Re Kilgannon

IN THE MATTER OF:

The By-Laws of the Investment Dealers Association of Canada (IDA)

and

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

and

Robert Jay Kilgannon

2013 IIROC 32

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

Heard: May 28, 2013
Decision: June 12, 2013

Hearing Panel:
The Honourable Fred Kaufman, C.M., Q.C. - Chair, Mr. Robert Guilday and Mr. Charles Macfarlane
Appearances:
Rob DelFrate, Enforcement Counsel
Nigel Campbell, Blakes LLP, for the Respondent

REASONS FOR THE DECISION

¶ 1 IIROC Enforcement Staff and Robert Jay Kilgannon (the "Respondent"), having reached agreement on the disposition of two contraventions of IIROC Rules, Guidelines, IDA By-Laws, Regulations or Policies alleged against the latter, submitted a Settlement Agreement to the Panel on May 28, 2013. At the conclusion of the hearing, having heard from both parties, the Panel accepted the Agreement, reasons to follow, and these are the reasons.

Introduction

¶ 2 On June 1, 2008, IIROC consolidated the regulatory and enforcement functions of the Investment Dealers Association of Canada and Market Regulation Services Inc. Pursuant to the *Administrative and Regulatory Services Agreement* between IDA and IIROC, effective June 1, 2008, the IDA has retained IIROC to provide services for IDA to carry out its regulatory functions.

¶ 3 An investigation carried out into certain actions taken by the Respondent revealed that, between February 2007 and January 2009, he contravened two IDA Regulations by

(i) failing to use due diligence to learn and remain informed of the essential facts concerning Nortel Cumulative Redeemable ClassA Preferred Shares Series 5, contrary to IDA Regulation 1300.1(a) (now Dealer Member Rule 1300.1(a)); and

(ii) recommending the purchase of these shares to a client, HH, without using due diligence to ensure that the recommendations were suitable for the client based on her financial situation, investment knowledge, investment objectives and risk tolerance, contrary to IDA Regulation

1300.1(q) (now Dealer Member Rule 1300.1(q)).

The Facts

¶ 4 The facts of this case, as agreed upon by the parties (and as stated in the Settlement Agreement), are as follows.

Overview

¶ 5 The Respondent failed to use due diligence to ensure that a product he recommended to a client, HH, was suitable for her. The Respondent recommended the purchase of high risk Nortel Cumulative Redeemable Class A Preferred Shares Series 5 (the "Nortel Preferreds") to a client who had no tolerance for high risk investments in her portfolio.

¶ 6 Although the Respondent did conduct some due diligence on the Nortel Preferreds, he did not fully understand the risks as well as other important features of the securities. As a result, he was unable to communicate these risks to HH to ensure that she was able to make an informed investment decision.

Registration History

¶ 7 The Respondent has been registered as a Registered Representative with an Oshawa, Ontario branch of RBC Dominion Securities Inc. ("RBCDS") since February 1995.

¶ 8 On June 1, 2008, the Respondent became a regulated person of IIROC.

¶ 9 The Respondent has no prior disciplinary history and has cooperated fully with IIROC's investigation into this matter.

The Client - HH

¶ 10 HH had been a client of the Respondent since 1998.

¶ 11 In January 2007, she completed an Investment Policy Statement ("IPS") with the Respondent. The IPS identified HH as having a "conservative" risk tolerance, the most risk-averse category used by RBC at that time and noted that, based on this risk tolerance, there would be an equal emphasis on minimizing risk as on maximizing gains.

¶ 12 HH's "Know Your Client" ("KYC") information recorded in March, 2005 indicated a risk tolerance of 50% "Investment Grade" and 50% "Good Quality". The KYC information was updated in October 2008 and indicated a risk tolerance of 50% "Low" and 50% "Medium".

¶ 13 In February 2007, the Respondent recommended HH purchase the Nortel Preferreds. The Respondent concluded that the Nortel Preferreds were a low risk investment and were therefore suitable for HH. In fact, the Nortel Preferreds were high risk securities that were not suitable for HH.

¶ 14 Several rating agencies had identified risks associated with the Nortel Preferreds. Specifically:

i. In June 2006, Standard & Poor's Ratings Services ("S&P") had rated the Nortel Preferreds "CCC-" (P-5 in Canadian scale). Obligations rated "CCC" are regarded by S&P "as having significant speculative characteristics." The "CCC" rating is described as "Currently vulnerable to nonpayment, and is dependent upon favorable business, financial and economic conditions for the obligor to meet its financial commitment on the obligations. In the event of adverse business, financial or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation." The minus (-) sing indicates the relative standing within the rating category.

ii. In July 2006, Dominion Bond Rating Service ("DBRS") had confirmed the ratings of Nortel Preferreds as "Pfd 5 (low)". Preferred shares rated Pfd-5 are defined by DBRS as "highly speculative and the ability of the entity to maintain timely dividend and principal payments in the future is highly uncertain. Preferred shares rated Pfd-5 often have characteristics which, if not remedied, may lead to default." The "low" grade indicates the relative standing of the credit

within a particular rating category.

iii. In September 2006, Moody's Investor Services had rated the Nortel Preferreds as "Caa3". Moody's defines an issue rated "caa" as "likely to be in arrears on dividend payments." The numerical modifier 3 indicates that the issue ranks in the lower end of its generic rating category.

¶ 15 The Respondent nonetheless concluded that the Nortel Preferreds were low risk and suitable for HH. On February 12, 2007, HH purchased approximately $25,000 of the Nortel Preferreds at a price of $19.54 per share. This represented approximately 4% of HH's total portfolio. At or around that time, the Respondent also recommended the purchase of other, less speculative, preferred shares to HH.

¶ 16 Following the purchase, HH had concerns about the recent purchases, including the Nortel Preferreds. By email dated April 18, 2007, HH advised: "I also want to make sure that the new investments are not subject to a loss in value. I will sleep better."

¶ 17 In response, the Respondent advised HH that there would be capital gains in addition to the dividends paid by the recently purchased preferred shares, including the Nortel Preferreds. He advised her that the minimum return annually would be 4%.

¶ 18 In fact, the Nortel Preferreds were not guaranteed investments and were subject to potential loss in value. Although the potential for capital gains existed, these were not certain.

¶ 19 By the end of December, 2007, the share price of the Nortel Preferreds had declined to $15.00. By email dated January 16, 2008, HH again asked the Respondent for information relating to preferred shares and whether she was "right in thinking that the actual value of my Preferred Shares is the book value providing they are cashed at maturity?"

¶ 20 In response, the Respondent confirmed that HH was correct and that "the important number is the book value, not market value."

¶ 21 In fact, the Nortel Preferreds did not have a redemption at maturity feature and there was no guarantee that the Nortel Preferreds could or would be redeemed at par value.

¶ 22 The share price of the Nortel Preferreds continued to decline and by the end of November 2008 had reached a price of $0.55. By email dated December 5, 2008, HH again asked the Respondent about her investments in preferred shares, including the Nortel Preferreds.

¶ 23 In response, the Respondent provided some information on the preferred shares. He recommended that HH re-allocate some of her holdings which would "allow us to 'lock in' some losses so that we can use them going forward to offset any capital gains".

¶ 24 In response, by email dated December 11, 2008, HH advised that she was confused and that she "thought with preferred shares there were no losses, that they mature at book value." She also asked about the status of the Nortel Preferreds and concluded "I think I need to understand these better before moving anything around right now."

¶ 25 Following a discussion with HH about her investments, the Respondent recommended that HH sell some of her other preferred share holdings (but not the Nortel Preferreds) and invest the proceeds into similar preferred shares. He advised that this was "overall, a good strategy to take in a guaranteed investment that doesn't afford opportunities like this often".

¶ 26 In January 2009, Nortel filed for bankruptcy protection and trading in the Nortel Preferreds was halted.

¶ 27 Despite HH's lack of understanding of preferred shares in general and the Nortel Preferreds in particular, at no time did the Respondent recommend that HH liquidate her holdings or switch to a more risk averse investment, nor did he take steps to ensure that she properly understood the risks associated with the Nortel Preferreds.

¶ 28 He failed to fully understand the risks associated with the Nortel Preferreds and to adequately explain these to HH, thereby failing to ensure that the investment was suitable for her.

Other

¶ 29 In January 2011, HH complained to RBCDS about her account performance. Similar complaints were received from two other clients who had invested in the Nortel Preferreds. RBCDS has reached settlements with these clients, pursuant to which the clients were repaid over $80,000. The Respondent has reimbursed this entire amount to RBCDS. No other complaints have been filed by clients who had invested in the Nortel Preferreds.

Terms of Settlement

¶ 30 The terms of the settlement are as follows:

i. A fine in the amount of $35,000;

ii. A period of four (4) months of close supervision commencing on the date of acceptance of the Settlement Agreement;

iii. The Respondent shall re-write and successfully complete the Conduct and Practices Handbook examination within 12 months of the acceptance of the Settlement Agreement;

iv. Costs in the amount of $5,000.

Discussion

¶ 31 As the facts indicate – and as Enforcement Counsel very fairly stressed – the Respondent's conduct was not manipulative of fraudulent. Rather, it was his failure to fully understand the risks associated with the investment and, having failed to understand them, he failed to convey them to his client. When HH raised concerns, he continued to mischaracterize the features of the investment, thereby compounding his initial error. Yet, as indicated by the facts set out above, three major ratings agencies (S&P, DBRS and Moody's) had warned about the risks associated with this issue which, at the very least, should have caused the Respondent to be extremely cautious and to realize that this was not an appropriate investment for HH, nor for the other two clients to whom he had recommended the Nortel Preferreds.

¶ 32 There is no indication that the Respondent made the recommendation with the intent to enrich himself. The investment constituted but 4% of his client's portfolio, so her loss (for which she was fully compensated) was relatively small. Also, in the Respondent's favour, are his clean record and the fact that he fully cooperated with the investigators, saving a great deal of time and money for concerned. Moreover, he has repaid over $80,000 to RBCDS, thereby making good his employer's loss.

¶ 33 IIROC's Dealer Member Disciplinary Sanction Guidelines suggest a minimum fine of $10,000 in cases where unsuitable investments are recommended. They also suggest a disgorgement of profits (not an important factor in this case), a rewrite of the Conduct and Practices Handbook examination, and a period of supervision. In egregious cases, a period of suspension would be appropriate, but this is not that type of case.

¶ 34 The sanctions agreed upon by the parties not only followed the Guidelines, but they are also consistent with sanctions imposed in the past for similar types of misconduct: see, for instance, *In re Skelton*, 2012 IIROC 46 (a fine of $30,000 and costs), *In re Beechey*, 2011 IIROC 80 (a fine of $50,000, disgorgement and costs), and *In re Chrabalowski*, 2011 IIROC 49 (a fine of $20,000, disgorgement and costs).

¶ 35 Having considered the terms of the Settlement Agreement, the facts, the aggravating as well as the mitigating factors, the Guidelines, and previous decisions in similar cases, the Panel was satisfied that the Agreement was in the public interest and should, therefore, be accepted, which it was.

Given in Toronto, Ontario, this 12th day of June, 2013.

Hon. Fred Kaufman, Chair

Robert Guilday, Member

Charles Macfarlane, Member