

Re CIBC World Markets

IN THE MATTER OF:

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

and

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

and

CIBC World Markets Inc

2012 IIROC 57

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

Hearing: July 24, 2012
Decision: October 17, 2012

Hearing Panel:

Alan V.M. Beattie, Q.C. (Chair), Martin Davies, William Welton

Appearances:

David McLellan, Senior Enforcement Counsel for IIROC

James Heelan, Q.C, Counsel for the Respondent

Per Humle, Current manager of the Respondent (not manager at the relevant times)

REASONS FOR DECISION

I. INTRODUCTION

¶ 1 A Settlement Agreement was entered into July 17, 2012 between the Investment Industry Regulatory Organization of Canada Enforcement Staff (“Staff ” or “IIROC”) and CIBC World Markets Inc. (“the Respondent”) in accordance with IIROC Dealer Member Rules 20.35 to 20.40, inclusive and Rule 15 of the Dealer Member Rules of Practice and Procedure.

¶ 2 The Settlement Agreement contains a complete Statement of Facts, a description of the Contraventions and the Terms of Settlement (all below). In the Settlement Agreement the Respondent admits to the contraventions. Staff of IIROC and the Respondent jointly recommend that the Hearing Panel accept the Settlement Agreement. It is stated that the Settlement Agreement is subject to acceptance by the Hearing Panel and if the Panel accepts the Settlement Agreement, the Respondent waives his right under IIROC rules and any applicable legislation to a disciplinary hearing, review or appeal.

¶ 3 A Settlement Hearing Book was provided in advance of the Hearing by IIROC to the Respondent and his Counsel, and members of the Hearing Panel.

II. SETTLEMENT AGREEMENT

¶ 4 The Settlement Agreement includes the following:

STATEMENT OF FACTS

(i) Acknowledgment

9. Staff and the Respondent agree with the facts set out in this Section III and acknowledge that the terms of the settlement contained in this Settlement Agreement are based upon those specific facts.

(ii) Factual Background

Overview

10. Two clients, both knowledgeable, experienced and actively involved in the management of their accounts, held options positions which presented high risk scenarios and suffered significant losses when the market declined between June and October, 2008.
11. The Respondent, CIBC World Markets Inc. (“Respondent”) failed in its supervisory responsibility because its supervisors did not take sufficient steps to ensure that options positions in these client accounts were suitable for them.

Respondent

12. At all material times, the Respondent was a duly registered member firm of the IDA and its successor, IIROC.

Registered Representative

13. Soliterman is an RR with the Respondent in Calgary, He has been an RR since 1989.
14. On February 6, 2012 an IIROC Hearing Panel accepted a settlement agreement entered into between Staff and Soliterman in which Soliterman admitted that he failed to know his clients, LK and JK, and that he failed to use due diligence to ensure that acceptance of orders was suitable for these clients. He agreed to a fine in the amount of \$55,000 plus \$5,000 costs. (*Panel’s Note: The Decision is summarized below at p.11*)

Supervision

15. Soliterman was supervised by the Respondent at the Tier 1 level (branch level) in Calgary. He was also supervised at the Tier 2 level in Toronto by the Designated Options Principal (DROP) and/or the Assistant Registered Options Principal (AROP), and their designates. Tier 1 reviews encompassed all option trades at the branch level. Tier 2 reviews were only focused on option trades of ten contracts or more. As such, approximately 30% to 40% of the trades executed by Soliterman for the clients in question would have been subject to review at Tier 2.

Clients LK and JK

16. At all material times, LK and JK held accounts with Soliterman permitting them to trade securities including options contracts.

Client LK

17. In May, 2005, LK opened a margin account and a registered account with Soliterman. Soliterman had known LK since 1979, and had previously had him as a client.
18. The NCAF for LK states that he is 58 years old, retired, with investment knowledge described as excellent. Under business and position, it states “Oil and Gas” and “V.P. - Accounting”.
19. The NCAF also states that he had a net worth of \$850,000 and an income of \$35,000. His investment objectives were 10% income/30% short term/30% medium term/30% long term and his risk tolerance was 10% low/70% medium/20% high. LK relied on his investments for income.

20. LK was an experienced investor with a high degree of knowledge and understanding of the investment markets, and more specifically, options contracts. He prepared spreadsheets reflecting his own analysis of possible securities and options trades, and shared these with Soliterman. He was actively involved in the management of his accounts, and regularly discussed possible trades and strategies with Soliterman.
21. LK frequently engaged in the selling of uncovered put options, an activity referred to as “premium selling”. This strategy presented high risk scenarios and was based on the premise that the market, or individual securities, would remain relatively flat or move higher. As long as this was the case, LK would receive premium payments from the contracts as income.
22. During all of 2007 and the first half of 2008, Soliterman accepted a large number of options orders from his client, LK which created a very large contingent liability position which could result in substantial losses if the underlying securities declined significantly in value.
23. Despite the extremely high risk scenarios presented with these options positions, Soliterman continued to accept orders from LK.
24. In June, 2008, the markets began to decline culminating in a dramatic drop in September, 2008. As a result, the uncovered put options contracts sold short by LK increased in price and LK was forced to cover his short positions at a loss.
25. LK frequently received margin calls and was required to satisfy the margin calls in order to maintain the options positions in his accounts. He would satisfy the margin calls by depositing new funds into his accounts, borrowing from his home owners’ line of credit and in some cases, de-registering funds from his RRSP. Individuals conducting Tier 2 reviews were not aware of the fact that margin calls were being satisfied through borrowing from the line of credit and de-registering funds from an RRSP.
26. Between June and October, 2008, the value of LK’s trading account dropped from \$715,000 to negative \$90,000. The value of his registered account dropped from \$429,000 in May, 2008 to \$124,000 in October, 2008.
27. After factoring in deposits and withdrawals, in the 40 months of its existence LK’s margin account declined \$773,110 while his registered account gained \$23,606.

Client JK

28. In January, 2004, JK opened a margin account with Soliterman on the advice of her former husband, LK.
29. The 2004 NCAF for JK states that she was 31 years old, unemployed and had “good” investment knowledge. She had a net worth of \$350,000 and an income of \$20,000. Her investment objectives were 20% income/30% short term/30% medium term/20% long term and her risk tolerance was 10% low/60% medium/30% high.
30. In a 2007 NCAF update, JK is still listed as unemployed with “good” investment knowledge. Her investment objectives and risk tolerance parameters had not changed, however her net worth had increased to \$800,000 and her net income to \$30,000.
31. JK was trained as a lawyer, but during the period in question worked only briefly in short term employment contracts. JK relied on her investments for income.
32. Although not as experienced and knowledgeable as LK, JK had a good knowledge and understanding of the investment markets, including options contracts. She was actively involved in the management of her account, and regularly discussed possible trades and strategies with Soliterman.
33. JK traded options soon after she opened her account in 2004, and she continued to hold options

contracts until October, 2008.

34. Between 2004 and 2008, JK made several large deposits to, and withdrawals from, her account. Soliterman says that he did not inquire into the source of these deposits. Soliterman says that he later learned that JK had been borrowing from her home owner's secured line of credit to finance her investment account. Individuals conducting Tier 2 reviews were not aware that JK was borrowing from her home owner's secured line of credit when depositing funds to her account and/or to satisfy margin calls.
35. Her requests for unsolicited orders were very similar to those of LK, although they contacted Soliterman independently. Like LK, she frequently sold uncovered put options.
36. During all of 2007 and the first half of 2008, Soliterman accepted a large number of option orders from his client, JK which created a very large contingent liability position which could result in substantial losses if the underlying securities declined significantly in value.
37. Despite the extremely high risk scenarios presented with these options positions, Soliterman continued to accept orders from JK.
38. In June, 2008, the markets began to decline culminating in a dramatic drop in September, 2008. As a result, the uncovered put options contracts sold short by JK increased in price and JK was forced to cover her short positions at a loss.
39. In August, 2008 Soliterman urged JK to close out a number of her short options positions but she refused to do so.
40. In October, 2008, the Respondent liquidated all of the positions held in JK's account.
41. Between May and October, 2008, the value of JK's account dropped from approximately \$646,000 to approximately negative \$8,000.
42. After factoring in deposits and withdrawals, in the 56 months of its existence JK's margin account declined \$261,702.

Supervision

43. The Respondent had procedures in place with respect to account supervision. All trades were subject to review at the Tier 1 level (Calgary), and the Tier 2 level (Toronto). Tier 2 reviews were only focused on option trades of ten contracts or more. As such, approximately 30% to 40% of the trades executed by Soliterman for LK and JK would have been subject to a review at Tier 2.
44. Tier 1 and Tier 2 supervision consisted of a review of daily trading activity in order to identify and address issues related to suitability, concentration, excessive trading, margin leverage and trading within approved option strategy limits.
45. In May, 2008, the Respondent's systems triggered a mandatory account review ("MAR") at the Tier 1 level, which was further reviewed at the Tier 2 level in July, 2008. In total the account of LK was subject to four MAR reviews between October, 2007 and August, 2008. The MAR process is a formalized and structured review that allows branch management to conduct a thorough suitability and risk assessment for active client accounts. With respect to LK, the MAR process involved account documentation and transaction review, discussion between management and Soliterman and discussions between management and LK.
46. Between May and October, 2008 the two clients suffered substantial losses to the value of their accounts. In October, 2008, the Respondent liquidated the clients' accounts.
47. The Respondent's supervisors made many inquiries primarily focused on credit risk and margin with respect to these clients. However, the supervisors failed to adequately question the suitability of these high risk scenarios. As a result, the clients were allowed to build speculative

options positions, which were not suitable for them based on their age, employment status, financial situation, investment objectives and risk tolerance.

48. There were numerous supervisors at the Respondent who looked at individual trades, but better judgment was called for to account for the overall positions held by these clients which were far too risky in the circumstances.
49. In failing to adequately question the suitability of these high risk positions the Respondent failed to effectively perform its supervisory responsibilities.

CONTRAVENTIONS

7. The Respondent admits to the following contraventions of IIROC Rules, Guidelines, IDA By-Laws, Regulations or Policies:
 - a) From May, 2005 to October, 2008, the Respondent failed to effectively exercise its supervisory responsibilities by allowing options trades that were not suitable for two clients contrary to IIROC Dealer Member Rules 1300.2(a) and 2500 (formerly IDA Regulation 1300.2(a) and Policy No.2).

TERMS OF SETTLEMENT

8. Staff and the Respondent agree to the following terms of settlement:
 - a) The Respondent agrees to pay a fine to IIROC in the sum of eighty five thousand dollars (\$85,000.00);
 - b) The Respondent agrees to pay costs to IIROC in the sum of ten thousand dollars (\$10,000.00).

III. SUBMISSIONS OF IIROC

¶ 5 The foregoing Agreed Statement of Facts, Contraventions and Terms of Settlement were reviewed by Mr. McLellan, Senior Enforcement Counsel for IIROC.

¶ 6 Mr. McLellan referred to pertinent parts of the Settlement Hearing Book including IIROC Dealer Member Rules 20.33(2) (“Penalties”) and 20.36 (“Hearing Panel Powers”); IIROC Rules of Practice and Procedure Rule 15 (“Settlement Hearings”); Dealer Member Rules in IDA By-Law Rule 1300.2 (“Supervision of Accounts”) and Rule 2500 (“Minimum Standards for Retail Customer Account Supervision”).

¶ 7 Mr. McLellan also referred to the IIROC Dealer Member Disciplinary Sanction Guidelines “General Principles” and emphasized the importance of the sections entitled “1. Main Concerns When Determining an Appropriate Penalty”; “2. Disciplinary Sanctions as Deterrence”, “3. Key Considerations When Determining Sanctions” (14 subheadings), and “4.3 Failure to Supervise - Dealer Member Rule 25.27, 1300.2, 2500 and 2700” which includes “Recommended Sanctions”.

¶ 8 Mr. McLellan discussed the main aspects of the Respondent’s failure to supervise. He said it is not IIROC’s position that the Respondent did not have adequate procedures but rather that the procedures were not fully followed. The Respondent’s lack of action was not malfeasance but was failure to respond to a series of red flags. The clients were exposed to too much risk and the suitability of the investments was not properly considered by the Respondent. Mr. McLellan referred to the extensive compensation paid to the client LK by the Respondent, which Mr. Soliterman, the Registered Representative, is repaying to the Respondent. He also referred to the fact that the clients were knowledgeable investors but, on the other hand, one was retired and the other unemployed.

¶ 9 Mr. McLellan referred to the minimum fine of \$50,000 in the “Recommended Sanctions”. He discussed the following six decisions as providing guidance in determining the reasonable range of penalties (the decisions are discussed in the Reasons for Decision section, below):

Re Soliterman, 2012 IIROC 32, May 30, 2012 (Alberta District Council)

Re Berkshire Securities, 2011 IIROC 57, September 30, 2011 (Pacific District Council)

Re Research Capital Corp., 2005 I.D.A.C.D. No. 36, November 25, 2005 (Ontario District Council)

Re National Bank Direct Brokerage Inc., 2011 IIROC 2, January 11, 2011 (Québec District Council)

Re Midland Walwyn Capital Inc., 2000 I.D.A.C.D. No. 10, March 30, 2000 (Pacific District Council)

Re Milewski, 1999 I.D.A.C.D. No. 17, July 28, 1999 (Ontario District Council)

¶ 10 Mr. McLellan closed by stating that considerable effort went into negotiating the Settlement Agreement which the parties consider to be a reasonable settlement. He requested that the Panel accept the Settlement Agreement.

IV. SUBMISSIONS OF THE RESPONDENT

¶ 11 Mr. Heelan, Counsel for the Respondent, stated that the Respondent has accepted responsibility for the inadequate supervision and has agreed to the significant fine, as did the Registered Representative, Mr. Soliterman, in the earlier case (below). He said that the Respondent has made a substantial payment to the client LK and negotiations with the client JK are ongoing. He stated that the Respondent has cooperated with IIROC throughout. He submitted that although the decisions relied upon by IIROC (above) provide guideposts, the circumstances in those cases were, in the main, more serious than those in the present case.

¶ 12 Mr. Heelan reiterated the submission of Mr. McLellan that the Settlement Agreement is a product of considerable negotiation and the Respondent also urges the Panel to accept the Settlement Agreement.

V. REASONS FOR DECISION

¶ 13 In the Settlement Agreement the Respondent admits to the Contraventions of IIROC Rules, IDA By-Laws, Regulations or Policies set out above. The Hearing Panel accepts that the Contraventions have been established.

¶ 14 The Rules referred to in the Settlement Hearing Book and discussed by Counsel for IIROC (above) have numerous provisions relating to supervision, including, in Rule 2500, “V. Option Account Supervision”. There are provisions for determining whether the risk characteristics are appropriate for the customer and in keeping with his or her investment objectives and risk tolerance.

¶ 15 As submitted by Counsel for IIROC, Guideline 4.3 of the IIROC Dealer Member Disciplinary Sanction Guidelines is particularly pertinent to this case:

4.3 Failure to Supervise - Dealer Member Rule 29.27, 1300.2, 2500 and 2700

Each Dealer Member must designate a director, partner or officer who is responsible for the opening of new accounts and the supervision of account activity (Ultimate Designated Person).

The Ultimate Designated Person (or Branch Manager appointed by Ultimate Designated Person) is responsible for establishing and maintaining procedures for account supervision and shall ensure that the handling of client business is within the bounds of ethical conduct, consistent with just and equitable principles of trade and not detrimental to the interests of the securities industry.

The minimum requirements for establishing and maintaining a system to supervise the activities of each partner, director, officer, registered representative, employee, and agent are set out in Dealer Member Rule 29.27. The minimum standards for retail account supervision are detailed in Dealer Member Rule 2500 (including branch office and head office account supervision). The minimum standards for institutional account supervision are detailed in Dealer Member Rule

2700.

Considerations in Addition to
General Principles

1. Extent of inadequacy in the procedures For supervision or the actual supervision of employee(s).
2. Extent of employee(s) misconduct.
3. Amount of losses or compensation for which the Dealer Member is liable as a result of the employee(s) misconduct.
4. “Red flag” warnings that should have been caught by a proper system of supervision/failure to follow-up or to conduct periodic reviews.
5. Corrective measures taken since discovery of problem.

Recommended Sanctions

Dealer Member:

- Fine: Minimum fine of \$50,000.
- Consider condition that Dealer Member demonstrate that its procedures and practices meet the Corporation standards; additional monthly fine until the Corporation is satisfied.
- Suspension or expulsion of Dealer Member in egregious cases.

Counsel for IIROC also reviewed the opening section of the Disciplinary Sanction Guidelines:

GENERAL PRINCIPLES

The following principles and rules are proposed to provide a framework for assessing the gravity of a particular breach of the Dealer Member Rules, and help to determine which sanction(s) is reasonable in the circumstances.

1. Main Concerns When Determining An Appropriate Penalty

As set out in *Re Derivative Services Inc.*, [2000] I.D.A.C.D. No. 26, at page 3, a Hearing Panel’s main concerns in determining an appropriate penalty are:

1. Protection of the investing public;
2. Protection of the Investment Industry Regulatory Organization’s membership;
3. Protection of the integrity of the Investment Industry Regulatory Organization’s process;
4. Protection of the integrity of the securities markets, and
5. Prevention of a repetition of conduct of the type under consideration.

The penalty imposed in a specific proceeding should reflect the Hearing Panel’s assessment of the measures necessary in the specific case to accomplish these goals, ranging from a reprimand to an absolute bar, and may take into account the seriousness of the respondent’s conduct and specific and general deterrence.

¶ 16 We agree with the Submissions of Counsel for IIROC (above, pp. 7-9). Some guidance is provided by the cases upon which he relied.

¶ 17 In *Soliterman* (above) the panel was dealing with the Settlement Agreement between IIROC and Mr. Soliterman who was the Registered Representative of the Respondent in this case and whose clients were LK and JK. Mr. Soliterman admitted that he had breached Rule 1300.1 with respect to the two clients, as follows:

- i. failed to use due diligence to learn and remain informed of the essential facts relative to every

customer and to every order or account accepted contrary to IIROC Rule 1300.1(a)

- ii. failed to use due diligence to ensure that the acceptance of any order from a customer is suitable for such customer contrary to IIROC Rule 1300.1(p).

The panel accepted the settlement agreement and imposed the following proposed penalties which they found to be within the reasonable range: a fine of \$55,000 and costs of \$5,000. The panel referred to the substantial losses of the clients which warranted a fine well above the minimum in the Recommended Sanctions of \$10,000. They referred to the respondent being cooperative with IIROC and accepting responsibility. The Reasons of the panel include, at p. 3:

11....Additionally, we accept as mitigating that he has no prior discipline history but more importantly, that the actions of the Respondent did not display any degree of moral culpability and the two clients involved were certainly not vulnerable, unsophisticated “victims”. It is also noteworthy that the Respondent is repaying several hundred thousand dollars to his employer as a result of his negligence.

¶ 18 In *Berkshire Securities* (above) the supervisors knew that the Registered Representative “commonly recommended leveraged loans to his client”. Nevertheless they failed to review either the extent or suitability of the leveraged loans taken out by the clients to purchase equity based mutual funds. The loans were not suitable having regard to the age, income, net worth and risk tolerance of the clients. The investment loans of five clients (four of whom were couples) totalled nearly \$2 million. The Registered Representative entered into a guarantee with one of the clients against loss in the account and also to share with the client in certain defined gains. He had discussed the guarantee with the Branch Manager who discussed it with the Regional Compliance Manager and advised the Registered Representative that no such commitment could be made to a client without involving head office. It was not until months later that the respondent contacted the client to discuss details of the guarantee. The Panel agreed with IIROC that there were a number of red flags, including the guarantee, to warrant more effective supervision. The Registered Representative’s employment with the Respondent was terminated. The one client was compensated by the Respondent for the losses in the account. The penalties imposed by the panel were a fine of \$120,000 and costs of \$10,000.

¶ 19 In *Research Capital and Walsh* (above) T was hired by the respondent Research Capital (“RCC”), with the knowledge and approval of the respondent Walsh, as a Registered Representative. To the knowledge of several senior managers at RCC, T had been fined and suspended four years earlier by the Ontario Securities Commission and was under investigation by the IDA. The employment of T was approved by the IDA subject to a request that he be placed under “close supervision”. RCC agreed and named the Branch Manager to be responsible for the supervision. T engaged in a number of activities and practices which were contrary to IDA By-Laws, Regulations and Policies. His conduct should have raised concerns in RCC’s senior management and he should have been subject to closer scrutiny. The respondent bore responsibility for numerous failures on their part (which are set out in the case report). Sales compliance reviews of RCC had been carried out by the IDA in 2002 and 2004 which identified problems in many areas of compliance, including the accounts of T. It was pointed out to RCC that T was a “main risk”. In addition there had been no annual report from RCC’s Chief Compliance Office to its Board of Directors and therefore no formal review by the Board on the status of compliance at RCC, as required. IDA Staff and the respondents agreed that the penalty proposed in the Settlement Agreement would have been significantly higher except for (1) RCC conducting a significant search process and hiring an experienced individual as Chief Compliance Office at a cost in excess of \$100,000 and hiring a consulting expert who made detailed recommendations. Substantial improvement in sales compliance performance resulted; (2) the respondents cooperated fully with IDA staff; and (3) the respondent Walsh had no history of previous disciplinary action. The penalties agreed to in the Settlement Agreement and accepted by the panel were a fine of \$160,000 and payment of \$40,000 towards the IDA’s investigation and prosecution costs.

¶ 20 In *National Bank Direct Brokerage Inc.* (above) the Settlement Agreement set out under Contraventions that NBDB failed in its duty to provide supervision and to establish adequate internal controls in allowing its representative Chher to carry out several documentary requirements involving clients, make

improper transfers of funds and continue the registration of its Chief Compliance Office with the regulatory authorities when that person was no longer in the employ of NBDB. The agreed penalties, accepted by the panel, were a fine of \$75,000 and costs of \$25,000.

¶ 21 In *Midland Walwyn Capital* (above) the respondent admitted that during a period of two years, with respect to the activities of a registered representative, it:

...failed to supervise the trading activity in 24 client accounts to ensure that the registered representative had used due diligence to learn or properly document the essential facts and investment objectives of each client, and that the trades in the accounts were suitable for the clients, contrary to By-law 29.1, Regulations 1300.1(a) and (c), and Policy 2; and failed to follow and/or enforce its own internal policies governing letter authorizing the transfer of securities and funds between client accounts, the issuance of third-party cheques, the changing of addresses on client accounts, and the safekeeping of a critical form, contrary to Association By-law 29.1 and Regulation 1300.2.

The penalties imposed by the panel, as per the Settlement Agreement, were a fine of \$25,000 and costs of \$2,000.

¶ 22 The circumstances in the foregoing cases and penalties imposed cover a wide range but do provide some guidance. We agree with the rationale in the *Milewski* decision (above) about panels not altering the terms of a settlement agreement unless the penalty “clearly fall(s) outside a reasonable range of appropriateness”.

¶ 23 Applying the general principles of protection of the investing public, protection of the integrity of the IIROC process, protection of the integrity of the securities market, prevention of a repetition of conduct of the type under consideration, and general deterrence, leads us to the conclusion that the penalties agreed upon between IIROC and the Respondent in the Settlement Agreement fall within the reasonable range established in the decisions, are appropriate and should be accepted.

¶ 24 We have taken into consideration the mitigating factors referenced by Counsel for IIROC and Counsel for the Respondent (above).

¶ 25 The Hearing Panel advised, at the conclusion of the Hearing, that we accepted and we signed, the Settlement Agreement. We confirm that decision.

¶ 26 The Respondent, in the Settlement Agreement, agreed to the following terms of settlement, which we have accepted as appropriate:

- (a) to pay a fine to IIROC of \$85,000
- (b) to pay costs to IIROC of \$10,000

¶ 27 We consider the amount of the costs to be within the reasonable range and although they will not fully cover IIROC’s costs, they reflect the reduced involvement and cost for IIROC resulting from the Respondent’s cooperation.

October 17, 2012

Alan V.M. Beattie, Chair

Martin Davies - Industry Representative

William Welton - Industry Representative

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