

In the Matter of the *Securities Act*  
S.N.B. 2004, c.S-5.5, as amended

And in the Matter of

**Keybase Financial Group Inc.,  
And James Edward Sellars**  
(Respondents)

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**REASONS FOR DECISION**

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**Date of Opportunity to be Heard: 2 February 2010**

**Date of Order: 6 August 2010**

**Date of Reasons for Decision: 18 August 2010**

**Heard Before**

Rick Hancox  
Executive Director

**Counsel**

Mark McElman For Staff of the New Brunswick Securities Commission

Arthur Doyle For Keybase Financial Group Inc

Bruce Johnson For James Edward Sellars

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## REASONS FOR DECISION

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### BACKGROUND

[1] This matter involves an application by Staff (Staff) of the New Brunswick Securities Commission (Commission) for relief and remedies by imposing terms and conditions on the respective registrations of the respondents Keybase Financial Group Inc. (Keybase) and James Edward Sellars (Sellars) pursuant to section 48(2) of the *Securities Act*.

[2] Section 48(2) of the *Securities Act* states as follows:

48(2) The Executive Director may at any time restrict a registration by imposing such terms and conditions as he or she considers appropriate on the registration and, without limiting the generality of the foregoing, may restrict

- (a) the duration of the registration, and
- (b) the registration to trades in certain securities or exchange contracts or a certain class of securities or class of exchange contracts.

[3] Staff sought a term and condition on the respective registrations of the Respondents that they may not recommend nor act in the furtherance of trades involving the borrowing of money to invest.

[4] On 11 December 2009, Staff filed an application and supporting affidavit of Commission Senior Investigator Ed LeBlanc seeking relief and remedies against the Respondents. Staff based their application on the investigation undertaken by Mr. LeBlanc.

[5] The Respondents were advised by letter dated 11 December 2009 of their right to have an opportunity to be heard in accordance with section 48(4) of the *Securities Act*. Section 48(4) of the *Securities Act* states as follows:

48(4) The Executive Director shall not refuse to grant, reinstate or amend a registration or impose terms and conditions on the registration without giving the applicant or registrant an opportunity to be heard.

[6] The Respondents requested an opportunity to be heard and both respondents and their respective counsel met with the Executive Director on 2 February 2010. Counsel for Staff of the Commission was also present. In response to a request by the Executive Director, Keybase provided additional information on 25 February 2010.

### THE FACTS

[7] After reviewing the information submitted by Staff and the Respondents, I find the following as facts:

[8] Keybase Financial Group Inc. is registered as a Mutual Fund Dealer in New Brunswick and has been since 5 September 2001. In addition, Keybase is registered as an Exempt Market Dealer in New Brunswick and has been since 15 December 2009. Keybase is also registered as a mutual fund dealer elsewhere in Canada. Its head office is Markham, Ontario.

[9] As a registered mutual fund dealer, Keybase is required to be a member of the Mutual Fund Dealers Association of Canada (MFDA) and abide by its Bylaws, Rules and Policies.

[10] James Sellars has been registered as a Dealing Representative in New Brunswick, under Keybase since September 2009, prior to that as a Mutual Fund Salesperson since 24 September 2001 and has been registered as the Branch Manager of the Moncton office since 23 October 2003. Sellars is an "Approved Person" at Keybase and with the MFDA. Sellars is also subject to MFDA bylaws, rules and policies.

[11] MFDA's Rule Number 2 establishes the Business Conduct requirements of its Members and Approved Persons.

[12] The practice of "leveraging" involves an investor who uses borrowed funds to invest. The investment industry has recognized that this practice is not suitable for all investors, and that registrants have a responsibility to ensure that all leveraging recommendations are suitable for the client, in keeping with the client's current "Know Your Client" information.

[13] Mr. Sellars was introduced to a new type of leverage investing in 2005. This approach, as described, if properly implemented, was designed to enable certain investors to build wealth at a faster pace than standard investment practices.

[14] In 2006, in the absence of any specific MFDA guidelines, Sellars and Keybase developed a client disclosure process and financial plan for potential investors relating to leveraged investing. The intent of the process and plan, as described, was to ensure that the client was fully informed as to the approach. This process included various public and private briefings, published resource materials, information gathering and sign-off forms.

[15] Keybase issued Leverage Evaluation Guidelines in 2007, with updates in September 2008 and January 2009. The guidelines identified various parameters for determining the suitability of a client for leveraging. Each updated version of the guideline provided a more comprehensive approach to determining eligibility.

[16] MFDA's Member Regulation Notice MR-0069 was issued on 14 April 2008. It provided MFDA Members and Approved Persons with guidance on their suitability obligations. Part 4 of MR-0069 describes the responsibilities of Members and Approved Persons with respect to leveraged transactions. It also provides guidance on a wide

range of suitability issues with respect to leveraged investments including investment knowledge, risk tolerance, age, investment time horizon, net worth and income.

[17] Keybase's 2008 guidelines and January 2009 revisions, both issued several months after the MFDA MR-0069 guideline, while defining similar criteria, maintained some financial thresholds that were in excess of twice those set by the MFDA.

[18] The MFDA has been reviewing Keybase's approach to leveraging since at least July 2008. The MFDA requested that Keybase conduct a review of their entire leveraged book of accounts for a number of registrants, including Sellars. They provided a template to enable the review of suitability and to assess the leveraging practices.

[19] This information was provided by Keybase in January 2009.

[20] The initial information provided by Keybase indicates that Sellars had 256 clients with assets under administration (AUM) of \$21,416,620. Of these, 101 (39%) are leverage accounts with AUM of \$13,566,399 (63%). 93 of these accounts (92%) are leveraged beyond the MFDA guidelines of not more than 30% of net worth. Seventy-one accounts are leveraged beyond Keybase's internal guideline of not more than 70% of net worth. Thirty-four (48%) of these accounts are leveraged in excess of 99.9% of net worth, the highest leveraged amount is recorded at in excess of 540%. In one situation, a client showing a negative net worth had his debt load tripled.

[21] Of the 93 accounts that exceeded MFDA's established net worth threshold, 19 clients (20%) are listed as having an investment knowledge level of fair or novice and seven clients are listed as being older than 60.

[22] Of the 71 accounts that exceeded Keybase's established net worth threshold, 13 clients (18%) are listed as having an investment knowledge level of fair or novice and five clients are listed as being older than 60.

[23] Of the 71 accounts that exceeded Keybase's established net worth threshold, 52 clients (73%) have loans from two or more lenders. Typically, these loans were taken out within 1 – 30 days of each other.

[24] Sellars' total net commissions earned were \$43,797 in 2004; \$125,678 in 2005; \$237,346 in 2006; \$519,585 in 2007; and \$304,848 in 2008.

[25] Sixty-three of the 93 accounts (68%) that exceeded MFDA's established net worth threshold were leveraged in 2007 and 2008; 48 of the 71 accounts (68%) that exceeded Keybase's established net worth threshold were leveraged in 2007 and 2008.

[26] Both Respondents indicated that they have done no new leveraging since November 2008.

[27] An updated spreadsheet was provided by Keybase on 25 February 2010, in response to a request by the Executive Director. The updated spreadsheet indicates two leverage accounts initiated in 2009 (April and September).

[28] In August 2009, the MFDA conducted a compliance review of the Keybase head office in Markham and their branch office in Moncton. Both reports raised concerns about the number and suitability of the leveraged accounts.

## **THE LAW**

[29] Prior to imposing terms and conditions on a registrant, the Executive Director must consider the appropriateness of any term and condition. In making this determination it is necessary to consider the mandate of the Commission and whether or not the Respondents are living up to their responsibilities as registrants.

[30] Investor protection is a fundamental consideration and a key purpose of the Commission's mandate. The responsibility to comply with securities legislation and the rules established by the self-regulatory organization and the obligation on the part of registrants to determine suitability of their clients investments are fundamental conditions of registration.

### **Responsibility to Comply with Securities Legislation**

[31] The obligations of registrants to comply with securities legislation and the various regulatory instruments, rules and policies are well articulated in the *Securities Act*, National Instrument 31-103 and the MFDA rules.

[32] Section 38(1) of the *Securities Act* enables a recognized self-regulatory organization to regulate the operations, standards and conduct of its members in accordance with its bylaws, regulatory instruments, practices and policies. On 23 July 2007, the Commission issued a recognition order recognizing the Mutual Fund Dealers Association (MFDA) as a self-regulatory organization under section 35(1)(b) of the *Securities Act*. This recognition order requires the MFDA to have its members confirm that their Approved Persons comply with applicable securities legislation and are properly registered.

[33] National Instrument 31-103 *Registration Requirements and Exemptions* Parts 5 and 11 identify requirements for a registered firm. These include the requirement to:

1. designate an Ultimate Designated Person responsible for promoting compliance with securities legislation by the firm and its individuals;
2. designate a Chief Compliance Officer responsible for establishing and maintaining policies and procedures for assessing compliance with securities legislation and monitoring and assessing compliance by the firm and its individuals;

3. maintain records that demonstrate the firm's compliance with securities legislation.

[34] MFDA Rule 1.2 requires Members to ensure that any Approved Person who conducts business on behalf of the Member commits to be bound by the bylaws and rules of the MFDA.

[35] MFDA Rule 2.5 requires each Member to establish, implement and maintain policies and procedures to ensure that its business is conducted in accordance with the bylaws, rules and policies of the MFDA and applicable securities legislation. The rule also requires a Member to:

1. designate a compliance officer responsible for monitoring adherence by the firm and its personnel to the bylaws, rules, policies, standards of business conduct and applicable securities legislation.
2. designate a branch manager for each branch office who is responsible for ensuring that business conducted by its personnel is in compliance with applicable securities legislation and the bylaws and rules of the MFDA.

[36] Section 180 of the *Securities Act* makes it an offence for any member or employee of a member of a recognized self-regulatory organization to contravene or fail to comply with any bylaw, regulatory instrument, practice or policy of the self-regulatory organization.

[37] The Respondents clearly had, and have an obligation to comply with securities legislation, MFDA bylaws and rules. Keybase clearly had, and has a responsibility to ensure its policies and procedures complied with the bylaws, rules and policies of the MFDA and applicable securities legislation, and that its staff act in compliance.

#### **Responsibility to Exercise Standards of Conduct**

[38] The *Securities Act* and the MFDA rules describe the standards of conduct that registrants are expected to meet.

[39] Section 5(b)(iii) of the *Securities Act* indicates that the Commission shall be guided by the requirement to maintain high standards of ethics and business conduct to ensure honest and responsible conduct by market participants.

[40] Section 54 of the *Securities Act* sets out a registrant's duty of care to act fairly, honestly and in good faith with its clients.

[41] MFDA Rule 2.1 describes the standards of conduct for Members and Approved Persons to deal fairly, honestly and in good faith with its clients and observe high standards of ethics and conduct in the transaction of business.

[42] MFDA Rule 2.2 requires each Member and Approved Person to use due diligence to ensure that each order accepted or recommendation made is suitable for the client

and in keeping with the client's investment objectives. Members and Approved Persons have a responsibility to ensure that this "Know Your Client" information is updated.

[43] The Respondents clearly had, and have an obligation to act in a manner that meets the standards of conduct.

## **ANALYSIS**

[44] In this section, reference is made to various numbers and percentages derived from the spreadsheets provided by Keybase. The initial spreadsheet of January 2009 had a number of mathematical errors and data inconsistencies. The updated spreadsheet provided by Keybase on 25 February 2010 listed additional clients and loans, and also had a number of mathematical errors and data inconsistencies, particularly in the formulas used. The inaccuracies in the data make the validity of the information provided very suspect. Therefore the figures used in this analysis are not intended to be absolute, but rather for indicative and comparative purposes.

### **Compliance with Client Suitability Guidelines**

[45] Sellars appears to have executed at least 163 leverage transactions over the period from October 2005 to November 2008. In order to best examine the leveraging practices and the determination of suitability undertaken by the Respondents it is necessary to review the practices in three distinct time frames. These are:

1. Period prior to April 2007 (Absence of Leveraging Guidelines)
2. Period between April 2007 and April 2008 (Keybase Leverage Guidelines issued)
3. Period post April 2008 (MFDA Member Notice 0069 issued).

### **Period prior to April 2007**

[46] Sellars was introduced to a new concept of leverage investing in 2005 and researched its legality and use by other professionals. He implemented this approach with a number of his clients at that time. In 2006, together with Keybase, Sellars developed a fairly thorough client disclosure process to introduce a financial plan that would take a client through the use of leveraging as an investment strategy. The process was designed to ensure that the client had the information and materials needed to understand the process. Safeguards were taken in the execution to see that clients were set up in blue chip funds that would likely provide steady monthly distributions and that loans were set up as a "no-margin call" loan.

[47] It is unclear whether Keybase had leverage guidelines prior April 2007. The MFDA did not have guidelines on leveraging in this period.

[48] At least 68 (42%) of the 163 leverage transactions occurred in the period between October 2005 and April 2007 where it appears that there were no guidelines to assess suitability.

### Period between April 2007 and April 2008

[49] Keybase issued Leverage Evaluation Guidelines 2007 on 16 April 2007. The 2007 guidelines, which pre-dated the MFDA MR-0069 guidelines, identified suitability parameters such as risk tolerance level; investment horizon; investment knowledge; and income. It also stipulated that borrowed funds cannot exceed the lower of 50% of the client's total assets or 70% of the client's net worth; and that the client's investment knowledge must be good or excellent. However, in its 15 August 2008 letter to the MFDA, Keybase's Chief Compliance Officer indicates that Keybase's head office approved the loans mainly based on the Total Debt Service Ratio calculation and not Loan to Net Assets Ratio. Total Debt Service Ratio is not a defined parameter in the 2007 written guidelines.

[50] During this timeframe, Sellars executed 65 or 40% of the leverage transactions. The following table indicates the number and percentage of these transactions that exceeded Keybase thresholds for some of the key criteria.

Criteria	MFDA Threshold	Keybase Threshold (Apr 2007)	Transactions Exceeding
Knowledge	N/A	Good or Excellent	7 (11%)
Risk Tolerance	N/A	Medium or Higher	0 (0%)
Time Horizon	N/A	Long term	Long term not defined – all clients indicate >5 years
Borrowed Funds not to exceed	N/A	≤50% of total assets or ≤70% of net worth	Total assets info not captured. 24 (37%) exceeded net worth threshold (Due to multiple loans 30 of 41 clients (73%) exceeded the net worth threshold, including a client with a negative net worth whose debt load was tripled.)
Family income	N/A	≥\$25k for 1:1 or 1:2 loans or ≥ \$50k for loans ≥\$100k or 100%	8 (12%)
Age	N/A	N/A	Not assessed

### Period post April 2008

[51] The MFDA issued specific guidelines on 14 April 2008 for assessing suitability where borrowed funds are used to invest (leveraging). Keybase updated and issued its Leverage Evaluation Guideline 2008 in September 2008. Another updated Leverage Evaluation Guideline 2009 was issued in January 2009. The updated guidelines for 2009 contained comprehensive disclosure forms and client sign-off agreements. The following table compares the key criteria specified by the MFDA with those revised and issued by Keybase.

Criteria	MFDA Threshold (April 2008)	Keybase Threshold (Sep 2008)	Keybase Threshold (Jan 2009)
Knowledge	Not low or poor	Good or Excellent	Good or Excellent
Risk Tolerance	Medium or higher	Medium or Higher	Medium or Higher
Time Horizon	Long term ≥5 years	Long term ≥5 years	Long term ≥5 years



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Criteria	MFDA Threshold (April 2008)	Keybase Threshold (Sep 2008)	Keybase Threshold (Jan 2009)
<b>Borrowed Funds not to exceed</b>	≤50% of liquid net worth <b>and</b> ≤30% of net worth	≤50% of total assets <b>or</b> ≤70% of net worth <b>And</b> Total Debt Service Ratio ≤40% before <b>and</b> after loan	≤ 70% of net worth <b>And</b> Total Debt Service Ratio ≤40% before <b>and</b> after loan
<b>Family income</b>	Debt payments ≤35% of gross income	Not specified (Dropped from 2007 guidelines)	Not specified (Dropped from 2007 guidelines)
<b>Age</b>	Red flag ≥60	≥60, OK if high net worth	≥60, OK if high net worth

[52] While there are a number of similar criteria, there are major differences in the key financial criteria. Keybase did not make any adjustments to bring their financial thresholds in line with those established by the MFDA.

[53] The MFDA guidelines indicate that leveraging should not exceed 30% of a client's net worth and 50% of a client's liquid net worth. In addition, debt payments should not exceed 35% of the client's gross income, not including income generated by the leveraged investment. Other guidelines indicate that leveraging is not suitable for clients whose investment knowledge is low or poor; or for those who are 60 years or older. The guidelines clearly state that Members and Approved Persons cannot rely on approval of a loan by the lending institution as an indication of suitability.

[54] The 2008 guidelines issued by Keybase in September 2008, maintained their earlier criteria that the leveraged loan amount should be the lesser of 50% of the client's total assets or 70% of the client's net worth; and that a client's investment knowledge must be good or excellent. It also introduced a new criterion into the written guidelines that in addition, the total debt service ratio (TDSR) should be 40% or less before and after the loan is implemented and that non-guaranteed cash distributions cannot be included in the calculation. The guidelines do not provide a formula for the calculation of TDSR. It indicates that Keybase requires the disclosure of financial information even if the lending institution waives the disclosure. This updated guideline was issued five months after the MFDA MR-0069 guideline yet did not comply with the MFDA guideline.

[55] The January 2009 guidelines issued by Keybase maintained the requirement to meet the dual thresholds of 70% net worth **and** 40% or less total debt service ratio. However, it dropped the requirement for the leveraged loan to be less than 50% of the client's total assets as a determining criterion. The guidelines required Keybase advisors to obtain specific proof of income and property appraisal information for all leveraged loans. These guidelines maintain the same net worth threshold that is in excess of twice that set by the MFDA nine months earlier.

[56] Of the 71 accounts that exceeded Keybase's established net worth threshold, 52 clients (73%) have loans from two or more lenders. Typically, these loans were taken out within 1 – 30 days of each other. Sellars indicates in his 25 January 2010 affidavit that this

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was “to maintain borrowing limits to a minimum with individual lenders and to facilitate a loan with a lower level of scrutiny than loans for greater amounts”.

[57] Between **May and September 2008**, Sellars executed 14 or 8% of the leverage transactions. The following table indicates the number and percentage of these transactions that exceeded the MFDA's and Keybase's thresholds for some of the key criteria.

Criteria	MFDA Threshold (April 2008)	Keybase Threshold (Apr 2007)	Transactions Exceeding MFDA	Transactions Exceeding Keybase
<b>Knowledge</b>	Not low or poor	Good or Excellent	0 (0%)	0 (0%)
<b>Risk Tolerance</b>	Medium or higher	Medium or Higher	0 (0%)	0 (0%)
<b>Time Horizon</b>	Long term ≥5 years	Long term	0 (0%)	0 (0%)
<b>Borrowed Funds not to exceed</b>	≤50% of liquid net worth and ≤30% of net worth	≤50% of total assets or ≤70% of net worth	Liquid net worth info not captured. 9 (65%) exceeded net worth threshold	Total assets info not captured. 2 (14%) exceeded net worth threshold (Due to multiple loans 5 of 14 clients (36%) exceeded the net worth threshold
<b>Family income</b>	Debt payments ≤35% of gross income	≥\$25k for 1:1 or 1:2 loans or ≥\$50k for loans ≥\$100k or 100%	0 (0%)	0 (0%)
<b>Age</b>	Red flag ≥60	N/A	1 (7%)	Not assessed

[58] Between **September and November 2008**, Sellars executed 16 or 10% of the leverage transactions. The following table indicates the number and percentage of the transactions that exceeded the MFDA's and Keybase's thresholds for some of the key criteria.

Criteria	MFDA Threshold (April 2008)	Keybase Threshold (Sep 2008)	Transactions Exceeding MFDA	Transactions Exceeding Keybase
<b>Knowledge</b>	Not low or poor	Good or Excellent	0 (0%)	0 (0%)
<b>Risk Tolerance</b>	Medium or higher	Medium or Higher	0 (0%)	0 (0%)
<b>Time Horizon</b>	Long term ≥5 years	Long term ≥5 years	0 (0%)	0 (0%)
<b>Borrowed Funds not to exceed</b>	≤50% of liquid net worth and ≤30% of net worth	≤50% of total assets or ≤70% of net worth <b>And</b> Total Debt Service Ratio ≤40% before <b>and</b> after loan	Liquid net worth info not captured. 13 (81%) exceeded net worth threshold.	Total assets info not captured. 4 (25%) exceeded net worth threshold. (Due to multiple loans 5 of 16 clients (31%) exceeded the net worth threshold
<b>Family income</b>	Debt payments ≤35% of gross income	Not specified (Dropped from 2007 guidelines)	0 (0%)	0 (0%)
<b>Age</b>	Red flag ≥60	≥60, OK if high net worth	0 (0%)	0 (0%)

[59] Both Respondents indicated that the last leveraged loan transactions took place in November 2008. However, the updated spread sheet provided on 25 February 2010 indicates two leveraged loan transactions took place in 2009, one in April and one in September. The April transaction complied with Keybase's guidelines, but not with those of the MFDA. The September transaction was in compliance with both guidelines.

[60] Mr. Sellars indicates that he did not become aware of MFDA Member Notice MR-0069 until November 2009 at a Keybase training seminar. It is noted that the MFDA Compliance Examination Report of Keybase's Moncton office, dated 21 August 2009, expressed concern over the suitability of leveraging and made specific reference to the MFDA guideline.

### **Conclusion**

[61] Keybase had guidelines to determine suitability in place since 2007. Although they were revised annually, they were not brought into line to comply with those issued by the MFDA. In addition, neither Keybase nor Sellars, who had responsibility as a branch manager, exercised the proper supervision to see that Keybase personnel complied with any of the written guidelines. It appears that they had no effective means of ensuring that their personnel complied with any guidelines.

[62] In general, Sellars and Keybase operated well outside the MFDA guidelines and in many cases well outside their own established guidelines. In reality, they used a dramatically different scale to determine suitability and had no effective means of accurately determining if their clients met the specific financial thresholds.

### **The Process of Determining Suitability**

[63] Keybase guidelines have **dual** thresholds of  $\leq 50\%$  of total assets or  $\leq 70\%$  of net worth and Total Debt Service Ratio  $\leq 40\%$  before and after the loan. However, the guidelines do not provide a formula for the calculation of TDSR. Keybase indicated that the TDSR was the main determinant used for suitability, and in most cases this appears to have been the only determinant used. In addition, the guidelines indicate that the TDSR should be 40% or less before and after the loan is implemented and that non-guaranteed cash distributions cannot be included in the calculation.

[64] Of equal concern, and of more significance is that there is little supporting evidence to show that Sellars took the necessary steps to accurately determine if his clients met the specific financial thresholds. Much of the information reviewed in the materials presented that related to the financial status of many clients was incomplete or conflicting. This included information on asset valuation, income, net worth etc., particularly in those cases where clients had more than one loan. This concern is highlighted by the inaccuracies in the data provided in both leveraging status spreadsheets provided by Keybase.

[65] When determining suitability, there appeared to be a great reliance placed on the general financial data requested on the "Know Your Client" form. This form asks for

an indication of a client's financial information in fairly broad ranges, e.g., income in \$25,000 increments; and net worth in \$100,000 increments. Each range has a "tick box" and the appropriate range is then ticked. Nowhere in the documentation reviewed did it indicate that accurate calculations were performed using specific financial data. As such, it is difficult for Sellars or Keybase to accurately determine if a client met any of the financial thresholds. The imprecision was compounded for those clients who had more than one loan. It is clear that the thresholds specified in the MFDA guidelines were not used.

[66] In addition, the responsibility for determining specific suitability appears to have been abdicated to the lending institutions. Sellars indicated during his appearance that he relied on the lending institutions to gather the client's specific financial information. However, Sellars previously indicated in his 25 January 2010 affidavit that he had his clients apply for two separate loans with different companies "to maintain borrowing limits to a minimum with individual lenders and to facilitate a loan with a lower level of scrutiny than loans for greater amounts". The MFDA guidelines clearly state that Members and Approved Persons cannot rely on approval of a loan by the lending institution as an indication of suitability. Keybase guidelines require the disclosure of financial information even if the lending institution waives the disclosure. The guidelines require Keybase advisors to obtain specific proof of income and property appraisal information for all leveraged loans.

### **Conclusion**

[67] Accurate information is a critical component for an investor to make a proper and informed investment decision. Sellars clearly had a responsibility to determine whether a leveraging situation was appropriate for his clients. Sellars was well compensated by these arrangements and a more precise determination of whether a client meets the established guidelines is a service that his clients deserve and should expect. Investors should have received better value for the fees that they paid. It is also a level of service that Keybase should demand from its personnel and ensure is being provided.

[68] This ties back to the responsibility of the registrant exercise a duty of care toward the client. With respect to leveraging, the issue is not how big a loan a client can afford, but rather what size loan is suitable. This emphasises the importance of accurately knowing a client's true financial situation. When a client is leveraged beyond the guidelines, it gives the appearance that the advisor's self-interest is the motivation behind the advice.

### **Disclosure**

[69] There is a section in the client new account application form that covers leverage disclosure. It addresses the risks of borrowing for purchasing investments. It covers the general risks and provides an example of what might happen to the investment. The new account application form also has a section on how advisors get paid. This section covers the generalities of the two choices for compensating the advisor. As well, this form includes a section on how a client can make a complaint. It is

interesting to note that out of all the options presented “contacting your local securities regulator” is not one of them. The application form requires a signature from the client for each of these general information sections.

[70] For leverage clients there is a more detailed memorandum of understanding that requires the client to sign off on each step of the process, presumably to ensure that the client understands the procedural aspects and nature of risks associated with leveraged investing.

[71] There appears to be a key element missing in the disclosure to clients considering a leveraged investment. This relates to the client-specific costs and benefits of a leveraged investment. Nothing in the material provided indicated that clients had a clear understanding of how their financial status made them suitable candidates, i.e., how they specifically met the financial thresholds established for suitability. Nor did they have a clear accounting of specific direct or indirect fees and commissions being paid to the advisors or lending institutions; the expected monthly interest charges; expected monthly return on investment (used to offset the interest charges); expected tax return to be applied against the loan principle, etc.

[72] Reviewing the client-specific information provided by Keybase and Sellars reinforces this view. Sellars pointed out in his submission that Staff had neglected to include the distributions made by the investment in the calculation. While the spreadsheet provided in February 2010 had a column incorporating current investment value and cumulative cash distribution against current loan balance, nowhere did any of the figures reflect the cost of fees or the cumulative cost of interest paid.

### **Conclusion**

[73] While disclosure on the process and the generalities of the risks is useful for providing information to clients, the critical information to make an informed decision is absent. In this context, having a client sign off on the various individual clauses seems to be more for the advisors' protection than the clients'. It is important for clients to be made aware of the shortcomings in the services they received in determining their suitability for leverage investing.

[74] Leveraging involves significant risk, which while it can have a positive upside, can be devastating on the downside. The advisor has to have a good understanding of the client's financial situation in order to demonstrate the suitability of this strategy and to have accurate information on the costs and benefits to enable the client to make an informed decision. It is important that Keybase and Sellars meet their legislated responsibilities and properly review these leveraged accounts for suitability. They need to take appropriate corrective action on those accounts determined to be unsuitable.

[75] Sellars indicated in his submission that none of his clients had complained about the suitability and that he “had received numerous letters thanking him for introducing them to an excellent investment plan”. The issue, of course is suitability and acting in the client's best interest, not whether the strategy worked and that nobody complained.

Recognizing that the recent economic downturn has had an effect on many investments, it is noted that approximately 94% of the 175 transactions listed in the February 2010 spreadsheet have virtually the same loan balance as when they started, some dating back to 2005. Of the 175 transactions, 114 (65%) have a current market value of their investment that is less than their current loan balance.

## **Key Considerations**

[76] There are a number of important key considerations:

- Keybase developed a detailed process design to ensure clients understood the nature and risks of leveraging.
- Keybase had written leverage evaluation guidelines in place in April 2007 before the MFDA.
- Keybase revised their guidelines in September 2008 and January 2009.
- These revisions did not take into account the criteria set by the MFDA in its guidelines issued in April 2008, even though the MFDA expressed concerns about Keybase leveraging practices in July 2008.
- Keybase written guidelines allowed for the consideration of exceptions that fell outside the guidelines, however accepting exceptions appeared to be the norm.
- Keybase written guidelines required a number of financial conditions to be met before the suitability criteria were met, however the practice was to base suitability on selective criteria.
- Keybase and Sellars had no effective means of accurately determining if their clients met the specific financial thresholds outlined in either their own guidelines or those of the MFDA.
- Keybase had no effective mechanism to ensure its guidelines were in compliance with those of the MFDA.
- Keybase had no effective mechanism to ensure that its personnel were aware of the MFDA guidelines.
- Keybase had no effective means to ensure that its personnel complied with the MFDA guidelines.
- Keybase had no effective means of ensuring that its personnel complied with Keybase guidelines.
- Keybase's Ultimate Designated Person is responsible for promoting compliance with securities legislation by the firm and its individuals.
- Keybase's Chief Compliance Officer is responsible for establishing and maintaining policies and procedures for assessing compliance with securities legislation and monitoring and assessing compliance by the firm and its individuals.
- Sellars was designated as the branch manager for Keybase's Moncton branch office and was responsible for ensuring that business conducted by its personnel was in compliance with applicable securities legislation and the bylaws and rules of the MFDA.
- Sellars disregarded the MFDA guidelines as well as those of Keybase.

- Sellars acted without taking appropriate steps to determine client suitability and thus jeopardized the financial safety of his clients.
- Sellars personal financial benefit from his actions leads one to conclude that he acted out of self interest.
- MFDA had ongoing concerns and their compliance review of August 2009 identified significant issues with leveraging practices at Keybase and at the Moncton branch office.

## DECISION

[77] Section 48(2) of the *Securities Act* provides that the Executive Director may restrict a registration by imposing terms and conditions as considered appropriate. Based on an analysis of the information presented and reviewed, the Executive Director considered the following terms and conditions appropriate, and ordered that:

1. The Respondents and their personnel are prohibited from acting in furtherance of any trade involving the use of borrowed money to invest, including:
  - a) counselling or recommending to any client the use of borrowed money to purchase securities for the purpose of investing;
  - b) referring any client to a lender or arranging for any client to borrow money for the purpose of investing;
  - c) investing on behalf of a client, knowing the client has borrowed money from a third-party lender for the purpose of investing; and
  - d) opening any new leverage account for new or existing clients.
2. This prohibition shall remain in place until the following conditions are met to the satisfaction of the Executive Director and until further order of the Executive Director:
  - a) The Respondents shall present policies, procedures and guidelines with respect to all aspects of “leveraging” for use by Keybase Financial Group Inc. and its personnel that:
    - i. at a minimum, meet all the current MFDA requirements;
    - ii. are satisfactory to the MFDA; and
    - iii. are satisfactory to the Executive Director.
  - b) Keybase documentation with respect to the use of “leveraging” must cover, at a minimum:
    - i. the determination of and specific calculations related to client suitability;
    - ii. disclosure to clients of the costs of borrowing, together with all fees and charges related to referrals and commissions;
    - iii. disclosure to clients of risk scenarios;



**Keybase Financial Group Inc.,  
And James Edward Sellars**  
(Respondents)

- iv. internal controls related to account opening approvals and follow up supervision;
  - v. client reporting and follow up.
- c) Keybase is required to review all of its current leverage accounts in New Brunswick for suitability with respect to the current MFDA guidelines, and in accordance with the following:
- i. the Chief Compliance Officer shall conduct this review;
  - ii. the review shall commence within 30 days of the date of this order;
  - iii. Keybase shall take appropriate steps, in a timely manner to correct those accounts determined to be unsuitable;
  - iv. Keybase shall provide to the Executive Director a report of its review and any corrective steps taken within 60 days of completion of the review;
  - v. the report shall be signed by both Keybase's Chief Compliance Officer and Ultimate Designated Person.
- d) Keybase shall advise all of its New Brunswick clients that are in, or have been in a leverage account or otherwise in a "leveraged" situation since October 2005, of the terms and conditions placed on the registration of the Respondents. The advisory notice shall be issued within 30 days of the date of this order in a manner and message that are satisfactory to the Executive Director.
3. The policies, procedures and guidelines approved as a result of the action to be taken in 2a) above shall not be amended without the approval of the Executive Director.
4. Keybase Financial Group Inc. and its personnel shall comply with the approved policies, procedures and guidelines issued as a result of the action taken in accordance with 2a) above.

[78] Section 48(3) of the Securities Act requires a registrant to comply with terms and conditions imposed by the Executive Director. Section 48(3) states as follows:

48(3) A registrant shall comply with the terms and conditions imposed on the registration by the Executive Director under subsection (2).

**DATED** at Saint John, New Brunswick this 18<sup>th</sup> day of August 2010.

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Kenrick G. Hancox  
Executive Director  
New Brunswick Securities Commission