

Re BMO Nesbitt Burns

IN THE MATTER OF:

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

and

**The Universal Market Integrity Rules
and**

BMO Nesbitt Burns Inc.

2012 IIROC 21

Investment Industry Regulatory Organization of Canada
Hearing Panel (Ontario District Council)

Heard: April 3, 2012 in Toronto, Ontario
Decision: April 16, 2012

Hearing Panel:

Hon. Patrick T. Galligan, Q.C. (Chair), Brigitte J. Geisler, Peter J. Gribbin

Appearance:

Charles Corlette, Enforcement Counsel

Michael Petrocco, Counsel for the Respondent

Jeff Paulsen, Representative of BMO Nesbitt Burns

DECISION AND REASONS

¶ 1 The Staff of Investment Industry Regulatory Organization of Canada (“IIROC”) and the Respondent entered into a Settlement Agreement which they had negotiated pursuant to Part 3 of Universal Market Integrity Rules (“UMIR”) and Policy 10.8. They submitted the Settlement Agreement to this Hearing Panel pursuant to Section 3.4 of Part 3 for approval or rejection. After considering the material filed and the submissions made by counsel, we issued an order approving the Settlement Agreement. These are our reasons for making that order.

THE CONTRAVENTION

¶ 2 The Respondent has admitted that on October 13, 2010, it contravened UMIR’s 7.1 and Policy 7.1 by failing to adopt adequate policies and procedures and a supervision system sufficient to manage the risks associated with its trading activities to prevent the submission of erroneous orders, which resulted in the entry of a clearly erroneous order by one of its traders to the Market-on-Close Facility (“MOC Facility”) of the Toronto Stock Exchange (“TSX”).

TERMS OF SETTLEMENT

¶ 3 Staff and the Respondent have agreed upon the following disposition:

- (i) a fine of \$50,000.00 payable by the Respondent to IIROC; and
- (ii) costs of \$5,000.00 payable by the Respondent to IIROC.

THE CIRCUMSTANCES

¶ 4 The circumstances are set out, in detail, in Appendix A to the Settlement Agreement. The Settlement Agreement is attached as a Schedule to these reasons. The following is a brief summary of them:

In the early morning of October 13, 2010, a BMO NB trader entered a Market-on-Close Order (“MOC Order”) to sell 33,000,000 shares of Bank of Montreal (“BMO”) stock when he intended to enter an order to sell 33,000 shares. The BMO NB trader did not discover the error until 3:40 p.m., when the TSX published the MOC imbalance. BMO NB immediately called IIROC and the TSX to report the error and seek guidance on the appropriate way to correct the error. In the interest of a fair and orderly market, IIROC Market Integrity Officials authorized the trader to enter an offsetting limit order into the MOC Facility. The offsetting order executed in a cross trade with the BMO NB sell order. The trade was then cancelled by the TSX. BMO NB thereby avoided significant harm for themselves and the markets.

At the time of the erroneous order, no pre-trade filters were enabled on the trader’s trading application. BMO NB had insufficient procedures in place to ensure that appropriate pre-trade filters were activated on its traders’ trading applications, and had insufficient procedures in place to review the accuracy of MOC Orders prior to 3:40 p.m. Had an adequate supervision system been in place, the error would have been detected prior to entry in the MOC Facility.

¶ 5 Counsel for the Respondent stated that his client was embarrassed to be in front of a Hearing Panel. Mr. Petrocco assured us that what happened on October 13, 2010 was an “inadvertent aberration”. We accept that assurance.

SERIOUSNESS OF THE CONTRAVENTION

¶ 6 While prompt reporting of the error by the Respondent and the action taken by IIROC officials and the TSX avoided significant harm in this particular case, failure to effectively supervise trading can seriously undermine the maintenance of fair and orderly markets. Thus, even though inadvertent, the contravention must be viewed as a very serious one.

CIRCUMSTANCES OF MITIGATION

¶ 7 In the determination of an appropriate penalty it is always necessary to consider circumstances of mitigation. As noted above, this contravention was inadvertent. What is particularly relevant are the remedial steps which have been taken by the Respondent. BMO carried out a thorough review of its policies and procedures and systems following the entry of the clearly erroneous MOC Order and instituted a number of changes, including:

- (i) conducting a review to assess and define appropriate pre-trade limits, and ensure appropriate pre-trade limits were activated on trading applications for equity traders;
- (ii) establishing a process by which MOC Orders are reviewed by its Trade Supervision Group prior to 3:40 p.m. when the MOC Facility is locked; and
- (iii) drafting and implementing procedures to ensure the proper activation and modification of pre-trade limits in the trading applications used by its traders and the proper monitoring of any changes or authorizations to change those pre-trade limits.

THE DUTY OF A HEARING PANEL UPON A SETTLEMENT HEARING

¶ 8 It is clear from jurisprudence emanating from the courts and from Hearing Panels of IIROC, Investment Dealers Association and the Mutual Fund Dealers Association, that our task is not to decide whether, in this case, we would have arrived at the same decision as that reached by the parties. Rather, our duty is to determine whether the penalty is a reasonable one and that it meets the objectives of the disciplinary process which are to maintain the integrity of the investment industry. We cite from the recent decision of the Hearing Panel in *Re CIBC World Markets Inc.*, [2011] IIROC No. 38:

13 Finally, hearing panels will not lightly interfere with a negotiated settlement. As was said in *Re Milewski*, [1999] IDACD No. 17,

... a District Council considering a settlement agreement will tend not to alter a penalty that it considers to be within a reasonable range, taking into account the settlement process and the fact that the parties have agreed. It will not reject a settlement unless it views the penalty as clearly falling outside a reasonable range of appropriateness.

14 Or, as put by Winkler J. (albeit in another context) in *Gilbert v. CIBC*, [2004] O.J. 4260:

There is a presumption of fairness when a proposed class settlement negotiated at arms length ... is presented to the court for approval. A court will only reject a proposed settlement when it finds that the settlement does not fall within a range of reasonableness.

The test to be applied is whether the settlement is fair and reasonable ... This allows for a range of possible results and there is no perfect settlement. Settlement is a product of compromise, which by definition, necessitates give and take.

15 In our view, the settlement, negotiated as it was by the parties assisted by capable counsel, does not clearly fall “outside a range of appropriateness” and it should therefore be, and was, accepted by the panel.

GUIDELINES AND OTHER DECISIONS

¶ 9 In determining whether a settlement is a reasonable one, a hearing panel is entitled to look at regulatory guidelines and other decisions. Guidelines are not binding upon a hearing panel and cannot derogate from its responsibility to decide what may be an appropriate penalty in a given case. However, they are useful in that they show what penalties members of the industry think are generally appropriate. The IDA Guidelines had recommended a minimum fine of \$25,000 for failure to maintain adequate internal control.

¶ 10 Decisions in other cases can also help to indicate what might be a reasonable range of penalties. Counsel referred us to three cases. The first is *Re CIBC World Markets (supra)*. In that case a changed methodology was adopted for adjusting options contracts when there was a stock split for an underlying security. CIBC erroneously failed to implement the change into its Canadian system. Over a 2-1/2 month period the failure to implement the changes prevented the proper monitoring of the margin accounts of a number of its clients. Losses resulted. When the error was discovered CIBC implemented appropriate internal controls and sought to compensate affected clients. The settlement, approved by the hearing panel, was a fine of \$80,000 plus costs of \$15,000. We note that the error in that case continued for 2-1/2 months and resulted in significant harm to a number of clients.

¶ 11 The next case was a decision of a hearing officer at the New York Stock Exchange (“NYSE”). It is re *Credit Suisse Securities (USA)*, NYSE Hearing Board Decision 11-NYSE-5 (2011). That case has remarkably similar circumstances to the one before us. The case involved the failure of supervision to prevent MOC and Limit-on-Close violations of time frames required by the NYSE. The parties settled for censure and a fine of \$50,000. The settlement was approved by a hearing officer.

¶ 12 The third case is also from the NYSE. It is re *Morgan Stanley & Co., Incorporated*, NYSE Hearing Board Decision 06-220 (2006). In one respect that case is very like this one. A trader inadvertently entered an order with a value of \$10.8 billion when he intended an order worth \$10.8 million. Without going into details, the order, which would have been caught but for a failure of supervision, caused “significant market disruption in certain NYSE listed securities ...”. The parties settled for censure and a \$300,000 fine. The significant difference between that case and this one is that in this case the error did not result in market disruption.

DECISION

¶ 13 The circumstances of this case, considered in the light of decisions in other cases, led us to the conclusion that this settlement was a reasonable one. Therefore, we approved it.

¶ 14 This case should serve to emphasize the importance of strict compliance with members’ obligations to

have and maintain effective supervision of its trading.

DATED this 16th day of April, 2012.

The Hon. Patrick T. Galligan, Q.C.

Brigitte J. Geisler, Industry Representative

Peter J. Gribbin, Industry Representative

OFFER OF SETTLEMENT

A. INTRODUCTION

1. The Enforcement Department Staff (Staff) of the Investment Industry Regulatory Organization of Canada (IIROC) has conducted an investigation (the Investigation) into the conduct of BMO Nesbitt Burns Inc. (the Respondent).
2. The Investigation has disclosed matters for which IIROC seeks certain sanctions against the Respondent pursuant to Rule 10.5 of the Universal Market Integrity Rules (UMIR).
3. If this Offer of Settlement is accepted by the Respondent, the resulting settlement agreement (the Settlement Agreement), which has been negotiated in accordance with Part 3 of UMIR Policy 10.8, is conditional upon the approval by a hearing panel appointed pursuant to IIROC Transitional Rule No.1, Schedule C.1 (the Hearing Panel).
4. The Respondent agrees to waive all rights under UMIR to a hearing or to an appeal or review if the Settlement Agreement is approved by the Hearing Panel.
5. The Respondent consents to be subject to the jurisdiction of IIROC and its relevant disciplinary process and rules in relation to this matter.
6. Staff and the Respondent jointly recommend that the Hearing Panel accept this Settlement Agreement.

B. AGREEMENT AS TO REQUIREMENTS CONTRAVENED

7. The Respondent agrees that it contravened UMIR 7.1 and Policy 7.1 by failing to adopt adequate policies and procedures and a supervision system sufficient to manage the risks associated with its trading activities to prevent the submission of erroneous orders, which resulted in the entry of a clearly erroneous order by one of its traders to the Market-on-Close Facility ("MOC Facility") of the Toronto Stock Exchange ("TSX") on October 13, 2010.

C. ADMITTED FACTS

8. For the purposes of this Settlement Agreement only, Staff and the Respondent agree with and rely upon the admitted facts and conclusions which are set out in the Statement of Allegations attached as Appendix "A" to this Settlement Agreement.

D. DISPOSITION

9. For the contraventions in paragraph 7 above, Staff and the Respondent have agreed upon disposition as follows:
 - (i) a fine of \$50,000.00 payable by the Respondent to IIROC; and
 - (ii) costs of \$5,000.00 payable by the Respondent to IIROC.
10. If this Settlement Agreement is accepted by a Hearing Panel, the Respondent agrees to pay the amounts referred to in paragraph 9 within 30 days of such acceptance.

E. PROCEDURES FOR ACCEPTANCE OF OFFER OF SETTLEMENT AND APPROVAL OF

SETTLEMENT AGREEMENT

11. The Respondent shall have until the close of business on March 23, 2012 to accept the Offer of Settlement and serve an executed copy thereof on Staff.
12. This Settlement Agreement shall be presented to a Hearing Panel at a public hearing (the Approval Hearing) held for the purpose of approving the Settlement Agreement, in accordance with the procedures described in UMIR Policy 10.8 in addition to any other procedures as may be agreed upon between the parties. The Respondent acknowledges that IIROC shall notify the public and media of the Approval Hearing in such manner and by such media as IIROC sees fit.
13. Pursuant to Part 3.4 of UMIR Policy 10.8, the Hearing Panel may accept or reject this Settlement Agreement.
14. In the event the Settlement Agreement is accepted by a Hearing Panel, the matter becomes final, there can be no appeal or review of the matter, the disposition of the matter agreed upon in this Settlement Agreement will be included in the permanent record of IIROC in respect of the Respondent and IIROC will publish a summary of the Requirements contravened, the facts, and the disposition agreed upon in the Settlement Agreement.
15. In the event the Hearing Panel rejects the Settlement Agreement, IIROC may proceed with a hearing of the matter before a differently constituted Hearing Panel pursuant to Part 3.7 of UMIR Policy 10.8 and this Settlement Agreement may not be referred to without the consent of both parties.
16. The Respondent agrees that, in the event it fails to comply with any of the terms of the Settlement Agreement, IIROC may enforce this settlement in any manner it deems appropriate and may, without limiting the generality of the foregoing, suspend the Respondent's access to marketplaces regulated by IIROC until IIROC determines that the Respondent is in full compliance with all terms of the Settlement Agreement.
17. The Respondent agrees that neither it, nor anyone on its behalf, will make a public statement inconsistent with this Settlement Agreement.

IN WITNESS WHEREOF the parties have signed this Settlement Agreement as of the dates noted below.

DATED at Toronto, Ontario on the 15th day of March, 2012.

Witness Signature

per: BMO Nesbitt Burns Inc.

Name of Witness

Address of Witness

DATED at Toronto, Ontario on the 2nd day of March, 2012.

Per: JEFFREY KEHOE

VICE-PRESIDENT, ENFORCEMENT

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

Suite 2000, 121 King Street West

Toronto, Ontario M5H 3T9

This foregoing Settlement Agreement is hereby approved this 3rd day of April, 2012, by the following hearing panel constituted to review the terms thereof:

Per: The Honourable Patrick Galligan

Panel Chair

Per: Ms. Brigitte Geisler
Panel Member

Per: Mr. Peter Gribbin
Panel Member

STATEMENT OF ALLEGATIONS

I. REQUIREMENTS CONTRAVENED

1. BMO Nesbitt Burns Inc. (“BMO NB”) contravened Universal Market Integrity Rule (“UMIR”) 7.1 and Policy 7.1 by failing to adopt adequate policies and procedures and a supervision system sufficient to manage the risks associated with its trading activities to prevent the submission of erroneous orders, which resulted in the entry of a clearly erroneous order by one of its traders to the Market-on-Close Facility (“MOC Facility”) of the Toronto Stock Exchange (“TSX”) on October 13, 2010.
2. Schedule “A” sets out the text of the relevant UMIR Requirements.

II. RELEVANT FACTS AND CONCLUSIONS

Overview

3. On the morning of October 13, 2010, a BMO NB trader entered a Market-on-Close Order (“MOC Order”) to sell 33,000,000 shares of Bank of Montreal (“BMO”) stock when he intended to enter an order to sell 33,000 shares. The BMO NB trader did not discover the error until 3:40 p.m., when the TSX published the MOC imbalance. BMO NB immediately called IIROC and the TSX to report the error and seek guidance on the appropriate way to correct the error.
4. In the interest of a fair and orderly market, IIROC Market Integrity Officials authorized the trader to enter an offsetting limit order into the MOC Facility. The offsetting order executed in a cross trade with the BMO NB sell order. The trade was then cancelled by the TSX. BMO NB thereby avoided significant harm.
5. At the time of the erroneous order, no pre-trade filters were enabled on the trader’s trading application. BMO NB had insufficient procedures in place to ensure that appropriate pre-trade filters were activated on its traders’ trading applications, and had insufficient procedures in place to review the accuracy of MOC Orders prior to 3:40 p.m. Had an adequate supervision system been in place, the error would have been detected prior to entry in the MOC Facility.

Background

6. BMO is registered as an investment dealer, is a Participating Organization of the Toronto Stock Exchange (the “TSX”), and therefore, a Participant under UMIR.
7. The TSX MOC Facility permits the entry of market orders to trade at the closing price from 7:00 a.m. to 3:40 p.m. At 3:40 p.m., the TSX calculates and publishes the order imbalance for each of the securities participating in the MOC Facility indicating the size of the imbalance and whether the imbalance is on the buy or sell side. After 3:40 p.m., only limit orders on the opposite side of the market imbalance may be entered. The MOC Facility is “blind” as there is no transparency with respect to particular orders entered as market MOC Orders or limit MOC Orders. A market MOC Order entered prior to 3:40 p.m. may not be amended or cancelled after 3:40 p.m.
8. The TSX MOC Facility is intended to provide all market participants with an opportunity to participate in setting the closing price, reduce volatility at the close, and guarantee the anonymity of broker numbers and volumes in the close.

Facts

9. On October 13, 2010 at 8:56:53 a.m., a trader at BMO NB entered a market MOC Order on the TSX to

sell 33,000,000 shares of Bank of Montreal (BMO) stock when he intended to enter an order for 33,000 shares.

10. The BMO NB trader was a Director assigned to the Structured Finance Trading Desk and had six years equities trading experience.
11. BMO NB has the ability to employ pre-trade filters on its electronic trading applications to avoid the risk of erroneous order entry. The trading application used by the BMO NB trader to enter the erroneous order allowed for pre-trade limits and warning messages to be set as a safeguard against errors. These filters were used in many cases but not all cases.
12. On October 13, 2010, no pre-trade filters or pre-trade limits were enabled on the BMO NB trader's equity trading application. There was no alert, message or warning to the trader or the firm confirming that an unusually large order was about to be sent to the TSX marketplace.
13. At the relevant time, BMO NB had no procedures in place to verify that pre-trade filters or limits were activated on the trading applications used by its traders.
14. At the relevant time, BMO NB had insufficient procedures in place to review and confirm the accuracy of MOC Orders before 3:40 p.m.
15. At 3:40 p.m., the TSX published a MOC imbalance of 33,065,500 shares in BMO.
16. After the publication of the imbalance, the BMO NB trader recognized the error and attempted to cancel the order through the TSX. MOC Orders may not be amended or cancelled after 3:40 p.m. BMO NB contacted IIROC and the TSX to report the error and seek guidance on the appropriate way to correct the error.
17. For a brief period following the initial publication of the MOC imbalance the price of BMO shares experienced its largest decline of the day (approximately \$0.50) before rising again.
18. In the interest of a fair and orderly market, IIROC Market Integrity Officials authorized the BMO trader to enter an offsetting limit order into the MOC Facility and advised that any volume crossed would be cancelled by the TSX.
19. At 3:46:55, the TSX published corrected imbalance information for BMO shares, listing the sell imbalance as 65,500 shares. The publication of the corrected MOC imbalance does not necessarily reach all market participants who entered orders on the basis of the original MOC imbalance.
20. At 3:49:58, the BMO trader entered a purchase order for 33,000,000 shares of BMO at \$60.45. Subsequently, Market Integrity Officials advised that the offsetting purchase order price should be varied to \$60.21, resulting in a variation of the order at 3:57:46.
21. In the end result, BMO purchased 32,821,400 and sold 33,000,000 shares in the MOC Facility. BMO executed a cross trade for 32,749,300 shares which was then cancelled by the TSX.
22. The authorization to enter the offsetting order allowed BMO NB to avoid significant harm.

Supervision

23. UMIR 7.1 and Policy 7.1 requires each Participant to adopt written policies and procedures that are adequate, taking into account the business and affairs of the Participant, to ensure its trading activities are in compliance with UMIR and each Policy, and has an obligation to supervise orders entered on a marketplace.
24. Guidance about a Participant's obligations with respect to trading in the MOC Facility of the TSX was issued in Market Integrity Notice 2004-021 (issued August 26, 2004), wherein it was advised that "[a] Participant or Access Person should take every precaution to ensure that Market MOC Orders entered into the MOC Facility are accurate. In particular, it is recommended that all Market MOC Orders be reviewed and confirmed prior to 3:40 p.m."

25. BMO NB failed to meet its obligations under UMIR 7.1 and Policy 7.1 in that it failed to adopt adequate policies and procedures to prevent erroneous orders from being entered into the MOC Facility and failed to provide for full and proper supervision of orders entered into the MOC Facility.
26. BMO NB had insufficient procedures in place to ensure that adequate pre-trade filters were enabled to ensure order accuracy and manage the risk of order entry errors.
27. BMO NB had insufficient procedures in place to ensure the accuracy of MOC Orders or to review and confirm MOC Orders prior to 3:40 p.m.
28. In the circumstances of this case, had such procedures been in place the erroneous MOC Order could have been prevented. There was ample opportunity to prevent or detect the clearly erroneous MOC Order entered by the trader before the MOC Facility was locked and the imbalance was published to market participants.

Remedial Steps taken by BMO NB

29. BMO NB carried out a thorough review of its policies and procedures and systems following the entry of the clearly erroneous MOC Order and instituted a number of changes, including:
 - (i) conducting a review to assess and define appropriate pre-trade limits, and ensure appropriate pre-trade limits were activated on trading applications for equity traders;
 - (ii) establishing a process by which MOC Orders are reviewed by its Trade Supervision Group prior to 3:40 p.m. when the MOC Facility is locked; and
 - (iii) drafting procedures to ensure the proper activation and modification of pre-trade limits in the trading applications used by its traders and the proper monitoring of any changes or authorizations to change those pre-trade limits.
30. BMO NB cooperated fully in the resolution of the error and with the IIROC investigation.

III. CONCLUSION

31. A Participant must supervise orders entered on a marketplace and its trading activity to ensure it is being carried out in compliance with applicable regulatory standards and all requirements of UMIR. Effective trading supervision is integral to ensuring fair and orderly markets. Erroneous orders, especially during sensitive pricing periods such as in the MOC Facility, can cause significant market impact that may adversely affect market participants.

March 2, 2012

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

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