representatives; and
- Additional training for problematic dealing representatives.

Additionally, if a client account appears to be unsuitable the issue will need to be addressed. Courses of action to address these accounts should include supervisory staff communicating directly with the clients to obtain sufficient information to make the assessment. If the leverage is determined to be unsuitable, then supervisory staff should discuss the options available to the client. This result will likely require the collapsing the leverage arrangement in whole or in part. Any corrective action taken must be done in a fair and objective manner.



6.0 Self Regulatory Requirements and Guidelines for Leveraging

Under New Brunswick securities law, a member or an employee of a member of an SRO that is recognized by the NBSC is required to comply with any by-law, regulatory instrument, practice or policy of the SRO.

Staff have provided the SRO rule references below regarding the topics addressed in this report. We strongly suggest that firms make sure all staff are familiar with these SRO rules and requirements and ensure that these rules are implemented and enforced in the branch offices in New Brunswick.

6.1 MFDA Requirements and Guidelines

Policies and Procedures

MFDA Rule 2.10- Policies and Procedures Manual
MFDA Market Regulation Notice MR-0008 –Policies and Procedures Manual
MFDA Bulletin #0395-C – Policies and Procedures Manual Reference Guide

Know-Your-Client

MFDA Rule 2.2.1 – Know-Your-Client
MFDA Policy 2 – Minimum Standards for Account Supervision
MFDA Market Regulation Notice – Know-Your-Product

Supervision of Accounts

MFDA Policy 2 – Minimum Standards for Account Supervision
MFDA Market Regulation Notice MR-0069 – Suitability Guidelines
MFDA Bulletin #0431-C - Leverage Guide, Leverage Review Worksheet & Approved Person Leveraging Analysis Template

Suitability

MFDA Rule 2.2-Client Accounts
MFDA Market Regulation Notice MR-0069 – Suitability Guidelines

Leverage Disclosure

MFDA Rule 2.6 Borrowing for Securities Purchases
MFDA Market Regulation Notice MR-0064 – Maintaining Evidence of Disclosure
MFDA Market Regulation Notice MR-0070 – Misleading Communications Regarding Leverage
MFDA Market Regulation Notice MR -0074 – Leverage Risk Disclosure



6.2 IIROC Requirements and Guidelines

Policies and Procedures

IIROC Rule 38.1

Know-Your-Client

IIROC Rule 1300.1

IIROC Rule 1300.2

IIROC Rule 2900 Part I

Supervision of Accounts

IIROC Rule 1300 – Supervision of Accounts

Suitability

Rule 1300.1(p) – Suitability Generally

Rule 1300.1(q) – Suitability Determination Required When Recommendation Provided

IIROC Guidance Note 09-0172- Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds

Leverage Disclosure

IIROC Rule 29.26(1)