

Re Laurentian Bank Securities

IN THE MATTER OF:

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

and

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

and

Laurentian Bank Securities Inc.

2012 IIROC 49

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

Hearing held on July 11, 2012, in Montréal
Decision rendered on August 16, 2012

Hearing Panel:

Me Claude Bisson, Mr. Jean André Élie, Mr. Jean Morin

Appearances:

Me Myriam Giroux-Del Zotto, Enforcement Counsel

Me Julie Martine Loranger (Gowling Lafleur Henderson), Counsel for Respondent, Laurentian Bank Securities Inc.

DECISION ON SETTLEMENT AGREEMENT

- ¶ 1 This decision pertains to a Settlement Agreement signed and submitted by virtue of rules 14 and 15 of the Rules of Practice and Procedure;
- ¶ 2 This Settlement Agreement signed on May 22 and 24, 2012 is appended in its original to form part of this decision as though herein cited at length;
- ¶ 3 Until January 4, 2012, the date of his departure and of the termination of his approval with IIROC, Mr. F had for four years held the position of Vice-President and Manager of the Montréal branch of Laurentian Bank Securities Inc. (LBS);
- ¶ 4 Since then, Mr. F has been employed with a financial institution, in a position ungoverned by IIROC;
- ¶ 5 For twelve years before going to work for Laurentian Bank Securities Inc., Mr. F worked for a variety of investment firms;
- ¶ 6 On February 8, 2008, LBS hired Mr. C as a registered representative (retail) at its Laval branch;
- ¶ 7 Three months later, IIROC imposed on Mr. C and his employer the requirement of "close supervision" of his daily transactions, with monthly reports to be kept by LBS;

¶ 8 At the same time, and in connection with this requirement, Mr. C was transferred to the Montréal branch, under the supervision of Mr. F who had not participated in his hiring at Laval;

¶ 9 Not only did Mr. F carry out the "close supervision" imposed by IIROC, he decided instead to make it "strict supervision", with the consequence, among others, that Mr. F would individually preapprove every transaction for each of Mr. C's clients;

¶ 10 From the outset, Mr. C already had two clients, a couple, Mrs. D and Mr. E, some of whose investments were leveraged Exchange-Traded Funds (ETF);

¶ 11 The complaint in this matter covers the period from October 2008 to April 25, 2010, on which date these investors wrote to LBS to inform it of the situation which had become financially disastrous;

¶ 12 At the branch managed by Mr. F, such a situation only presented itself relative to the representative Mr. C and his clients Mrs. D and Mr. E — at least only the latter filed complaints;

¶ 13 The losses incurred by the latter, small investors with modest incomes, totaled \$168,000, in large part compensated by LBS after the complaints were lodged;

¶ 14 To properly understand the Settlement Agreement, one must situate the various individuals within the context of the period covered by the complaint, namely from October 2008 to April 25, 2010;

- Mrs. D and Mr. E are a couple and were the only two investors involved in a complaint of this type, at the time;
- Mr. C is the representative (retail) who had these two investors as clients;
- Mr. F was the manager of the Montréal branch, who had representative C under his supervision. Within the structure of the Respondent, this was the first level of supervision;
- Mr. B was the chief compliance officer at the Respondent's head office. He was responsible for the second level of supervision; in actual fact, it was a junior analyst reporting to Mr. B who was responsible for examining all the retail client accounts;
- Mr. A was the Vice-President at the Respondent's head office.

¶ 15 The product in question here consisted of leveraged Exchange-Traded Funds, the prospectus for which stated (paragraph 24 of Settlement Agreement) that it was a "highly speculative" instrument, involving "a high degree of risk" and that it was only suitable for certain investors, and certainly not for Mrs. D and Mr. E in the concentration that made up their portfolios;

¶ 16 Yet, as paragraph 25 of the Settlement Agreement recognizes:

"... at no time, did the Respondent offer training in leveraged ETFs to the supervisors at the first and second levels or to its registered representatives (retail)."

¶ 17 This situation is the root of the two counts that form the complaint, as stated in paragraph 7 of the Settlement Agreement which provides for the following penalties:

- a fine of \$140,000; and
- costs in the amount of \$10,000.

¶ 18 The Respondent has two disciplinary measures on its record in matters of supervision:

- In 2006, for situations in 2000 and 2001, a fine of \$100,000 was imposed by the Bourse de Montréal;
- In 2009, for the sale in 2007 of Asset-Backed Commercial Paper (ABCP), a fine of \$3.2 million was imposed by the Autorité des marchés financiers.

¶ 19 In the case under study in the Settlement Agreement, the Respondent acknowledges in paragraphs 45, 47

and 48:

“45. [The Respondent] should have taken reasonable measures to ensure that its supervisors had a sufficient and adequate level of knowledge concerning the features and risks inherent in leveraged ETFs, but it did not do so;

...

47. The total losses in the combined value of Mrs. D's and Mr. E's portfolios attributable to leveraged ETFs are evaluated at approximately one hundred and sixty-eight thousand dollars (\$168,000);

48. Mrs. D and Mr. E have entered into a settlement agreement with the Respondent to cover part of the losses attributable to leveraged ETFs.”

¶ 20 Given all the circumstances, the fine of \$140,000 seems adequate to us;

¶ 21 Moreover, the principal characteristic of a monetary penalty is the punitive aspect for the offender, to which is added the deterrent aspect for the profession as a whole;

¶ 22 But as they expressed at the hearing of July 11, 2012, the Hearing Panel members are, aside from these aspects, concerned with the restoration of the situation that prevailed at the Respondent's in 2008, 2009 and 2010;

¶ 23 The person in the junior analyst position who supported Mr. B with the second level of supervision is now an analyst in his own right;

¶ 24 We were told that training sessions are to be organized, but this has yet to come to pass;

¶ 25 Moreover, paragraph 33 of the Settlement Agreement states:

"33. For the period between October 2008 and April 25, 2010, the Respondent allowed the monthly second-level supervision to be conducted by examining only fee-based accounts in which there had been transactions, whereas the standard procedure in force at the Respondent requires the routine supervision of all fee-based accounts. The Respondent's supervision structure was such that no one noticed this departure from routine;

¶ 26 Although we were told that a policy would be written to frame this "procedure", this has not yet come to pass;

¶ 27 A Hearing Panel, in disposing of a Settlement Agreement, must ensure the protection of the investor public and also that its decisions have a deterrent effect;

¶ 28 With this in mind, to protect the market's integrity, IIROC must ensure that its dealer members take appropriate corrective measures promptly in order to remedy the situations that gave rise to investigations and complaints;

¶ 29 In the case at bar, this duty applies to the existence within the Respondent of the policy mentioned in paragraph 26 and to the organization of the training sessions mentioned in paragraph 24 above, such measures being expected to be realized with all due diligence;

¶ 30 **FOR THESE REASONS**, given these recommendations, the Hearing Panel accepts the Settlement Agreement appended hereto, and gives effect to it from this date forward.

Montreal, August 16, 2012

Claude Bisson, Chair

Jean André Élie

SETTLEMENT AGREEMENT

I. BACKGROUND

1. Enforcement Staff of the Investment Industry Regulatory Organization of Canada (Staff) and Laurentian Bank Securities Inc. (the Respondent) consent and agree to the settlement of these matters by way of this settlement agreement (Settlement Agreement);
2. The Enforcement Department of the Investment Industry Regulatory Organization of Canada (IIROC) has conducted an investigation (the Investigation) into the conduct of the Respondent.
3. On June 1, 2008, IIROC consolidated the regulatory and enforcement functions of the Investment Dealers Association of Canada (IDA) and Market Regulation Services Inc. Pursuant to the Administrative and Regulatory Services Agreement between the IDA and IIROC, which came into force June 1, 2008, the IDA has retained IIROC to provide the necessary services for the IDA to carry out its regulatory functions.
4. The Respondent consents and agrees to be subject to IIROC's jurisdiction;
5. The Investigation disclosed matters for which the Respondent may be disciplined by a Hearing Panel appointed pursuant to Part C of Schedule C.1 to Transition Rule No. 1 of IIROC (the Hearing Panel).

II. JOINT SETTLEMENT RECOMMENDATION

6. Staff and the Respondent jointly recommend that the Hearing Panel accept the Settlement Agreement;
7. The Respondent admits to the following contraventions of IIROC Rules and Guidance and IDA By-Laws, Regulations or Policies:
 - a) Between October 2008 and April 25, 2010, the Respondent failed to exercise adequate and effective supervision by not taking every measure to ensure that its supervisors fully understood the features and risks inherent in the leveraged Exchange-Traded Funds in the accounts of two retail clients, contrary to Part 3.A (1) of IIROC Dealer Member Rule 2500; and
 - b) Between October 2008 and April 25, 2010, the Respondent failed to use due diligence, by neglecting to offer training to ensure that its supervisors had full knowledge to adequately supervise the trading of leveraged Exchange-Traded Funds in its retail client accounts, contrary to Rule 18.3(b), Rule 38.2(b) and Part 3A (5) of Rule 2500 of the IIROC Dealer Member Rules;
8. Staff and the Respondent have accepted the following terms of settlement:
 - (a) a \$140,000 fine.
9. The Respondent agrees to pay IIROC costs in the amount of \$10,000.

III. STATEMENT OF FACTS

(i) Acknowledgment

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

(ii) Factual Background

SUMMARY OF THE RESPONDENT'S ALLEGED MISCONDUCT

11. The Respondent failed to exercise adequate and effective supervision, and failed to take measures to ensure that its supervisors had the necessary knowledge to fully understand the features and risks inherent in leveraged Exchange-Traded Funds (ETF) such that they might adequately supervise the accounts of clients who trade in these instruments throughout its retail sales network;

12. As a consequence of these omissions, for many of its clients, the Respondent was unable to ensure that the recommendation made to a client was suitable given the client's personal and financial circumstances, risk tolerance and investment objectives;

DISCIPLINARY HISTORY IN MATTERS OF SUPERVISION

13. On or around May 9, 2006, the Bourse de Montréal rendered a decision against the Respondent. This ruling by the Bourse concerned the following misconduct:
- (i) In February 2000, for opening an account for two (2) clients without their investment objectives having been recorded on the new account application forms;
 - (ii) Between November 1999 and May 2001, for failing in its supervision obligations relative to the retail accounts of three (3) clients. Adequate supervision would have revealed a substantial variance in the percentage of annualized commissions and the asset turnover rate in these accounts.
14. On or around December 21, 2009, the Autorité des marchés financiers (AMF) and the Respondent signed a settlement agreement. In that agreement, the Respondent admitted having engaged in the following misconduct contrary to Section 160.1 of the *Québec Securities Act* (R.S.Q., ch. V-1.1) :
- (i) Between July 25 and August 13, 2007, the Respondent continued to sell non-bank-sponsored asset-backed commercial paper ("non-bank ABCP") to its clients, including products affected by the American subprime mortgages, which were sold until August 2, 2007;
 - (ii) During this period, the Respondent sold \$130 million of non-bank ABCP to its clients who had not received the information regarding the American subprime mortgages and their liquidity problems.

SUPERVISION STRUCTURE IN PLACE IN RESPONDENT'S ESTABLISHMENTS

Supervision at the First Level

15. Concerning supervision in the Respondent's establishments, it is up to each branch manager to supervise the activity of the branch that is under his responsibility;
16. The Respondent's compliance department may also intervene with the branch manager or the registered representative, if it detects an irregularity in a retail client account;

Supervision at the Second Level (Head Office)

17. From October 2008 to April 25, 2010, the supervision at the second level was such that one person, assisted by a junior analyst and reporting to the head of Finance and Compliance, was responsible for examining all of the Respondent's retail client accounts. Supervision therefore relied essentially on the assessment of this one person, since the head of Finance and Compliance only intervenes upon request, meaning in extremely serious cases;

INEFFECTUAL SUPERVISION OF THE ACCOUNTS OF TWO CLIENTS IN REGARD TO THE TRADING OF LEVERAGED EXCHANGE-TRADED IN THEIR ACCOUNTS

18. Around February 8, 2008, Mr. C was hired by the Respondent to work in the Laval branch as a registered representative (retail). At the time of his hiring, Mr. C informed his employer that a customer complaint had been filed with his former employer Desjardins Securities Inc. (DS);
19. On or around May 2, 2008, the Respondent accepted IIROC's request that the following condition be imposed on it with respect to Mr. C:
- (i) That Respondent fill out and keep in C's file a monthly close supervision report of his daily transactions.

20. On or around April 28, 2008, Mr. F was acting as Vice-President and Manager of the Respondent's Montréal branch. He held this position until January 4, 2012;
21. In order to exercise greater supervision over Mr. C's activities, on or around April 28, 2008, the latter was transferred to the Montréal branch. Although the requirement from IIROC was to exercise close supervision, in actual fact, Mr. F exercised strict supervision of Mr. C's daily trades;
22. At all material times, except during the period between June and September 2009, Mr. F was always the manager responsible for the supervision of the daily activities of Mr. C, and indeed of all registered representatives (retail) under his supervision;
23. Commencing in 2008, leveraged ETFs were held in many of the Respondent's retail client accounts;
24. By January 2008, the Respondent, through its registered representatives (retail) and its supervisors, had access to the leveraged ETFs prospectus that stated the following information:
 - *"ETF units are highly speculative and involve a high degree of risk (...)"*;
 - *"ETFs are designed to provide daily investment results (...)"*;
 - *"An ETF by itself does not constitute a balanced investment plan. ETFs are not for investors whose main objective is a regular income or the preservation of capital. Investors must be prepared to lose a large portion or even all of the money that they invest in an ETF (...)"*;
 - *"Investing in Units of an ETF is speculative, involves a high degree of risk and may only be suitable for persons who are able to assume the risk of losing their entire investment. (...)"*;
 - *"ETFs are subject to increased volatility as they seek to achieve the multiple or inverse (opposite) multiple of the daily performance of an underlying index. (...)"*.
25. The Respondent had access to the prospectus on leveraged ETFs, but took no further initiative to provide training regarding these instruments. In fact, at no time did the Respondent offer any training in leveraged ETFs to either the first-level or second-level supervisors or to its registered representatives (retail);
26. Mrs. D and Mr. E are clients of Mr. C and are both retired. They first met Mr. C when the latter was employed with DS. Mrs. D has an annual income of two thousand dollars (\$2000), while Mr. E's income is sixteen thousand dollars (\$16,000). These two individuals are a couple and have no other income source other than that generated by their investments. Mrs. D and Mr. E have a good knowledge of investing, but their knowledge is not excellent;
27. Mrs. D and Mr. E already held some leveraged ETFs when their brokerage accounts were transferred to the Respondent, but in a proportion consistent with their investment objectives;
28. Despite the fact that Mrs. D and Mr. E are low-income retirees and despite the fact that their investment objectives indicate 20% short-term growth and 20% speculation, Mr. F preapproved all of the trades involving leveraged ETFs, because he considered that these investments presented a moderate risk, and not a high risk. As a consequence of this risk assessment, Mr. F is of the opinion that leveraged ETFs constitute a suitable investment for Mrs. D and Mr. E;
29. Notwithstanding the information stated in the leveraged ETFs prospectus, Mr. F, who was the manager of the Respondent's Montréal branch and a first-level supervisor, estimated that leveraged ETFs represent a moderate investment risk. He based his risk assessment on his professional experience;
30. Mr. F's assessment of the risks represented by leveraged ETFs directly influenced his supervision function, including the strict supervision that he exercised over Mr. C's daily trades. Ultimately, this assessment affected the quality of the supervision practiced throughout the branch under his responsibility and more specifically his assessment of the suitability of the investments he was approving. Given this reality, the Respondent should have taken reasonable measures to ensure that its

first-level supervisors' knowledge of leveraged ETFs was both sufficient and adequate;

31. For the period between October 2008 and April 2010, the supervision of retail client accounts at the head office consisted in a daily and monthly review. The criteria used to effect the monthly review of accounts included, among others:
 - (i) the client accounts that had generated more than three thousand dollars (\$3000) in commissions over the course of the month (October 2008 to November 2008 inclusive);
 - (ii) the client accounts that had generated more than twenty-five hundred dollars (\$2500) in commissions over the course of the month (from December 2008 to April 2010)
 - (iii) All fee-based accounts (October 2008 to April 2010).
32. For the period between October 2008 and April 25, 2010, the monthly review of fee-based accounts fell entirely to the Respondent's head office;
33. For the period between October 2008 and April 25, 2010, the Respondent allowed the monthly second-level supervision to be conducted by examining only fee-based accounts in which there had been transactions, whereas the standard procedure in force at the Respondent requires the routine supervision of all fee-based accounts. The Respondent's supervision structure was such that no one noticed this departure from routine;
34. Yet between September 26, 2008 and May 22, 2009, sixty-five (65) transactions involving leveraged ETFs were executed in the accounts of Mrs. D and Mr. E. These transactions did not trigger any questioning from the Respondent's compliance department, as to their suitability;
35. Prior to November 2009, Mr. B's appreciation of the concentration of a security in a client account was made without the help of a concentration report, because this report was not yet available as a working tool at the Respondent. Deprived of this tool, Mr. B personally evaluated the concentration aspect of a financial product by looking at the account statements and basing himself on the following scale: the presence of a financial product in a proportion of greater than 25% in a client account was equivalent to a high concentration and required a more thorough analysis to determine whether there was excessive concentration;
36. In June 2008, the combined value of Mrs. D's and Mr. E's portfolios was approximately four hundred and thirty-eight thousand one hundred and thirty-five dollars (\$438,135);
37. Towards October 2008, Mr. C recommended thirty-six (36) leveraged ETF trades in the retail accounts of Mrs. D and Mr. E. Given that Mr. C was supervised by Mr. F, every trade that concerned him was preapproved by Mr. F. The execution of these trades in the retail accounts of Mrs. D and Mr. E led to their portfolios consisting of leveraged ETFs in a proportion of 56% and 57% respectively, and the combined value of Mrs. D's and Mr. E's portfolios was approximately three hundred and forty thousand four hundred and thirty-seven dollars (\$340,437);
38. Around the end of May 2009, the combined value of Mrs. D's and Mr. E's portfolios was approximately one hundred and forty-nine thousand six hundred and forty-one dollars (\$149,641). At that time, Mrs. D and Mr. E discussed the situation with Mr. C, who told them that the stock market would continue to decline and recommended that they position themselves on the side of leveraged Bear Plus ETFs to take advantage of the market activity and recover the lost money. Mrs. D and Mr. E followed the Respondent's suggested strategy and trades were made in that direction in their respective brokerage accounts. After these trades were executed in Mrs. D's and Mr. E's accounts, their portfolios were composed respectively of 98% and 99% leveraged ETFs.
39. Yet, despite the fact that Mrs. D's and Mr. E's portfolios were comprised of more than 90% leveraged ETFs, and despite the number of trades executed to achieve this concentration level, neither of the Respondent's two supervision levels perceived these facts as being an irregularity due to an excessive concentration of leveraged ETFs or a suitability problem. In fact, to Mr. F and Mr. B, there was no

necessity to evaluate the concentration, since they were market-based financial instruments. Yet, according to the prospectus, these leveraged ETFs were speculative instruments. What's more, the prospectus clearly states that there is no leveraged ETF that can by itself constitute a balanced investment plan;

40. Between October 2008 and April 25, 2010, Mrs. D and Mr. E were not the only clients of the Respondent holding leveraged ETFs. In fact, on or around December 31, 2009, approximately two hundred and seventy-six (276) retail clients of the Respondent held leveraged ETFs. Of these two hundred and seventy-six (276) clients, eighty-one (81) clients held a thousand (1000) or more units of this financial product in their brokerage accounts. And of these eighty-one (81) clients, twenty-seven (27) or 33% held leveraged ETFs whereas their investment objectives did not allocate any percentage for speculation;
41. The fact that all of these clients held leveraged ETFs without their investment objectives allocating a percentage for speculation denotes an ineffectiveness of the supervision in place at the Respondent, since neither of the two levels of supervision questioned the suitability of the recommendations made to Mrs. D and Mr. E;
42. On or around June 11, 2009, IIROC published Guidance Note 09-0172 concerning the obligations of dealer members that sell leveraged and inverse Exchange Traded Funds (ETFs). In this notice, IIROC reiterates the following:
 - (i) While such products [ETFs] may be useful in some sophisticated trading strategies, they are highly complex financial instruments that are typically designed to achieve their stated objectives on a daily basis. Due to the effects of compounding, their performance over longer periods of time can differ significantly from their stated daily objective. Therefore, leveraged and inverse ETFs that are reset daily typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets. (...) ».
43. Guidance Note 09-0172 is available on the Respondent's internal website;
44. All the information published regarding leveraged ETF's, including notably Guidance Note 09-0172, did not trigger any intervention on the part of the Respondent;
45. The Respondent should have taken reasonable measures to ensure that its supervisors had a sufficient and adequate level of knowledge concerning the features and risks inherent in leveraged ETFs, but it did not do so;
46. On or around April 25, 2010, Mrs. D and Mr. E sent a written complaint to the Respondent, in which they criticize it and Mr. C for failing to use due diligence in the exercise of supervision and in the investment recommendations that were made to them considering their personal and financial circumstances.
47. The total losses in the combined value of Mrs. D's and Mr. E's portfolios attributable to leveraged ETFs are evaluated at approximately one hundred and sixty-eight thousand dollars (\$168,000);
48. Mrs. D and Mr. E have entered into a settlement agreement with the Respondent to cover part of the losses attributable to leveraged ETFs.

IV. TERMS OF SETTLEMENT

49. This settlement is agreed to in accordance with Dealer Member Rule 20.35 to 20.40 inclusively, and Rule 15 of the Dealer Member Rules of Practice and Procedure;
50. The Settlement Agreement is subject to acceptance by the Hearing Panel;
51. The Settlement Agreement shall become effective and binding upon the Respondent and Staff from the date of its acceptance by the Hearing Panel;
52. The Settlement Agreement will be presented to the Hearing Panel at a hearing ("the Settlement

