Re Brodie

IN THE MATTER OF:

The By-Laws of the Investment Dealers Association of Canada

and

The Dealer Member Rules of the
Investment Industry Regulatory Organization of Canada (IIROC)

and

John Edward Brodie

2013 IIROC 12

Investment Industry Regulatory Organization of Canada
Hearing Panel (Nova Scotia District)

Heard: October 15 - 18, 2012
Decision: March 22, 2013

Hearing Panel:
Richard Bird, Q.C.(Chair), Mr. Bruce Walker and Mr. John Chappell
Appearances:
Mr. Milton Chan, Enforcement Counsel, Investment Industry Regulatory Organization of Canada
Mr. Brian Awad, Counsel for the Respondent

DECISION

THE ALLEGATIONS

¶ 1 IIROC alleges that the Respondent committed the following contraventions:

1. Between 2005 and 2009, the Respondent made investment recommendations that were unsuitable for two clients, contrary to IIROC Dealer Member Rule 1300.1(q) (IDA Regulations 1300.1(q) prior to June 1, 2008).
2. Between 2005 and 2009, the Respondent made discretionary trades in the accounts of two clients without first having the accounts approved and accepted as discretionary accounts, contrary to IIROC Dealer Member Rule 1300.4 (IDA Regulation 1300.4 prior to June 1, 2008).
3. Between May 2008 and June 2009, the Respondent personally compensated two clients for losses in their accounts without the knowledge or approval of his Member firm, contrary to IIROC Dealer Member Rule 29.1 (IDA By-Law 29.1 prior to June 1, 2008).

FINDING OF FACTS

¶ 2 The clients are herein identified as Mr. and Mrs. W. Mr. W was born in 1958. He attended the College of Cape Breton and received a diploma that qualified him as an electrical engineering technician. He worked in that capacity with Michelin and then in the mid 1990's with Pratt & Whitney. By 2005 his salary was in the mid $75,000 range. At the time of this hearing he was still employed with that firm. He described his job as one of performing preventive maintenance on equipment. His wife, Mrs. W, had taken business courses and had been the manager of a shoe store in 1985 when she assumed the role of full time homemaker. In 2005 they owned their own home. It was subject to a mortgage. The exact amount was not disclosed at the hearing.

¶ 3 In the fall of 2005 the mother of Mr. W won over $7 million in a lottery. She gave $1.1 million of her winnings to her son. (It is possible that the gift was made to her son and daughter-in-law jointly, but nothing in these proceedings turns on that point.) Mr. W and Mrs. W decided to invest a portion of the gift and sought out an investment advisor. They considered using at least one other investment advisor before settling on the Respondent. Mr. W's uncle had an account with the Respondent and asked the Respondent if he would mind if he gave his nephew the Respondent's name as a potential investment advisor. After one or two meetings between Mr. and Mrs. W and the Respondent, the Respondent submitted an Investment Proposal that was prepared in November 2005. The Proposal is attached as Appendix A to this decision.

¶ 4 Although the Proposal states that the objective was to invest $1.1 million. It is clear that even if the full amount of the gift were placed in the account that some of it would be temporary. The Recommendation on page one of the Proposal states that one half of the funds would be invested in income trusts and "the balance of the monies in highly liquid Government of Canada 30-day T-Bills pending a new home purchase and unknown financial requirements over the next six months." When the account was opened in December, 2005 only $500,000 deposited to the account.

¶ 5 The Proposal states that one of the objectives was to "produce a sustainable income of $5000 per month in a tax efficient manner." It is clear from page two of the proposal that if the figures there are accurate, that an investment of $500,000 in the selected income trusts would produce sufficient cash flow to meet that objective.

¶ 6 The second objective mentioned on page one of the Proposal was to "Protect and grow capital with an objective of growing the account at a 10 percent annual rate." Apart from the slight excess of income projected ($65,460) over the payments to Mr. and Mrs. W (12 x $5000 = $60,000) that growth would have to come from capital appreciation. The objective could be seen as aggressive, but the Respondent testified that it was "doable."

¶ 7 The Respondent recommended that the funds be invested in income trusts because the rate of return was generally higher in those investments compared to more traditional equities. The reason why this was so at the time was that income trusts were structured to avoid the double taxation the existed with dividends in the corporate setting. As it came to pass, a change in the taxation of income trusts would have a significant impact on the value of income trusts.

¶ 8 The Proposal states twice that the portfolio would be diversified (once under the heading Rationale – "Diversification among traditional asset classes is available through careful selection of individual positions…" and once under the heading Recommendation – "invest half of the funds available now in a diversified portfolio of income trusts").

¶ 9 A margin account was set up on December 12, 2005. Mr. and Mrs. W signed an "Account Information" statement, known in the industry as a "know your client" (KYC) statement. The first page of that statement is attached as Appendix B. The Respondent testified that he completed the form and had Mr. and Mrs. W sign it. Under the heading "Investment Experience" the Respondent checked "moderate" for numerous categories. For short sales, options, and commodities futures, he checked "none." As the Respondent pointed out, the form only provided three choices of investment experience, "none", "moderate", and "extensive." The Respondent testified that he was partly influenced in making these choices by the fact that Mr. W had a Registered Retirement Savings Plan and a Locked-in Retirement Savings Plan with Scotia McLeod. In the latter plan Mr. W held some shares in a mining company.

¶ 10 While on the stand, Mr. W professed to know nothing about investments. However, we do not take issue with the initial judgments made by the Respondent with regard to Mr. W's investment experience.

¶ 11 The next part of the KYC form sets out five categories of investment objectives. The choices made were:

Preservation of Capital, Low Risk	20%
Income, Low-medium Risk	20%
Moderate Growth, Medium Risk	50%
Short Term Trading, Medium –high Risk	0%
Speculative, High Risk	10%
Total	100%

¶ 12 When the account was opened in December, 2005 not all the securities mentioned in the Proposal were purchased. By the end of December, 2005 the percentage amount invested in oil and gas and energy sectors was greater than that which was originally proposed.

¶ 13 In an Agreed Statement of Facts dated October 12, 2012 it is stated:

> "1. In regard to account 52A-621E-8 [herein referred to as the "margin account"] at Canaccord Capital:
>
> (a) From December 2005 to December 2007
>
> i. The account was invested in furtherance of strategies that were moderately-aggressive or aggressive, and that carried moderately-high or high levels of risk.
>
> ii. For much of the time period, 80% or more of the account's holdings carried a medium-high or high level of risk."

¶ 14 It is our conclusion that at the end of December, 2005 the margin account was not as diversified as the November Proposal suggested it would be. One security, Trilogy Energy, constituted 24% of the portfolio at this time. And, the Respondent has agreed that the monies were invested in securities that were riskier than the KYC suggested it would be.

¶ 15 The Respondent recommended a margin account at the very beginning. The evidence of the Respondent was that it was intended to use the borrowing power to facilitate the timing of trades and that it was not intended as source of long term funds.

¶ 16 In addition to the margin account, Mr. W opened an RRSP Account, an LRSP Account and a Spousal RRSP Account with Canaccord.

¶ 17 Early in 2006, Mr. W spoke with the Respondent about the idea of mortgaging his home and placing the funds borrowed in the margin account. The Respondent's main concern was that Mr. W undertake the borrowing so that the interest on the funds borrowed would deductible for tax purposes. On February 27, 2006, a cheque for $186,500 was deposited into the margin account.

¶ 18 Given that Mr. W would be paying interest on the borrowed funds, implicit in this strategy was that the funds would be invested in securities that provided a higher return (and thus a higher risk) than the mortgage. It is not clear that Mr.& Mrs. W understood that implication or that the Respondent explained that to them. Changes were only made to the KYC form after prompting from other employees of Canaccord.

¶ 19 The margin account had a debit cash balance at the end of the first month. In the first six months of operation only at the end of February, 2006 (the month the proceeds from the mortgage were deposited in the margin account) did it have a credit balance. In the first six months the cash debit balance at the end of the month reached a high of over $70,000 at the end of April, 2006. By the end of 2007 the balance was over $570,000.

¶ 20 The Respondent did not keep any notes of any meetings or telephone calls with Mr. and Mrs. W. There are, however, a few emails from various employees of Canaccord to the Respondent concerning the account. On March 13, 2006 Ms. Peggy Farinha emailed the Respondent and raised the question whether the client's investment objectives were attainable unless additional equity was forthcoming. The solution proposed by the Respondent was to change the investment objectives. This was done in April, 2006 to show medium risk, 75% and high risk of 25%. The email from Ms. Farinha suggested “90% venture 10% C P” to reflect the portfolio at that time.

¶ 21 During this period, the monthly draw by Mr. and Mrs. W was increased from $5000 to $5900. Mr. W testified that the increase was in part to cover the payments require as a result of the mortgage of the family home.

¶ 22 At the end of October, 2006 the Margin Account Summary shows the following:

Cash	460,959 DR
Fixed Income	141,667
Common Shares	12,000
Other Securities	825,032
TOTAL ASSETS	517,739

¶ 23 On October 31, 2006 the federal Minister of Finance announced that the preferred tax treatment of income trusts would cease and new rules would be phased in over the next four to five years. At the end of November, 2006 the net value of the margin account was $341,383. Between these two dates Mr. and Mrs. W withdrew a total of $65,900 in cash. When that is added back, the decrease in value over the period October 1 – November 30, 2006 from market forces was just over $110,000.

¶ 24 Despite the drop in the market value of the margin account, withdrawals continued. In January of 2007, in addition to the $5900, $42,000 was withdrawn and another $21,666 in February, 2007.

¶ 25 The January withdrawal was noted by an employee of Canaccord, Christine Alphonso, who stated that the account was undermargined. Securities were sold to meet the call.

¶ 26 During the period August, 2006 to August 2007 Mr. and Mrs. W made significant cash withdrawals from the account. In addition to the monthly withdrawal of $5900 (which stopped around March, 2007), other withdrawals totaled more than $250,000. At the end of July, 2007 the cash in the margin account had a debit balance of more than $325,000. The Statement of Account for the period ending June 30, 2007 shows Net Income after the payment of interest of under $20,000 for the first six months of 2007. At this point is should have clear that the original investment objectives were not attainable.

¶ 27 From the very start of the margin account, investment in mines and minerals was contemplated. The KYC form dated April 20, 2006 changed the investment objectives to 75% moderate growth and 25 % speculative high risk. Short term trading was shown as 0%. Yet 5000 shares of Silver Wheaton were bought on April 20, 2006 and sold the next day for a gain of over $4000. Acadian Gold stock was purchased on April 28, 2006, and Gammon Lake Resources on December 28, 2006. But it was not until August, 2007 that the focus of the margin account shifted substantially. Investments in income trusts were sold and investments in mining and minerals increased and the cash debit balance reduced. By the end of August, 2007 the Account Summary for the margin account was as follows:

Cash	56,959 DR
Common Shares	44,090
Other Securities	111,070
TOTAL ASSETS	97,200

¶ 28 There was no evidence introduced at the hearing as to the balance of the mortgage at various times on Mr. and Mrs. W’s home. The original amount of the mortgage placed in the margin account was $186,500. There is a strong possibility that the overall investment was in the red at this point.

¶ 29 Over the next few months income trust securities were sold and new investment purchases in the margin account were concentrated in the mining sector.

¶ 30 On November 9, 2007 Peggy Farinha, Compliance Officer with Canaccord wrote Mr. and Mrs. W to confirm a change in the investment objectives to:

Moderate Growth	50%
Venture Situations	50%
Total	100%

The letter states that the changes were made as per discussions with the Respondent. There is conflicting evidence as to whether these discussions took place. Mr. W testified that he never received the letter.

¶ 31 The parties state in the Agreed Statement of Facts that:

> "1. (b) From January 2008 to December 2009:
>
> i. The account was invested in furtherance of strategies that were aggressive and that carried high levels of risk.
>
> ii. 90% or more of the account's holdings carried a high level of risk.
>
> iii. The account was heavily weighed in the mining sector."

¶ 32 During the period January, 2008 to December 2009 the value of the margin account gradually declined. During this period Mr. and Mrs. W withdrew a total of $12,000.

¶ 33 The pattern of events in the two RRSP accounts and the LRSP account set up for Mr. & Mrs. W was similar to that in the margin account.

¶ 34 The original KYC forms for these accounts contained the same investment objectives as the margin account. In the RRSP account set up for Mr. W the mutual funds that were transferred into the account were sold and shares in Acadian Gold Corp. (latter changed to Acadian Mining Corp.) were purchased. The other investment was in Stornoway Diamond Corp. Both companies are classified as "junior natural resources – mining."

¶ 35 Acadian Gold constituted a significant portion of the portfolio of both RRSP accounts and the LRSP account.

¶ 36 Starting May 9, 2008, the Respondent personally provided Mr. and Mr. W with financial assistance. The Respondent testified that he felt badly for the W's and he did not want to see the margin account closed. On May 9, 2008 he deposited $20,000 in Mr. and Mrs W's account at the Royal Bank. The transfer was by way of a money order. A similar deposit was made for another $20,000 on September 29, 2008 and another for $4000 on June 10, 2009.

¶ 37 On October 31, 2008 the Respondent deposited $2000 into the margin account to cover the deficit in the margin and another $200 on February 9, 2009 for the same purpose.

¶ 38 On June 15, 2009 the Respondent purchased 50,000 shares of Mantis Mineral Corp. that were in the margin account from Mr. and Mrs. W for $3900. The Respondent testified that the shares were placed in his wife's account and that he orally agreed to pay the W's any profit made from the sale of the shares. He testified that the objective of the transaction was to provide the W's with some liquidity in the margin account.

¶ 39 The Respondent's and Mr. W's testimony on the procedures that were followed in making trades over the life of the accounts with Canaccord is conflicting. The Respondent testified that he would have called Mr. W before making a trade. Sometimes he could recall the specific conversation, sometimes not. That is not surprising when one considers that the Respondent had between 100 and 150 clients. The Respondent kept no notes of any conversations. Mr. W denied receiving many calls. There is no question that a few calls were made. When it came time to liquidate holdings because of the withdrawals or the drop in the market value, Mr.

W and the Respondent were in agreement that Mr. W said something to the effect, “Do what you have to do.”

¶ 40 The Respondent testified that if he received an order to sell a security at a specific price that he would use his discretion as to when to make the sale as long as the period were no greater than two weeks.

ALLEGATION OF UNSUITABILITY OF INVESTMENTS

¶ 41 IIROC alleges that between 2005 and 2009, the Respondent made investment recommendations that were unsuitable for two clients (Mr. & Mrs. W), contrary to IIROC Dealer Member Rule 1300.1(q) (IDA Regulations 1300.1(q) prior to June 1, 2008).

¶ 42 Rule 1300.1 (q) states:

> Each Dealer Member, when recommending to a customer the purchase, sale, exchange or holding of any security, shall use due diligence to ensure that the recommendation is suitable for such customer based on factors including the customer’s financial situation, investment knowledge, investment objectives and risk tolerance.

¶ 43 In *Re Lamoureux* [2001] A. S. C. D. No. 613 at p.15 a panel of the Alberta Securities Commission described the duty of a registrant in assessing the suitability of an investment for a customer as follows:

> Suitability is to be assessed prior to any investment recommendation by the registrant to the client. The process that culminates in a registrant’s investment recommendation to a client has three component phases or stages that must occur in sequence.
>
> The first stage involves the “due diligence” steps undertaken by the registrant to “know your client” and to “know the product.” Knowing the product involves carefully reviewing and understanding the attributes, including associated risks, of the securities that they are considering recommending to their clients…
>
> Only after the “due diligence” of the first stage is completed, can the registrant move to the second stage in which they fulfill their obligation to determine whether specific trades or investments, solicited or unsolicited are suitable for that client.
>
> Suitability determinations…will always be fact specific. A proper assessment of suitability will generally require consideration of such factors as a client’s income, net worth, risk tolerance, liquid assets and investment objectives, as well as an understanding of particular investment products. The registrant must apply sound professional judgment to the information elicited from “know your client” inquiries. If, based on the due diligence and professional assessment the registrant reasonably concludes that an investment in a particular security in a particular amount would be suitable for a particular client, it is then appropriate for the registrant to recommend the investment to the client.
>
> By recommending a securities transaction to a client, a registrant enters the third stage of the process. Whether a particular transaction has in fact been “recommended” is to be determined objectively, taking into consideration the content, context and manner of communication from the registrant to the client, to assess whether it could be reasonably be understood as a suggestion that the customer engage in a securities transaction. At this stage, when making the client aware of the potential investment, the registrant is obliged to make the client aware of the negative material factors involved in the transaction, as well as positive factors.
>
> The disclosure of material negative factors in the third stage of the process is intended to assist the client in making an informed investment decision. It should be emphasized that such disclosure cannot ameliorate deficiencies in either of the first two stages of the process. If a registrant recommends securities that are not suitable for a particular client, then disclosure by the registrant during the third stage is irrelevant to their suitability

> obligation in stage two. *The registrant's failure may have been the result of not knowing the client, or not knowing the securities, or an error in the suitability determination but, once the improper recommendation has been made, it does not matter whether or how the registrant discloses the material negative factors, or whether the client claims to understand and accepts the risks involved in the investment. The registrant has failed to fulfill their obligations.* (Emphasis added)

¶ 44 We have concluded that the Respondent failed to fulfill his obligations to Mr. & Mrs. W in four ways.

¶ 45 First we have concluded that the portfolio was not sufficiently diversified to meet the investment objectives of Mr. & Mrs. W. Second, we have concluded that the extensive purchase of investments with borrowed funds was inappropriate. Third, the portfolio did not match the investment objectives in the KYC statement. Fourth, the risk factors for at least one investment was inappropriate for Mr.& Mrs. W.

(1) Diversification

¶ 46 With regard to diversification the Respondent has admitted that "From January 2008 to December 2009…90% or more of the account's holdings carried a high level of risk [and] the account was heavily weighed in the mining sector." We find that this was not suitable for Mr. & Mrs. W. It was contrary to the investment objectives set out in the KYC.

¶ 47 For the period before January 2008 counsel for the Respondent objected to the introduction of any evidence as to the classification of any securities other than through an expert witness. No expert witnesses were called. The Respondent made a preliminary motion asking the Panel to compel IIROC to do call expert witness(es). We refused. We did not think it appropriate to tell counsel for IIROC how to present their case.

¶ 48 The documents that counsel for the Respondent objected to are at Tabs 61 and 62 of Staff's Compendium of Documents (Tab 62 is also found in Appendix B of Staff's Submissions on the Merits) purport to summarize the investments that were in the margin account. Tab 61 purports to summarize the investment by risk and Tab 62, by industry.

¶ 49 Staff also included in the Compendium, company profiles filed with SEDAR and made available for public viewing. Each company is required to declare an Industry Classification. Counsel for the Respondent did not object to the presentation of these documents.

¶ 50 We should like to point out that these classifications are not necessarily irrebuttable, but we think that given the regulatory nature of the industry that they should at least be considered prima facie evidence.

¶ 51 Using the classifications that are presented on the company profiles for the investments in the margin account as of June 30, 2007 we have prepared the following summary:

Security	Value	Classification on Profile
Gammon Gold	53,680	Gold and precious metals
Calloway REIT	25,140	Real Estate
Canetic Resources	43,300	Oil and Gas
UT – Global Uranium	9,690	Financial
Harvest Energy Trust	82,375	Oil and Gas
Income Financial Trust	45,266	Financial
Mavrix Expl 2006	25,000	Financial
Paramount Energy	23,300	Oil and Gas
Provident Energy	75,120	Oil and Gas
WT – Sprott	1,200	Other

Tree Island Wire	40,000	Industrial Steel
Trilogy Energy	38,440	Oil and Gas
True Energy	48.875	Other.
TOTAL	$531,885	

The investments classified as "Oil and Gas" total $311,410 or 58.548% of the account. (This is the same figure that appears in Tab 62 for the Oil and Gas sector for June 30, 2007.)

¶ 52 We conclude that the margin account was heavily invested in the oil and gas sector. This concentration was unsuitable for Mr. and Mrs. W.

¶ 53 We also find that the portfolio of the two RRSP accounts and the LRSP account did not meet the investment objectives of Mr. & Mrs. W.

(2) Margin Account

¶ 54 The Respondent recommended that Mr. & Mrs. W set up a margin account to facilitate the purchase of securities. In addition, he recommended that they mortgage their home so that additional funds could be invested. We have concluded that the use of borrowed funds was not suitable given the investment objectives of the clients. The use of borrowed funds could only be a successful investment strategy if the rate of return on the investments was greater than the borrowing costs. This would require investments with a greater risk than the original KYC statement set out.

(3) KYC Statement

¶ 55 We also conclude that the portfolio was often out of line with the KYC statement. As noted previously, when a compliance officer with Canaccord contacted the Respondent about the discrepancy, the Respondent's solution to the problem was to obtain a revised KYC Statement to reflect the portfolio rather than bring the portfolio in line with the KYC statement. The KYC Statement appears to have played little or no role in the selection of investments.

(4) Example of an Inappropriate Investment

¶ 56 An example of an investment out of line with the needs of Mr. & Mrs. W., we note the purchase of 2500 units in Mavrix Explore 2006 – 1 FT Limited Partnership at a total price of $25,000. The prospectus (Tab 24 page 800 describes the investment as follows:

> THIS IS A BLIND POOL OFFERING. The units are speculative in nature as are the securities in which the Available Funds will be invested. An investment in Units should be considered only by those purchasers who can afford a complete loss of their investment. There is no assurance of a return on an investor's investment…Tax considerations ordinarily make the Units offered under this prospectus most suitable for investors whose income is subject to the highest marginal rate of tax …

¶ 57 Mr. & Mrs. W were not in the highest marginal tax bracket. In our opinion, Mavrix was not a suitable investment for Mr. & Mrs. W.

ALLEGATION OF DISCRETIONARY TRADING

¶ 58 IIROC alleges that between 2005 and 2009 the Respondent made discretionary trades in the accounts of two clients (Mr. & Mrs. W) without first having the accounts approved and accepted as discretionary accounts, contrary to IIROC Dealer Member Rule 1300.4 (IDA Regulation 1300.4 prior to June 1, 2008).

¶ 59 At paragraph 45 of the Post Hearing Submissions of the Respondent it is stated:

> The Respondent concedes that there were isolated occasions of some degree of discretion exercised by him, but not the rampant or habitual non-communication alleged in the allegation. "Less than five percent."

¶ 60 The testimony of Mr. W and that of the Respondent is conflicting on the degree of consultation before a trade in the account was made. Mr. W. testified that after a few months upon opening the account that he seldom heard from the Respondent. The Respondent, on the other hand, testified that he almost always contacted Mr. W. No written notes, emails, records of meetings, or other such documentation was presented to the panel to substantiate either position.

¶ 61 We accept the concession that there was a breach of the Rule. The allegation makes no mention of "rampant or habitual non-communication." We are unable to determine from the evidence the exact extent of the breach but we find any breach, even "less than five percent" to be significant..

ALLEGATION OF INAPPROPRIATE COMPENSATION

¶ 62 IIROC alleges that between May 2008 and June 2009, the Respondent personally compensated two clients (Mr. & Mrs. W) for losses in their accounts without the knowledge or approval of his Member firm, contrary to IIROC Dealer Member Rule 29.1 (IDA By-Law 29.1 prior to June 1. 2008.

¶ 63 The details of the compensation are set out at paragraphs 32 – 34 of these reasons.

¶ 64 At paragraph 48 of the Post –Hearing Submissions of the Respondent the allegation is admitted.

PENALTIES

¶ 65 Penalties will be determined after counsel have had an opportunity to speak to them.

DATED this 22nd day of March, 2013.

Richard Bird, Q.C. Chair

Bruce Walker, Member

John Chappell, Member