BLG
Borden Ladner Gervais

IIROC NOTICE 14 – 0044

Borrowing for Investment Purposes – Suitability and Supervision

Overview

This Guidance Notice focuses on investor loans obtained from a third party for the purposes of investment ("off-book lending") and holds that dealers must have adequate systems and controls to flag any investor accounts that involve off -book lending whether recommended by the investment adviser or not. The Guidance does recognize that where off-book loans are instigated by the client, they may be difficult to detect or supervise and therefore is "not expecting" "an expansive compliance framework to identify and monitor such loans". In such situations, it states that dealers and their registered representatives should not ignore:

1. When an off-book loan comes to light in its discussions with the clients;
2. A red flag that indicates a client may be using borrowed money to invest.

Where Off-Book Loan is Recommended

a) Policies and Procedures

Policies and procedures must detail how:

- risks related to the recommendation are evaluated;
- suitability is supervised;
- evidence of supervision is maintained;
- the loan amount;
- debt servicing ability;
- "suitability of investments and strategies";

b) Minimum controls for dealer members

Accounts should be readily identifiable for supervisory review and subject to specific review.

c) Registered Representative must:

- Have sufficient information about the proposed loan including amount, term, loan interest rate and collateral;
- Advise client if they do not believe arrangement to be suitable and/or "if *a proposed dealer member loan", refuse to advance the loan*;
- Provide leverage risk disclosure statement;
- Determine impact on client's financial situation defined as:
  - the client's total monthly debt service costs taking into account the proposed loan with other monthly expenses and income;
  - impact on debt to net worth leverage ratio and whether appropriate;
- Consider the collateral and whether the client appreciates the incumbrance;
- Consider whether the proposal involves higher leverage than under IIROC margin rules.

d) Best Practices

- *Use of an off-book borrowing to invest strategy subject to pre-approval;*
- Pre-approval may include review of past lending practices at prior firms and reports from approved lenders;
- Procedures to periodically assess suitability / the financial performance of the leverage strategy and noting steps if the leverage has become unsuitable. Should have more enhanced/frequent review during volatile market conditions;
- Activities with respect to third party lenders should be captured;
- Clients are to provide an acknowledgement that risks have been explained and are understood;

e) Red flags to Identify Undisclosed Off-Book Lending:

- Large deposits;
- Communications from lending institutions;
- Referral fees;
- Correspondence found in client files;
- Client complaints.

Author

Laura Paglia
Toronto
416.367.6050
lpaglia@blg.com