

MSC Notice 2001-5

NOTICE TO BROKER/DEALERS  
RESTRICTED TO THE SALE OF MUTUAL FUNDS  
LEVERAGED SALES OF SECURITIES

The Canadian Securities Administrators issued on January 24, 2001 a news release titled "Leveraging- A Risky Strategy To Increase Investment Returns". This news release was primarily directed to the investing public to make them aware of the risks that may be attached to borrowing money to invest in securities. This news release also identifies borrowing for the purchase of a RRSP investment as a type of leveraging strategy.

All of the news release details can be found on the MSC website [http://www.msc.gov.mb.ca/media\\_events/investor\\_alerts/index.html](http://www.msc.gov.mb.ca/media_events/investor_alerts/index.html).

In light of this news release, the Commission reminds registrants of the notice which was sent to the industry, by the Commission, dated January 26, 1998 wherein leveraging was identified as an investment strategy which may not be suitable for all clients. The notice stated:

"Staff of the Commission have become aware of problems with the use of leveraging to purchase mutual funds. It must be kept in mind at all times that leveraging, as with any investment strategy, is not suitable for all clients. Before leveraging is used, it is important that the matter be carefully reviewed by the salesperson for suitability based on the specific client's investment objectives, needs, experience and financial position. Staff suggest all salespeople should carefully and fully review with each client, the risks inherent to leveraging. In particular, the client must be advised that changes in interest rates and/or values of funds can result in the client having to make payments for the loans from other resources."

Several provinces have prescribed the type of disclosure required when a leveraging strategy is undertaken or proposed by the dealer for a client. The Investment Funds Institute of Canada ("IFIC"), in its "The Practical Guide for Compliance for Retail Distributors" also has suggested policies and procedures which a dealer should have when a leveraging strategy is being used. The dealer should have policies in place so that the full details of a client situation is known and that the client is fully aware of the benefits and risks of the leveraging strategy.

The Mutual Funds Dealers Association ("MFDA") will also require compliance with rules that include full disclosure of the leveraging strategy for clients. The MFDA rules will also prescribe a form of disclosure document to make the investor fully aware of the arrangement that he has undertaken.

A disclosure document should include:

1. A description of the meaning of leveraging;
2. Provide an example of how this strategy is implemented;

3. The example should include a numerical illustration of the effect of the increase or decrease of value of the security vis-a-vis the loan, in particular, how losses will be magnified;
4. The investor should also be made aware of the terms and conditions of the loan that he is assuming. For example, a type of margin requirement may be part of the loan and as well, it should be clearly shown that the loan will continue irregardless of the value of the security and investors should have adequate means otherwise to service this particular debt.

It is also important that the dealer be aware of any leveraging strategy which may have been undertaken. This includes a leveraging strategy initiated prior to a representative joining the dealer.

Any form of leveraging disclosure signed by a client will not diminish the requirement of MSC Policy 3.04 wherein appropriate "Know your Client Information" is required to be obtained. The dealer must have appropriate review and supervisory guidelines to review and approve the investment strategy proposed for a client.

Therefore, the MSC expects a broker/dealer restricted to mutual funds to have adopted a policy which will include a type of disclosure document recommended by IFIC. The document should have provisions for sign off by the representative, the client and the branch manager or compliance officer.

The document should be accompanied by appropriate written policy and procedures.

The investor must also be made aware of any fees which may be received by the advisor from the lending institution in connection with any loan assumed by the investor.

The proposed rules and policy of the MFDA should be considered when creating a policy for leveraging.

Please note that when field examinations of a broker/dealer operation are conducted by the MSC, the examiner will expect to see such policy in place.

Please direct any questions to:

Glenn Lillies, C.A.  
Compliance Auditor  
Manitoba Securities Commission  
204 – 945-5195  
[glillies@cca.gov.mb.ca](mailto:glillies@cca.gov.mb.ca)  
Toll-free in Manitoba 1-800-655-5244