Re Van Hee

IN THE MATTER OF:

THE BY-LAWS OF THE INVESTMENT DEALERS ASSOCIATION OF CANADA

AND

PETER DERUYTER VAN HEE

2008 IIROC 25

Investment Dealers Association of Canada
Hearing Panel (Alberta District)

Decision: November 26, 2008
(196 paras.)

Hearing Panel:
D. Brian Foster, Chair
Peter McWilliams
Bruce Calvin

DECISION

A. INTRODUCTION

¶ 1 The Hearing was brought pursuant to Part 10 of By-law 20 of the Association (the "Association") and was held for 4 days in November and 2 days in December, 2007. The Hearing concluded on December 4, 2007 with the parties filing written argument in February, 2008. The Association called three witnesses, Richard Douglas, a senior staff investigator, Gil Gauthier, the Manager of Investigations for the Association and an expert, Richard Croft. Peter Deruyter Van Hee (the "Respondent") testified on his own behalf. The Respondent also entered a report of an expert, Lorne Levy. There was a 26 page Agreed Statement of Facts plus attachments (the "ASF"), and 112 Exhibits were entered during the Hearing. Exhibit 3 consists of six bound volumes of documents. The ASF is annexed to this decision as Schedule 1.

¶ 2 By an Amended Notice of Hearing dated May 28, 2007 (the "ANOH"), the Association makes numerous allegations against the Respondent, who was at all material times the Designated Registered Option Principal ("DROP") for Union Securities Ltd. ("Union Securities"), a Member of the Association. The ANOH alleges a number of contraventions of by-laws, policies and regulations of the Association. There are five separate counts. While each of the counts must be considered separately, the common allegation made in each is that the Respondent failed to adequately supervise the account management and trading activities, and maintain adequate supervision records (evidence) relating to various client accounts of five Registered Options Representatives ("ROR's"), located in Calgary, Regina, Moncton and Toronto.

B. THE ISSUE

¶ 3 The allegations relate to 17 client accounts among the five ROR's. The investigation commenced in early 2003 and by October, 2004, the Association notified the Respondent in writing that it had begun an investigation into his conduct. Of the 17 client accounts mentioned in the ANOH, three of the clients had

complained about the trading activity in their account. Of the three, two were from the same family.

¶ 4 The specific allegations made in the ANOH are:

> **Count 1**
>
> The Respondent, at all material times, the Designated Registered Options Principal for Union Securities Ltd. ("Union"), a Member of the Association, failed to adequately supervise the account management and trading activities and maintain adequate supervision records (evidence) relating to the client D.M. and/or L.B. accounts of the Registered Options Representative, E.L., an employee of Union in Calgary, during the period October 2002 to March 2003; in contravention of Association Regulation 1300.1, 1300.2, 1900, and Policy No. 2 and Bylaw 29.1
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> **Count 2**
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> The Respondent, at all material times, the Designated Registered Options Principal for Union Securities Ltd. ("Union"), a Member of the Association, failed to adequately supervise the account management and trading activities, and maintain adequate supervision records (evidence), relating to, all or any of, twelve (12) client accounts of the Registered Options Representative, S.B., an employee of Union in Regina, Saskatchewan, during the period 2002 to 2003; in contravention of Association Regulation 1300.2, 1900, and Policy No. 2 and Bylaw 29.1.
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> **Count 3**
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> The Respondent, at all material times, the Designated Registered Options Principal for Union Securities Ltd. ("Union"), a Member of the Association, failed to adequately supervise the account management and trading activities, and maintain adequate supervision records (evidence), relating to the client B.S. accounts of the Registered Options Representative, J.E., an employee of Union in Calgary, during the period April 2001 to August 2003; in contravention of Association Regulation 1300.1, 1300.2, 1900, and Policy No. 2 and Bylaw 29.1.
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> **Count 4**
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> The Respondent, at all material times, the Designated Registered Options Principal for Union Securities Ltd. ("Union"), a Member of the Association, failed to adequately supervise the account management and trading activities, and maintain adequate supervision records (evidence), relating to the clients E.&R. B. accounts of the Registered Options Representative, R.L., an employee of Union in Monkton, New Brunswick, during the period September 2001 to May 2003; in contravention of Association Regulation 1300.1, 1300.2, 1900, and Policy No. 2 and Bylaw 29.1
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> **Count 5**
>
> The Respondent, at all material times, the Designated Registered Options Principal for Union Securities Ltd. ("Union"), a Member of the Association, failed to adequately supervise the account management and trading activities, and maintain adequate supervision records (evidence), relating to the client S.K. accounts of the Registered Options Representative, T.P., an employee of Union in Toronto, Ontario, during the period September 2001 to February 2003; in contravention of Association Regulation 1300.1, 1300.2, 1900, and Policy No. 2 and Bylaw 29.1.

¶ 5 Notwithstanding the wording of the above-noted Counts, counsel for the Association, in her written Brief, submits that the Respondent "failed to execute effective supervision over the account management activities of the five ROR's as referenced in Counts 1 to 5, contrary to Association Regulation 1900, 1300.2, Policy 2 and By-law 29.1." The wording in the Counts alleges that the Respondent "failed to adequately supervise" the account management and makes no reference to an allegation that the Respondent "failed to execute effective supervision." The Association did not, in their written submissions, address whether there is a difference between "effective supervision" and "adequate supervision." Nor do the Association Regulations, Policy No. 2 or By-law 29.1 use the words "adequate" or "effective" when describing the responsibilities of a DROP to supervise accounts.

¶ 6 Counsel for the Respondent states in the Respondent's written brief that the question for this Panel to decide is whether the Respondent's supervision with respect to the accounts in question was "reasonable in the circumstances of this case." Counsel for the Respondent suggests that the supervisory steps that the Association alleges should have been taken in this case are "merely examples of best practices" and that those steps may be considered "prudent, especially with the benefit of hindsight, but the question is whether, given the facts and

circumstances at the relevant time, these additional steps were reasonably necessary."

¶ 7 In the decision of Re: *Youden*, [2005] I.D.A.C.D. No. 52, a disciplinary panel of the Nova Scotia District Council dealt with a claim that the branch manager "failed to adequately supervise" the trading activity in certain client accounts. In that decision, the panel stated that the issue before it was whether the branch manager's supervisory efforts:

> … were reasonable in the circumstances of this case. Stated another way, did Mr. Youden take the supervisory steps that were reasonably required in light of the information available to him and his obligations under Policy 2 and the Regulations of the Association.

¶ 8 Similarly, in the decision of Re: *Mills*, [2000] I.D.A.C.D. No. 41, which dealt with supervisory obligations of a branch manager, the issue was stated in the following way:

> The issue before the District Council is whether Mr. Mills' supervisory efforts were reasonable in the circumstances of this case. Whether this question is treated as requiring proof of negligence by the Association or as flowing from a due diligence defence, the question is ultimately one of reasonableness. Did Mr. Mills takes the supervisory steps that were reasonably required in light of the information available to him and his obligations under the Policy? The answer to this question must be based on the facts relating to the accounts taking into consideration the standards of the industry during the relevant period of the practices followed at Burns Fry.

¶ 9 This Panel agrees that the issue that it must determine is whether the Respondent's supervisory efforts were reasonable in the circumstances of this case. Stated another way, did the Respondent take the supervisory steps that were reasonably required in light of the information available to him and his obligations under Policy No. 2 and the Regulations? To answer this question this Panel must consider the Association requirements described in the Regulations, Policy No. 2 and By-law and the other evidence entered at the Hearing.

C. STANDARD PROOF AND SIMILAR FACT EVIDENCE

¶ 10 Counsel for the Respondent submits that evidence relating to the handling of each of the separate client accounts should be addressed separately. In that regard, the Respondent relies on the decision in Re: *Mills* (*supra*). A portion of that decision states:

> The District Council also accepts Mr. Wardle's submission that Mr. Mills' conduct must be addressed separately with respect to each client's accounts. In the ordinary course, evidence, including admissions, relating to the handling of one client's account should not be used as a basis for factual determinations by the District Council on the handling of another client's accounts. Nevertheless, in some circumstances such conduct may constitute admissible similar fact evidence, with the only issue the weight to be attributed to it. In this case, the District Council determined to address the allegations and evidence relating to [the client's] Mr. Long and Mr. Catania separately.

¶ 11 While in *Mills* there was a basis to examine the two separate and distinct client accounts, in this matter, Counts 1 and 2 each deal with similar allegations that involve more than one client. In relation to Count 1, there are two clients, D.M. and L.B. that have some common client characteristics. In relation to Count 2, the allegations deal with 12 clients supervised by one ROR with common facts. In the case of Count 1 and Count 2, there is in the opinion of this Panel admissible similar fact evidence. In relation to Counts 3 through to 5, the allegations deal with a single client account in each case and the Respondent's conduct will be addressed separately with respect to each client account.

¶ 12 With respect to the standard of proof to be applied, James T. Casey, in *The Regulation of Professions in Canada* (Toronto: Thomson Carswell, 2003) describes the standard of proof in disciplinary proceedings as follows:

> …It is now generally accepted that the standard of proof to be applied in disciplinary charges against professionals is that of a preponderance of probability while recognizing that there may be degrees of probability within that standard depending on the nature of the charge and the potential consequences.

¶ 13 The standard of proof has also been described in the following way in the same text:

> The important thing to remember is that in civil cases there is no precise formula as to the standard of proof required to establish a fact.
>
> In all cases, before reaching a conclusion of fact, the tribunal must be reasonably satisfied that the fact occurred, and whether the tribunal is so satisfied will depend on the totality of the circumstances including the nature and consequences of the fact or facts to be proved, the seriousness of an allegation made, and the gravity of the consequences that will flow from a particular finding.

¶ 14 In the Alberta Court of Appeal decision of *Harrison v. The Law Society of Alberta*, [2005] A.J. No. 979, the Court stated:

> The appellant challenges some of the findings made by the Hearing Committee on the basis that the evidence was not sufficient to prove his guilt beyond a reasonable doubt. The standard of proof in disciplinary hearings is not proof beyond a reasonable doubt. The standard of proof in matters of professional conduct is preponderance of probability…

¶ 15 Counsel for the Respondent relies on the decision of *Octagon Capital Corp.*, [2007] I.D.A.C.D. No. 16 in which the following is stated:

> The guiding principle is accurately stated in *Re Boulieris* (2004, 27 OSCB 1597, a decision of the Ontario Securities Commission when sitting in review of a decision of the Ontario District Council. At page 8 of that decision, the Commission states:
>
> > [33] The degree of proof required in disciplinary proceedings involving a registrant is such that before a tribunal reaches a conclusion of fact, the tribunal must be reasonably satisfied that the fact occurred; and whether the tribunal is so satisfied depends on the totality of the circumstances including the nature and consequences of the facts to be proved, the seriousness of an allegation made, and the gravity of the consequences that will flow from a particular finding, See *Re Bernstein and College of Physicians and Surgeons of Ontario* (1977), 15 O.R. (2d) 447 at 470 (Ont. Div. Ct.): and *Re Coates et al, and Registrar of Motor Vehicle Dealers and Salesmen* (1988), 65 O.R. (2d) 526 at 536 (Ont. Div. Ct.).
> >
> > [34] *Bernstein* stands for the proposition that grave charges against a person cannot be established to the reasonable satisfaction of a discipline committee by fragile or suspect testimony, the evidence to establish the charges have to be of such quality and quantity as to lead a discipline committee acting with care and caution to the fair and reasonable conclusion that the person is guilty of those charges. The degree of proof required must be nothing short of clear and convincing and based upon cogent evidence which is accepted by the tribunal. See *Bernstein* at 485 and *Coates* at 536.
>
> Reference may also be made to *D.M. Graydon*, [1987] T.S.E.D.D. No. 20, at page 12:
>
> > The burden of proving the complaint made against Mr. Graydon is, of course, upon the Toronto Stock Exchange. The Exchange must produce enough evidence to satisfy us, on the balance of probabilities, of the facts upon which it relies to establish Mr. Graydon's guilt. We are also aware that the amount of evidence needed to prove a fact on the balance of probabilities depends, in part, upon the nature of the fact in dispute: the more serious the allegations made against a person's professional or business integrity, the more demanding should the standard of the balance of probabilities become. However, despite the seriousness of the allegations, and the potentially grave consequences of an adverse finding for the person charged, the authority instituting disciplinary proceedings before an administrative tribunal does not have to meet the criminal standard of proof. The tribunal may find the individual guilty, without having to satisfy itself beyond any reasonable doubt.
>
> The parties are agreed that the burden on the IDA is to establish the allegations on a standard of clear and convincing proof based upon cogent evidence.

¶ 16 The Respondent also relies on *Mills* (*supra*) in which the Hearing Panel stated:

> Although the standard of proof in a disciplinary proceeding is a balance of probabilities, in making

> its factual determinations the District Council accepted Mr. Wardle's submission that clear and convincing evidence is necessary for a finding of fact against a respondent. As a disciplinary proceeding may affect a respondent's ability to earn a living, as well as his career, an adverse finding against a respondent should only be made where there is clear and convincing evidence; see e.g. *Markandey v. Board of Ophthalmic Dispensers*, [1994] O.J. No. 2913 (G.D.); *Re Coates*, (1988) 52 D.L.R. (4th) 272 (Ont. Div'l Ct.) at 280-82.

¶ 17 Based on the above decisions, the Respondent submits that in view of the fact that a finding adverse to the Respondent may affect his ability to earn a living or his career, then an adverse finding against him should only be made where there is "clear and convincing evidence."

¶ 18 Counsel for the Association submits that there is no "third standard of proof, referred to as a standard of "clear, cogent and convincing evidence." The Association states that the phrase "clear, cogent and convincing evidence" is an evidential standard that goes to the quality of the evidence required to meet the requisite standard of proof, that being a balance of probabilities, which is dependent on the seriousness of the allegations or the consequences to the respondent." The Association refers to the *Stetler v. Ontario Flue-Cured Tobacco Growers' Marketing Board* decision, 2005 CanLII 24217 (Ontario Court of Appeal) decision in which Feldman, J.A. states:

> … [the] respondents' argument is misconceived. There are only two standards of proof used in legal proceedings. In civil and administrative matters, absent an express statutory provision to the contrary, the standard of proof is on a balance of probabilities, while in criminal matters it is proof beyond a reasonable doubt. **The well-established standard articulated in *Bernstein* and numerous subsequent cases is an evidential standard that speaks to the quality of evidence required to prove allegations of misconduct or incompetence against a professional.** Thus, within the administrative context, it is accepted that strong and unequivocal evidence within the civil standard of proof is required where either the issues, or the consequences for the individual, are very serious. [Emphasis added]

¶ 19 This Panel accepts that the standard of proof to be applied in a disciplinary hearing is that of proof on a balance of probabilities This Panel agrees that "clear, cogent and convincing evidence" is an evidential standard that goes to the quality of the evidence required to meet the requisite standard of proof. This Panel accepts that strong and unequivocal evidence within the standard of proof is required where either the issues, or the consequences for the individual, are very serious, as they are in this case.

D. RELATED INVESTIGATIONS

¶ 20 There were three separate proceedings brought against others that relate to some of the client accounts that are the subject of this proceeding. One of the ROR's, E.L., was the subject of a Notice of Hearing that was later withdrawn. In a second proceeding, a Hearing Panel of the Association in April, 2006 accepted a settlement agreement entered into between the Association and Union Securities and its Ultimate Designated Person, John Thompson. The settlement agreement contained admissions with respect to the supervision of E.L.

¶ 21 The Branch Manager of the Calgary branch office of Union Securities was also the subject of an investigation. The Association issued a Notice of Hearing in relation to his conduct alleging that he "failed to adequately supervise the client account management activities of the D.M. and L.B. investments accounts" (D.M. and L.B. are related and are two of the 17 accounts that are the subject of these proceedings) and that he "failed to maintain adequate supervision records and failed to establish appropriate procedures and controls for effective supervision of [E.L.]." In a decision dated January 16, 2007, a Hearing Panel found the Branch Manager, Mr. Schillachi, guilty on both counts (*Schillaci (Re)*, [2007] I.D.A.C.D. No. 6).

E. THE RESPONDENT'S BACKGROUND

¶ 22 At all material times the Respondent was the DROP at Union Securities. He commenced his employment with Union Securities in 1983 and completed the Canadian Securities course in that year. During the period from 1984 until 1993, he was principally a desk trader and subsequently became the head trader in the firm.

¶ 23 In 1993 the Respondent completed the Registered Option Principal examination as well as the Partners, Directors & Officers examination. Until 1993, Union Securities did not have options trading available to its clients. The Respondent and five others took the options trading course. The Respondent became the DROP for Union Securities in 1993. At that time, there were no branch offices of Union Securities.

¶ 24 By 2000, Union Securities had eight ROR's in its Vancouver office and two in a recently opened Toronto office. In 2001 Union Securities opened another one-half dozen offices and the ROR's increased from 12 to about 26. In 2002, there were 36 ROR's. By 2003, there were additional offices and Union Securities had 56 ROR's. At the time of the hearing in 2007, there were 80 ROR's with Union Securities.

¶ 25 The Respondent testified that he kept current with respect to the rules and regulations governing options trading and supervision. His sources of information included the Association website, bulletins and updates provided by the Association and updates provided by Canadian Depository Clearing Corporation, the clearing entity for Canadian Options. He also testified that he paid particular attention to the rules and regulations governing options trading in the United States since most of the options trading at Union Securities was in United States options. He also viewed the website of the Option Industry Council which he viewed as another important source of information. He stated that this organization is funded by major exchanges in the United States. Finally, he kept current with respect to the Montreal Exchange rules through which options trading in Canada takes place.

F. ASSOCIATION BY-LAWS, POLICY NO. 2 AND REGULATIONS

¶ 26 The following are excerpts from the Association By-laws, Regulations and Policies that are relevant to the issue of the duties of a DROP and in particular, the duties related to option account opening and approval and the duty to supervise.

> **Policy 2**
>
> MINIMUM STANDARDS FOR RETAIL ACCOUNT SUPERVISION
>
> Introduction
>
> This Policy establishes minimum industry standards for retail account supervision. These standards were developed by the Joint Industry Compliance Group (now the Compliance and Legal Section).
>
> These standards represent the minimum requirements necessary to ensure that a Member has in place procedures to properly supervise retail account activity. The Policy does not:
>
> (a) relieve Members from complying with specific SRO by-laws, rules, regulations and policies and securities legislation applicable to particular trades or accounts; or
>
> (b) preclude Members from establishing a higher standard of supervision and in certain situations a higher standard may be necessary to ensure proper supervision.
>
> Many of the standards in this Policy are taken from existing By-laws, Regulations and Policies of the Association and of other self-regulatory organizations. Securities legislation was generally not canvassed. To ensure that a Member has met all applicable standards, Members are required to know and comply with Association and other self-regulatory organization by-laws, rules, regulations and policies and applicable securities legislation which may apply in any given circumstance.
>
> The following principles have been used to develop these minimum standards:
>
> (a) The term "review" in this Policy has been used to mean a preliminary screening to detect items for further investigation or an examination of unusual trading activity or both. It does not mean that every trade meeting the selection process of this Policy must be investigated. The reviewer must use reasonable judgement in selecting the items for further investigation.
>
> (b) It has been assumed that Members have or will provide the necessary resources and qualified supervisors to meet these standards.

(c) The compliance with the know-your-client rule and suitability of investment requirements is primarily the responsibility of the registered representative. The supervisory standards in this Policy relating to know-your-client and suitability are intended to provide supervisors with a check-list against which to monitor the handling of these responsibilities by the registered representative.

A Member shall, for accounts where no commission is generated for trades placed by a client (such as a fee-based account where no commission is charged), develop supervisory policies for the review of such accounts at the branch and head office in lieu of the commission levels specified herein.

A Member may, with the written approval of its SRO, establish policies and procedures to carry out the supervision of client accounts pursuant to this Policy using criteria set out in, and by the persons designated by, such policies and procedures. Such policies and procedures may differ from this Policy in establishing the criteria used in selecting accounts for review and in the allocation of supervisory duties between Head Office and the Branch provided that, in the opinion of the SRO, the Member's policies and procedures are appropriate to supervise trading of its clients.

I. Establishing and Maintaining Procedures, Delegation and Education

Introduction

Effective self-regulation begins with the Member establishing and maintaining a supervisory environment which both fosters the business objectives of the Member and maintains the self-regulatory process. To that end a Member must establish and maintain procedures which are supervised by qualified individuals. A major aspect of self-regulation is the ongoing education of staff in all areas of sales compliance.

A. Establishing Procedures

1. Members must appoint designated principals who have the necessary knowledge of industry regulations and Member policy to properly perform the duties.

2. Written policies must be established to document supervision requirements.

3. Written instructions must be supplied to all supervisors and alternates to advise them on what is expected of them.

4. All policies established or amended should have senior management approval.

B. Maintaining Procedures

1. Evidence of supervisory reviews must be maintained. Evidence of the review, such as inquiries made, replies received, actions taken, date of completion etc. must be maintained for seven years and on-site for 1 year.

2. An on-going review of sales compliance procedures and practices must be undertaken both at head office and at branch offices.

3. Closer supervision of trading by approved persons who have had a history of questionable conduct must be carried out both in the Branch and at Head Office.

C. Delegation

1. Tasks and procedures may be delegated but not responsibility.

2. The Member must advise supervisors of those specific functions that cannot be delegated. However, the accepting of discretionary accounts and the approval of new accounts may be delegated to qualified individuals.

3. The supervisor delegating the task must ensure that these tasks are being performed adequately and that exceptions are brought to his/her attention.

4. Those to whom tasks are delegated must have the qualifications to perform them and should be advised in writing what is expected.

D. Education

1. The Member's current sales practices and policies must be made available to all sales and supervisory personnel. Members should obtain and record

acknowledgements from all sales and supervisory personnel that they have received, read and understood the policies and procedures relevant to their responsibilities.

2. Introductory and continuing education should be provided for all approved persons.

3. Information contained in compliance-related bulletins from the Association and other SROs and Regulatory Organizations must be communicated to all sales and other approved persons. Procedures relating to the method and timing of distribution of compliance-related bulletins must be clearly detailed in the Member's written procedures.

II. Opening New Accounts

Introduction

To comply with the "Know-Your-Client" rule each Member must establish procedures to maintain accurate and complete information on each client. The first step towards compliance with this rule is completing proper documentation when opening new accounts. Accurate completion of the documentation when opening a new account allows both the registered representative and the supervisory staff to conduct the necessary review to ensure that recommendations made for any account are appropriate for the client and in keeping with his investment objectives. Maintaining accurate and current documentation will allow the registered representative and the supervisory staff to ensure that all recommendations made for any account are appropriate for the client and in keeping with the client's investment objectives.

IV. Head Office Account Supervision

Introduction

A two-tier structure is required to adequately supervise client account activity. While the head office or regional area level of supervision by its nature cannot be in the same depth as branch level supervision, it should cover all the same elements.

B. Monthly Reviews

1. The criteria to be used to conduct monthly head office reviews are, among other things, the following:

- clients' statements which generated more than $3,000 commission during the month;
- where a Branch Manager is unable to conduct a review, all client and non-client accounts not reviewed by such Branch Manager which generated more than $1,500 commission during the month. This includes the accounts of producing Branch Managers.

2. Concentration of securities must be reviewed.

3. For all reviews evidence should be kept of inquiries, responses and actions.

4. Monthly reviews should be completed within 21 days of the period covered by the statement unless precluded by unusual circumstances.

V. Option Account Supervision

Introduction

Each Member dealing in options or Exchange traded commodity or index warrants must have an approved designated registered options principal (DROP) with overall responsibility for the opening of new option accounts and the supervision of account activity to ensure that all recommendation s made for any account are and continue to be appropriate for the client and in keeping with his/her investment objectives. In addition, there should be an alternate registered options principal (AROP) to assist in supervisory activities and to carry out the functions of the DROP in his/her absence. All supervisory reviews must be conducted by options qualified personnel. Any branch trading in options must have a Branch Manager who is options qualified.

A. Account Opening and Approval

1. The option trading agreement and option account approval form must be completed, signed and on hand prior to the first trade. This applies to new accounts or existing accounts approved for other products.

2. The option trading agreement contents must meet or exceed Association requirements.

3. All accounts must be approved in writing by the option qualified Branch Manager or the DROP or the AROP.

4. The option account approval form must indicate any trading restrictions imposed.

B. Daily Reviews

1. Branch offices must review all option daily trading activity for suitability, exercise limits, concentration, commission activity, and exposure of uncovered positions.

2. Head office must review on a daily basis all opening option trading activity in excess of ten contracts in any one account. In all options accounts, Head Office must monitor all trading to ensure that positions or exercise limits are not exceeded.

C. Monthly Reviews

1. Branch offices must review on a monthly basis all option activity based on the same criteria as for regular equity trading activity.

2. Head office must review on a monthly basis all option activity based on the same criteria as for regular equity trading activity.

Regulation 1300

1300.1(a) – Each Member shall use due diligence to learn and remain informed of the essential facts relative to every customer and to every order or account accepted;

1300.1(o) – Each Member shall use due diligence to ensure that the acceptance of any order for any account is within the bounds of good business practice;

1300.1 (p) – Subject to Regulations 1300.1(r) and 1300.1(s), each Member shall use due diligence to ensure that the acceptance of any order from a customer is suitable for such customer based on factors including the customer's financial situation, investment knowledge, investment objectives and risk tolerance;

1300.1(q) – Each Member, when recommending to a customer the purchase, sale, exchange or holding of any security, shall use due diligence to ensure that the recommendation is suitable for such customer based on factors including the customer's financial situation, investment knowledge, investment objectives and risk tolerance;

1300.2(a) – Each Member shall designate a director, partner or officer or, in the case of a branch office, a Branch Manager reporting directly to the designated director, partner or officer who shall be responsible for the opening of new accounts and the supervision of account activity. Each such designated person shall be approved by the applicable District Council and, where necessary to ensure continuous supervision, the Member may appoint one or more alternates to such designated person who shall be so approved. The director, partner or officer as the case may be, shall be responsible for establishing and maintaining procedures for account supervision and such persons or, in the case of a branch office, the Branch Manager 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…

Regulation 1900

1900.2(a) – One or more of the partners, directors or officers of the Member is designated in writing by the Member as a registered options principal who shall be responsible for the authorization of new options accounts and for the supervision of account activity involving options and, where necessary to ensure continuous supervision, one or more alternates to such registered options principal are appointed by the Member;

1900.4 – A registered options principal of a Member designated pursuant to Regulation 1900.2

> shall be responsible for establishing and maintaining procedures for account supervision and shall ensure that the handling of customers' business relating to options is in accordance with the By-laws, Regulations, Rulings and Policies including, in particular, Regulations 1300.1, 1300.2 and 1900.2(a). As part of this supervision, each new account involving trading in options shall be opened pursuant to an appropriate account application form and the registered options principal shall have, prior to the completion of the initial transaction, specifically approved the opening of such account, provided that in the case of a branch office or sub-branch office, such approval (other than in respect of discretionary or managed accounts) may be given by a Branch Manager unless such Branch Manager is not qualified for the supervision of options account.
>
> …
>
> 1900.7 The By-laws, Regulations, Rulings and Policies of the Association relating to trading or advising in respect of securities other than this Regulation 1900 shall apply to any Member or person acting on its behalf trading or advising in respect of options except to the extent they are inconsistent with this Regulation 1900.
>
> (underlining added)

¶ 27 The Association submits that the specific regulations and policy provisions contravened by the Respondent include Association Regulation 1300.2, Regulation 1900 (and by specific reference, Regulation 1300.1) and Policy 2 - I.B.1, I.C.1, I.C.2, IV.(Introduction), IV.B.2, IV.B.3, V.(Introduction), V.A.4 and V.C.2.

G. OPTIONS SUPERVISORY COURSE

¶ 28 The Association entered as an Exhibit portions of the Options Supervisory Course ("OSC"). The Respondent admitted that as the DROP, he is required to be aware of the information contained in the OSC and to understand how that information applies to the execution of his duties as the DROP. The OSC material describes options as:

> 30.
>
> Options are highly leveraged trading vehicles with short life spans. As a result they entail a fair amount of risk both for the client and ultimately for the firm. Commensurate with the risk, member firm policies with respect to account supervision must be carefully outlined and then stringently followed.

¶ 29 The OSC material describes leverage in the context of options trading, as follows:

> 31.
>
> The Lesson from Leverage
>
> An option's increased leverage is a double-edged sword. It can be attractive and profitable as an investment strategy if the investor's price expectation is realized by the expiration date of the option. If, however, the price expectation is not realized, the investor can possibly lose all his/her investment (i.e., the premium paid to acquire the call option).
>
> The lesson to be learned is that an investor should always ask himself/herself the following question before investing in options. "Do I understand the risk involved and am I in a position to afford it?" The options market is a "zero-sum game," which means that for every winner there is a loser, and the game is biased against non-professional investors. They are competing against professional investors and market makers whose only business is to predict stock prices and volatility. These professionals have tremendous analytical resources at their disposal and they are also likely to be taking the opposite side from many individual investors' options transactions.

¶ 30 The OSC material also states:

> 34.
>
> It is normal for the DROP to establish general guidelines for approving clients for various Levels of option trading privileges. In determining the Level of option activity for a client, it is prudent to determine the amount of capital a client can risk prior to trading, as well as the client's net worth and in particular, liquid assets. Knowledge, experience in the marketplace, and investment objectives must also be considered when assessing the Level of trading for which a client can be approved.

Not all clients are fully aware of how certain situations can affect an option or the strategies behind them. A client may have some experience trading stocks, be an avid speculator and have considerable net worth. But this does not necessarily qualify him/her for uncovered writing. Lack of experience could lead to poor decisions and place the IA in an uncomfortable situation.

(Underlining added)

¶ 31 The OSC material provides:

5. Key DROP Responsibilities

…

D) Checking Approvals

As the DROP is ultimately responsible for overseeing option activity in the firm, he/she should ensure that accounts have been approved properly and that **option trading is suitable for the client outright** and for the Level at which it was approved. ….

(Emphasis added)

…

F) Verification of Accounts

The DROP must ensure that only accounts that are authorized are trading options and **are doing so within their authorization limits.**

Exception reports showing accounts that are trading options without authorization or that are trading beyond their authorization level should be produced and reviewed at both the branch and head office level on a daily basis.

Ideally, the DROP should try and work towards an order entry system that is programmed so that orders from non-registered IA's are rejected.

(Emphasis added)

¶ 32 Further, the OSC material provides:

52.

2. The DROP's Account Opening and Approval Supervisory Role

…

The DROP must have a written policy in place detailing the account approval process (…). While the Branch Manager typically approves branch accounts, the DROP has ultimate responsibility and thus must ensure that audits and spot checks are being done. These audits and spot checks must make sure that:

- ...
- **Options trading is suitable for the account outright** and/or the level at which it was approved. (Emphasis added)

3. Retail Account Opening and Approval Process

D) Setting up Accounts

…

The head office department responsible for opening accounts and assigning account numbers will also code option accounts based on option-qualified Branch Manager or DROP instructions. When opening option accounts, some firms employ a system that has the following four Levels of allowable option activity:

Level 1

Allows for only purchase of equity, index and bond calls and puts.

Level 2

In addition to the above, allows for covered call writing.

Level 3

In addition to the above, allows for option spread trading.

Level 4

In addition to the above, allows for uncovered option writing.

It is normal for the DROP to establish general guidelines for approving clients for various Levels of option trading privileges. In determining the Level of option activity for a client, it is prudent to determine the amount of capital a client can risk prior to trading, as well as the client's net worth and in particular, liquid assets. Knowledge, experience in the marketplace, and investment objectives must also be considered when assessing the Level of trading for which a client can be approved.

Not all clients are fully aware of how certain situations can affect an option or the strategies behind them. A client may have some experience trading stocks, be an avid speculator and have considerable net worth. But this does not necessarily qualify him/her for uncovered writing. Lack of experience could lead to poor decisions and place the IA in an uncomfortable situation.

(Emphasis added)

64.

Introduction

A key responsibility of both the DROP and options-qualified Branch Manager is to ensure that option trading is reviewed for the purposes of assessing compliance with regulatory and member firm requirements. IDA policy dictates that each member dealing in options conduct both daily and monthly reviews of option trading activity. The reviews should be designed to identify failures to adhere to required policy and procedure and provide a means of revealing undesirable account activity.

2. Daily Trading Review

…

At the head office level, the DROP must ensure that reviews of option trading are taking place. The primary review is that of all option transactions of 10 contracts or more in an individual option series, and involves looking for the same activities as in the branch daily review. This is normally done by the head office compliance department and is produced on a *daily trading blotter*.

…

Whether the review is at the branch or head office level, evidence of the review must be maintained, including any investigations, queries, or other actions taken as a result of the review. Normally a log is maintained. Even if there was no activity that required further review, it should still be noted in the log that the review was performed.

…

A) Daily Trading Blotter

… Prompt action must be taken in cases where no satisfactory explanation is given for what appears to be improper conduct.

65.

4. Summary of Common Compliance Problems Related to the Supervision of Option Trading

The following is a list of common problems related to options trading that have been identified through interviews with DROPs and options-qualified Branch Managers. Particular attention should be paid to these problems.

- Accounts trading options without proper approval. This happens all too frequently, typically with clients who, upon hearing about an opportunity using options, demand to enter an order at or around the

same time as opening the account (prior to approval), and the IA (assuming approval is inevitable) complies. As discussed earlier, an exception report showing accounts that are trading without proper approval or beyond their approval level will identify such trades. The IA should be warned or reprimanded and probably should for a time afterward be subject to tighter supervision. The Branch Manager perhaps with consultation with the DROP or a compliance officer should give careful consideration as to how to handle the trade.

Member firms may consider order entry systems that reject orders entered for accounts that have not been approved for options trading as a way of minimizing this problem.

- Similar to the first problem, accounts will often trade beyond their approval level. An account that is approved for buying options may start to write covered calls or implement spreads. Once again, these trades will show up in the daily exception report. Some forums have order entry systems that are sophisticated enough to not allow IAs to enter orders that are beyond a specific client's approval level. (Emphasis Added)

(underlining added)

¶ 33 The OSC materials are not Association Regulations, Policies or By-laws. It is not alleged in the Counts that the Respondent breached any guidelines or responsibilities described in the OSC materials. However, the OSC materials are some evidence of industry standards for the duties of a DROP. The OSC materials also confirm other evidence given at the Hearing that options are highly leveraged trading vehicles with short life spans that can entail a fair amount of risk for the client.

H. UNION SECURITIES PROCEDURES MANUAL

¶ 34 Union Securities had a Securities Policies and Procedures Manual (May, 1998) in which the following is stated:

9. OPTION APPROVED ACCOUNTS

9.1 General

9.1.1. Listed options are highly leveraged trading vehicles that are time sensitive and subject to considerable volatility. Because of this, trading options can be highly speculative, risk oriented investment strategy not recommended for the inexperienced investor. An IA must fully explain to his or her clients the risks involved in trading options, and ensure that the client is not placed in a position beyond their financial means.

Reference: IDA Policy, Section V(B)(3)

9.3 Account Approval

9.3.1. All option eligible accounts shall be approved in writing by the DROP, or, in the case of an option eligible account maintained by the DROP, the Alternate Registered Options Principal (AROP), prior to the execution of an option transaction. Approval of an options trading account may not be given until the client has executed an Option Trading Agreement.

Reference: IDA Regulation 1900.2

IDA Policy 2, Section V

9.3.2. Options approved accounts will be classified by code according to the level of option activity permitted by the DROP. The classification must be noted on the NCAF. Union classifies option accounts as follows:

Level 1: Allows the purchase and sale of Exchange listed call and put options

Level 2: In addition to the above, allows covered writing

Level 3: In addition to the above, allows spread options

Level 4: In addition to the above, allows uncovered option writing

An option approved account may not be upgraded a level without the prior written consent of the DROP/AROP.

9.5 Option Account Supervision

9.5.1 The DROP shall be responsible for establishing and maintaining procedures for account supervision and shall ensure that the handling of customer's business relating to options is in accordance with the applicable rules, regulations and policies. (Refer to Section 19). It is the responsibility of the DROP to ensure that any new developments in the trading of options, including changes to industry regulations or Union policies relating to the handling of options, will be communicated to all relevant sales and other staff.

Reference: IDA Regulation 1900.3, IDA Policy 6 Part 1(A)

9.5.3 The DROP is responsible for ensuring Union is in compliance with regulations promulgated by any exchange, clearing corporation or other organization on or through which options are traded or issued for Union and its clients.

Reference: IDA Regulation 1900.2(f)

¶ 35 The portions of the above-noted manual provide confirmation of the risks associated with options trading and reference a number of the Association requirements relating to the duties of a DROP.

I. SALES COMPLIANCE REVIEWS OF UNION SECURITIES

¶ 36 The Association carried out a sales compliance review of Union Securities in 2001. The Association's report dated December, 2001 (the "2001 Compliance Review") was forwarded to Union Securities in September, 2001. Portions of the 2001 Compliance Review deal with options trading and were reviewed by the Respondent by late, 2002. The 2001 Compliance Review contains information that the Respondent reviewed by late, 2002:

- In relation to retail account supervision, of 76 sample accounts reviewed to ensure complete documentation was retained on file, 49 or 64% were deficient. When considering accounts opened since the 2000 sales compliance review and further adjusted to be comparable with the 2000 sales compliance review, 29 out of 56 accounts, or 52% were deficient, which the Association stated in the 2001 Compliance Review was unacceptable;
- The significant deficiency rates were reviewed. The significant deficiency rates included:
  - (i) Six out of nine options accounts, or 67% did not have a date of approval on the Options Account Application Form ("OA");
  - (ii) Four out of nine options accounts, or 44% had client information on the OA that was inconsistent with the New Client Application Form ("NCAF");
- In relation to suitability and trading concerns, 73 accounts were reviewed for the months of September to November, 2001 and 15 of the accounts, or approximately 21% were identified as having suitability and/or trading concerns; and
- Specifically in relation to options accounts and evidence of daily and monthly options supervision, having reference to IDA Policy No. 2 dealing with minimum standards for retail account supervision, the 2001 Compliance Review states that the Member advised that daily and monthly supervision of options trading activity was evidenced by the documentation of inquiries made, responses received and actions taken by the DROP. However, the Association noted the reviewer did not initial or indicate the date of completion of the reports and as such, the Association was unable to confirm that supervision was performed by a qualified person and in a timely manner. The 2001 Compliance Review stated that "the member must ensure a proper audit trail is maintained of all supervisory reviews. This audit trail should include the initials of the reviewer who is options qualified, the date the review was performed, and evidence of inquiries made, responses received and actions taken for any questionable items noted…"

¶ 37 The Respondent gave evidence at the Hearing about the 2001 Compliance Review. There was no evidence at the Hearing from the Respondent that the information in the 2001 Compliance Review was inaccurate.

¶ 38 The Association conducted a 2003 sales compliance review. The report dated September, 2003 (the "2003 Compliance Review") involved an audit of Union Securities that had Association staff at Union Securities for approximately three months. The Respondent received the 2003 Compliance Review in "perhaps October" of 2003. The 2003 Compliance Review includes the following information:

- In relation to options accounts, and in particular in relation to unregistered persons servicing options orders, together with IDA Policy No 2 with respect to minimum standards for retail account supervision, a sample of 34 manual options tickets were reviewed. Of the sample, 32% did not indicate an options licensed sales person had serviced the order. This was an improvement from prior years but was still considered by the Association to be an "error rate" to be high and required better controls to be implemented;
- In relation to documentation for deficiencies for accounts, not limited to options accounts, there were still deficiencies but there was a significant improvement from the deficiency rates noted for the reviews conducted in 2000 and 2001; and
- With respect to suitability and trading concerns, not limited to options accounts, only 11% of the accounts reviewed were identified as having suitability or trading concerns.

¶ 39 The allegations against the Respondent are not based on any specific inadequacies identified in the 2001 Compliance Review or 2003 Compliance Review. However, the Respondent put the sales compliance reviews in evidence. The reviews identify deficiencies in relation to some OA's and a lack of sufficient documentation of supervisory reviews. By 2003 there were fewer deficiencies noted. Overall, the two compliance reviews suggest deficiencies with respect to the adequacy of the Respondent's supervision, particularly in relation to the 2001 Compliance Review.

J. OVERVIEW OF SUPERVISORY DUTIES OF A DROP

(i) Introduction

¶ 40 There are a number of prior decisions of disciplinary panels that have dealt with supervisory obligations. A number of the decisions deal with supervisory obligations of branch managers, some examples of which are Re: *Youden (supra)* and Re: *Mills (supra)*. Neither the Association nor the Respondent has referred this Panel to any prior decisions that have considered in any detail the supervisory obligations of a DROP. Counsel for the Respondent argues that there is a distinction between branch office and head office supervision, where head office supervision is not required to be of the same depth as branch office supervision. Counsel for the Respondent therefore argues that the Panel would fall into error if it attempts to adjudge the Respondent's conduct by the standards expected of a branch manager. However, this Panel finds that some guidance can be taken from the decisions dealing with supervisory obligations of branch managers.

¶ 41 The starting point for any analysis of supervisory obligations is that participants in the investment industry, and specifically those who are employed by Members of the Association, operate in a self-regulated system. As stated in Policy No. 2, which describes the minimum standards for retail account supervision, "effective self-regulation begins with the Member establishing and maintaining a supervisory environment which both fosters the business objectives of the Member and maintains the self-regulatory process." Each Member must establish and maintain procedures that are supervised by qualified individuals. As stated in the Re: *Mills* decision (*supra*):

> The obligations requiring supervision of retail client accounts are intended to ensure appropriate handling of client accounts for the benefit of both the client and the firm, as recognized in Burns Fry Manual. The performance of these obligations takes place in a wide variety of circumstances, involving many clients and many accounts, each having its own characteristics and objectives. It is for this reason that the Policy establishes only minimum standards and expressly states that in

> some situations a higher standard may be required….

¶ 42 There are multiple levels of compliance responsibility in the industry. As stated in Policy No. 2, compliance with the most fundamental of investment regulatory requirements, the *Know Your Client* rule and suitability rule, are primarily the responsibility of the Registered Representative (or as would be the case with options trading, the ROR). The supervisory standards in Policy No. 2 relating to *Know Your Client* and suitability are intended to provide supervisors with a checklist against which to monitor the handling of those responsibilities by the registered representative or the ROR.

¶ 43 A two-tier structure is used to supervise client account activity. There is branch level supervision by the Branch Manager. There is also head office or regional area level supervision. In the case of options trading, there is additional supervision that is mandated by Policy No. 2. For options trading, each member must have an approved DROP "with overall responsibility for the opening of new option accounts and the supervision of account activity to ensure that all recommendations made for any account are and continue to be appropriate for the client and in keeping with his/her investment objectives."

¶ 44 Regulations 1900.2 and 1900.4 address the supervisory obligations of the DROP. However, as with Regulation 1300.2 that deals with supervisory obligations of a Branch Manager, Regulation 1900 does not specify the procedures or standards to be followed in the performance of the supervisory obligations. Policy No. 2 provides some guidance with respect to the minimum standards required. Policy No. 2 states that nothing would preclude a member from establishing a higher standard of supervision in situations where a higher standard may be necessary to ensure proper supervision. Policy No. 2 also makes it clear that evidence of supervisory reviews must be maintained. Evidence of supervision, such as inquiries made, replies received, actions taken and the date of completion of certain tasks must be created and then maintained for a specified period of time.

¶ 45 When a new account is opened, and thereafter when there is activity in the account, there must be compliance with the *Know Your Client* and suitability rules. The DROP, when carrying out his or her supervisory obligations, has overall responsibility for the opening of new option accounts and the ongoing supervision of account activity "to ensure that all recommendations made for any account are and continue to be appropriate for the client and in keeping with his/her investment objectives."

¶ 46 Neither Policy No. 2 nor the Regulations provide detailed and lengthy procedures to be followed. Policy No. 2 is not intended to address every factual circumstance that could arise. Therefore, it falls to this Panel to determine whether the supervisory actions taken by the Respondent were reasonable in the factual circumstances of this case. At the hearing, the Panel received evidence, including expert evidence. While expert opinion evidence was allowed at the Hearing, the ultimate decision turns on the judgment of this Panel as to whether or not the Respondent's supervisory efforts were reasonable in the circumstances of this case. This Panel finds guidance from the decision in Re: *Youden* (*supra*) which quoted, in part, the decision of *D.M. Graydon*, [1987] T.S.E.D.D. No. 20 in which the TSE Panel stated:

> There may well be cases where, before deciding whether a person's conduct was consistent with "just and equitable principles of trade" it will be helpful for the panel to hear witnesses testify as to whether a particular practice is, in their experience, prevalent and widely accepted in the securities industry. However, such evidence will rarely be conclusive of whether the conduct of a registered representative of a member firm has failed to comply with the statutory standard of "just and equitable principles", because the standard contains a normative element. The public would be inadequately protected if the standard of conduct to which members of the securities industry must comply depended solely on the views current in the industry about the acceptability of particular practices. The interpretation and application of this phrase depends ultimately upon the judgment of the Panel, informed, when necessary, by evidence.

¶ 47 On the issue of the experience of this Panel, Mr. McWilliams has been a Registered Representative from 1974 until his retirement in 2000. He completed all necessary options courses and was registered to sell options from the late 1970's until his retirement in 2000. Mr. Calvin entered the securities business with Bear, Stearns & Co. in the United States in 1983. He has successfully completed Options Licensing, Options Supervisors and Branch Managers designations with the Canadian Securities Institute. Further Mr. Calvin was a founding

principal of RiskAdvisory, an independent consultancy providing risk management advisory services to corporate and institutional clients on the implementation of derivative instruments, including options. He is currently employed as a Managing Director at an IIROC member firm. Any absence of a detailed definition of the supervisory responsibilities for any particular factual matrix does not prevent this Panel from considering whether there has been a failure to supervise in the facts of this case. In that regard, this Panel is guided by the following portions of the decision in Re: *Gareau,* [2005] I.D.A.C.D. No. 25, which was quoted in Re: *Youden*, and which states:

> Also with respect to appropriate standards, superior courts in Canada have made clear that members of self-governing professions are uniquely and best qualified to establish the standards of professional conduct. Thus, a hearing panel of three, two of whom are members or former members of the profession, possess a specialized knowledge with respect to both ethics and standards that can be applied in a particular case. In *Re Milstein and Ontario College of Pharmacy, et al* (1977), 72 D.L.R. (3d) 2, Corey J., of the Ontario High Court, confirmed this principle and went on to say at p. 234:
>
> > Members of the profession can best determine whether the conduct of a fellow member has fallen below the requisite standards and determine the consequences. The peers of the professional person are deemed to have and, indeed, they must have special knowledge, training and skills that particularly adapt them to formulate their own professional standards and to judge the conduct of a member of their profession. No other body could appreciate as well the problems and frustrations that beset a fellow member.
>
> Finally, the courts have made clear that the absence of a definition of misconduct does not prevent a disciplinary tribunal from considering whether there has been misconduct in a particular case. In *Re Matthews and Board of Directors of Physiotherapy* (1987), 61 O.R. (2d) 475, the Ontario Court of Appeal stated:
>
> > The absence of such a definition requires the board to judge the appellant by the objective standards of his own profession. Although these standards are unwritten, they are nonetheless real and it is within the jurisdiction of the appellant's professional brethren who constitute the board to determine in the particular case if he has fallen below that standard.
>
> Similarly in *Ripley and the Investment Dealers Assoc.* (*Business Conduct Committee*), [1990] N.S.J. No. 295, the Nova Scotia Supreme Court stated:
>
> > I agree with the respondent's statement that to require that evidence be given in proof of such issues as basic ethics and honesty would be an affront to the common sense, experience and intelligence of every professional Disciplinary Committee.

(ii) Expert Evidence

¶ 48 Both the Respondent and the Association led expert evidence with respect to the duties of a DROP, and specific duties in relation to the Counts alleged against the Respondent. The Association led evidence from Richard Croft, whose curriculum vitae was entered as an Exhibit. Mr. Croft is a licensed Investment Counsellor and Portfolio Manager. He has extensive experience in the securities industry and in particular, has extensive experience in options trading and the regulatory framework for options trading. He has authored books, including "*Aggressive Investing*", an options based book, as well as other books. He has served as an expert witness on cases involving broker fraud, specifically in the area of compliance as it relates to derivatives trading, portfolio management and suitability. He has taught weekend seminars for the Canadian Securities Institute that were designed to prepare registered representatives who were writing the Canadian Options examination. He also has taught a one day seminar on options trading for compliance and enforcement officers of the Association. He testified that he wrote about 60% of the OSC "Strategy Manual" in the late 1980's. The Association asked to have him qualified to give expert evidence in the following areas:

1. Options trading and options strategies;
2. Generally with respect to investment industry regulatory compliance for options trading; and

3. To give expert testimony of the appropriate exercise of discretion in options supervision, specifically from the perspective of the DROP, and focusing on the assessment of the risk reward.

¶ 49 No objection was taken by the Respondent at the Hearing to the qualification of Mr. Croft as an expert in options trading and options strategies. Objection was taken to Mr. Croft's qualifications in relation to the exercise of discretion in options supervision from the perspective of a DROP. Through cross-examination on his experience, it was shown that Mr. Croft worked as a registered representative from 1975 until 1984. Thereafter, he did not act as a registered representative but wrote articles on topics of interest to the investment industry. He became qualified as a portfolio manager in 1993 and has maintained his portfolio manager's licensing since that time. However, he has not been employed with any Association member firm since 1993. He has never been employed as a DROP or as an Ultimate Designated Person. He has not been employed as a Branch Manager for an Association member firm. Counsel for the Respondent also submitted that on a more fundamental basis, he did not believe it appropriate to seek to qualify an expert in an area that is a matter that this Panel must determine as a fundamental issue, that being whether there has been an appropriate exercise of discretion by the DROP.

¶ 50 The Panel considered the submissions of counsel with respect to the qualifications of Mr. Croft and ruled that he was qualified to give expert evidence in the first two requested areas as noted above. However, while it was satisfied that Mr. Croft had the qualifications to give opinion evidence about the investment industry's regulatory framework for options trading which would include account opening, and industry regulation of options trading, and the role of the DROP within that regulatory framework, and the regulatory responsibilities of the DROP, the Panel ruled that it was not prepared to qualify Mr. Croft with respect to the very particular question concerning the appropriate exercise of discretion and options supervision from the prospective of the DROP.

¶ 51 Mr. Croft's report dated July 9, 2007 together with an addendum, were both entered as Exhibits. Later in this report as the specific counts are reviewed, further evidence of Mr. Croft will be referred to. However, on the issue of general duties of a DROP, Mr. Croft was of the following opinion:

- The Association Policy 2 defines the role of the DROP as the person charged with the overall responsibility for the opening of new option accounts and the supervision of account activity to ensure that all recommendations made for any account are, and continue to be, appropriate for the client and in keeping with his or her investment objectives;
- The DROP is responsible for approving clients for specific levels of option trading. Level 4 is the highest risk level, and covers all types of option transactions, including the sale of uncovered options. Uncovered options introduce another level of risk to the client and to the firm since clients must assume an obligation to either buy (uncovered put option) or sell (uncovered call option) the underlying security at the strike price of the option. The obligation to buy or sell requires clients to provide "maintenance margin, which is similar to a 'good faith' deposit. Essentially, the client is providing a capital guarantee in the form of a treasury bill, cash on deposit or other securities with excess loan value, that can be used to finance the costs associated with any assignment." Mr. Croft described that as being very different from traditional margin where the client borrows capital and pays interest to finance the purchase of securities. With what he describes as "maintenance margin", there is no borrowing cost. In his experience, that makes it more difficult for the client to quantify the risk associated with a particular uncovered option position, and can sometimes lead inexperienced clients or ROR's to use excessive leverage, without a clear understanding of the inherent risk;
- He would expect DROP's to develop firm policies and specific guidelines as to what is an acceptable client profile for determining Level 4 suitability, including quantifying minimum conditions for income, net worth, trading experience, objectives and risk tolerance;

- Clients who have been granted Level 4 approval should be subjected to closer supervision. With respect to supervision, Branch Managers must review on a daily basis all option daily trading activity for suitability, exercise limits, concentration, commission activity and exposure of uncovered positions. The head office of a firm, which would dictate the DROP, must review on a daily basis all opening option trading activity in excess of ten contracts in any one account;
- On a monthly basis, Branch Managers must review all option activity using the same criteria for regular equity trading activity. The head office, which dictates the DROP, must review on a monthly basis all option activity based on the same criteria as for regular equity trading activity, which includes client statements that generate more than $3,000.00 commission during the month. Monthly reviews should look at concentration of securities, which he is of the view is particularly relevant to uncovered options because of the strategy's inherent leverage could result in a concentrated position;
- Association rules require closer supervision for ROR's with less than six months experience trading options. During this period, all of the ROR's transactions should be reviewed. In Mr. Croft's opinion, the DROP should have input in the six-month close supervision requirement and in that regard, the DROP "may" develop policies that could be delegated to another options qualified supervisor such as the Branch Manager. However, in his opinion, the DROP is responsible for ensuring that the duty is executed properly (this issue arises in relation to Count 1 since the ROR, E.L., had less than six month's experience);
- The DROP should pay particular attention to the client's investment knowledge, objectives, risk tolerances, income and net worth. The objective is to determine ongoing suitability for specific trading activity based on the client's experience, investment objectives, risk tolerance, income and net worth;
- If appropriate documentation is not on the file, the DROP should restrict the account and contact the broker to make certain updated documentation is provided. If the DROP is still not satisfied about concerns, then the DROP should contact the client directly to ascertain whether the client understands the characteristics of high risk option strategies;
- The DROP cannot delegate ultimate responsibility for the accounts to others, including to the Branch Manager;
- The DROP sets policies and procedures for option account supervision that must meet minimum Association guidelines. The DROP must ensure that the policies and procedures are followed. The DROP's supervisory procedures should be designed to enable the DROP to analyze activity in all client accounts and detect unusual put or call concentrations. The supervisory procedures should allow the DROP to analyze activity in each account for suitability, potential churning, any problem related to inside information, the use of restricted or controlled stock, the violation of position or exercise limits or any other violations. Any review should determine if transactions have been executed within the limits of the original options authorization level;
- The DROP must evaluate the suitability of options for specific clients, particularly at the account opening stage. Factors that influence suitability are the client's net worth, the percent of client assets that may be committed to high risk options strategies, the client's income, age, trading experience, objectives and risk tolerances;
- Mr. Croft does admit that some option strategies, such as covered call writing, are low risk and probably suitable at some level, for all investors for which equities are a suitable investment. Other strategies, such as uncovered writing, or buying calls or puts, carry greater risk, and are not necessarily suitable for all investors; and
- The determination of suitability for any transaction depends on many factors and to some extent

is subjective. However, some suitability questions are not subjective. In Mr. Croft's opinion, if a client engages in a Level 4 option trade, but has only been granted Level 3 approval, the trade is, by his definition, "unsuitable." Mr. Croft is of the opinion that unsuitable trades should be cancelled.

¶ 52 The Respondent's expert, Mr. Levy, in his report entered as Exhibit 98, provided some history of the supervision of options trading in Canada. Mr. Levy did not attend to give evidence and was not cross-examined on his report. The Panel accepted his qualifications to give expert evidence in the area set out in his report. Mr. Levy's involvement with the investment industry extends back to 1967 when he took the Canadian Securities course. He took the Partners, Directors & Officers qualifying examination in 1974. Since 1968 he has held senior positions with various investment firms. He has also been involved with industry organizations and other industry participants. He is a past chairman of the Toronto Stock Exchange Systems Committee, a past chairman of the TSE Systems Committee and member of the TSE Futures Committee, a past governor of the TSE and a past chairman of the TSE Ad Hoc Committee on the financing of developing companies. His industry qualifications include completing the Canadian Options Course, and the qualifying examination for a DROP, and acting as a Designated Registered Futures Principal, Ultimate Designated Person, a DROP and acting as a Portfolio Manager.

¶ 53 Mr. Levy's report gives information about the introduction of options trading in Canada. Prior to the introduction of options trading in Canada, the Toronto Stock Exchange appeared before the Ontario Securities Commission to seek approval for call option trading. The approval was granted with requirements that included special account opening procedures and approval processes for the securities industry to follow, including the requirement that there be a DROP, who was to be educated in options trading and was to supervise the option trading at his or her firm. The primary concern of the regulators was related to the risks of option trading and, according to Mr. Levy, specifically the unlimited liability of a naked call option position.

¶ 54 Mr. Levy's opinion, as set out in his report, includes the following:

- The highest or riskiest category of options trading is trading of naked (short) call options. However, many member firms also include in that highest authorization level (Level 4) put trading such as naked short put writing. Ignoring the option premium, a naked short put option has for all practical purposes the same worse case limited risk as owning the security outright and in his opinion, is not in the same risk category as naked call option positions;
- The coding of authorized levels of options trading has evolved not by specific by-laws, legislation, regulations or policies but has become an industry practice;
- When asked the question of whether a DROP must develop firm policies around Level 4 options trading authorizations and around what constitutes appropriate loan values relative to an account's net equity, he states that in his experience, a Level 4 authorization should not have to be quantified and related directly to minimum quantifying conditions, such as outlined in Mr. Croft's report. Mr. Levy recognizes that "clearly there are suitability and financial considerations in granting Level 4 approval. However, it is my opinion that the DROP has been educated and trained to make his decisions based on his/her assessment of the client as presented to him either directly or in the account opening documentation or has obtained in discussion with all or any of the ROR, the ROR's Branch Manager or the client";
- Mr. Levy agrees with Mr. Croft that a suitability evaluation must be done at the account opening stage. When opening the account, the ROR is required to discuss with the client the client's investment goals and objectives and financial background. Responses should be documented in the account opening documentation. The ROR should discuss risk and rewards of the proposed option strategies and make a determination as to the client's ability to understand those risks and rewards. The ROR then submits the fully completed and signed documentation which should reflect the client's fully informed investment strategy and the client's acknowledgment of the risk

involved. The DROP should then review all of the above information and make a "subjective account opening decision based on that information and upon his subjective suitability assessment that the client has been provided sufficient information to make reasonable and informed judgments.";

- In relation to suitability reviews, a DROP should have access to on-line current account data and month-end statements and supporting information as to the activity in option accounts. When losses are material or when trading appears to be very active, the ability to access or obtain commission summaries may be required;
- Mr. Levy is not aware of any specific requirement of the DROP to review all option trades of an ROR. However, it is clear in Association Policy No. 2 specific to options trading that branch offices must review all option trading daily activity for suitability, exercise limits, concentration, commission activity and exposure of uncovered positions;
- The Association does require a six-month period of supervision and supervisory reporting for new ROR's and it is Mr. Levy's opinion that other supervisors (other than the DROP) can complete that supervision and reporting requirement;
- With respect to the opinion given by Mr. Croft that if a client engages in a Level 4 option trade, but has only been granted Level 3 approval, the trade is by definition unsuitable, Mr. Levy stated that a DROP has the discretion to exercise judgment and to approve trades on a case by case basis even though such trades may be outside of the option approval levels for an account. Mr. Levy agrees with Mr. Croft that some activities in option trading would not be subjective as related to transactions completed in a non-approved category. However, it is Mr. Levy's opinion that the DROP may approve transactions outside of the approved levels of options trading. Mr. Levy also states that to minimize the potential for future problems, the DROP should appropriately document those decisions; and
- In response to whether Mr. Levy agrees with the statement by Mr. Croft that "the DROP cannot rely on second-hand information that may be forthcoming from the ROR", Mr. Levy stated that second-hand information may be important and form a material part of the overall assessment process. The DROP should review all sources of information about the client including all client documentation.

¶ 55 Two significant areas of difference between the opinions of Mr. Croft and Mr. Levy are:

- Mr. Croft believes that there should be quantified minimum conditions before giving Level 4 options approval. Mr. Levy disagrees with that position. Mr. Croft recognizes that there can be some subjectivity to an assessment, but in his view, a person requires some basis to make the discretionary or subjective judgment call. In Mr. Croft's view, there should be a written policy setting out the basis to make the approved option level decisions; and
- Mr. Croft believes that Level 4 trading in an account approved for Level 3 is by definition "unsuitable." Mr. Levy states that a DROP always has the discretion to approve trading outside of the authorized limits, but he also recognizes that those decisions made on a case by case basis should be appropriately documented by the DROP.

(iii) Admissions in the ASF

¶ 56 The ASF contains admissions with respect to some of the required supervisory duties of the Respondent. The Respondent and the Association agreed to the following:

> 4. As the Designated Registered Options Principal, the Respondent was required, as part of his supervisory duties, to do the following:
>
> (a) Maintain a regimen of supervision over the client options account trade activity of all ROR's employed with Union;

(b) Conduct a review of client account documentation and provide written approval for options trading, upon the opening of new options accounts;

(c) Determine appropriate options authorization codes and any options trading restrictions for new options accounts;

(d) Review and approve or decline updates to options authorization codes and options trading restrictions for options accounts;

(e) Conduct daily reviews and follow-up of all opening options trading activity in excess of 10 contracts;

(f) Conduct monthly reviews of all client options account statements where commissions for the month exceeded $3,000.00 and, if a Branch Manager is unable to conduct a branch level review, review all client and non-client options accounts generating $1,500.00 commission or more during the month;

(g) Retain records relating to options account supervision, including evidence of inquiries made, replies received, actions taken, dates of action completion and other related information, adequate to reflect that all necessary supervisory steps had been taken.

(iv) Conclusion

¶ 57 Having read the reports of the two experts and having heard the evidence of Mr. Croft, and having reviewed the Association Regulations, Policies and the OSC material and Union Securities Manual, it is clear that trading in options can have very high levels of risk. Equity options and options on various indices are derivative investments that are by their very nature complex and sophisticated. Their value is derived, often in a non-linear fashion, from movements in a distinct underlying price reference. As a necessary result of this complexity and risk, a separate and enhanced level of supervision has been mandated within the industry. It is the responsibility of the DROP to carry out that enhanced level of supervision. While the Branch Manager, and others within the regulatory framework, have a supervisory role to play, it is the DROP who has ultimate responsibility for overseeing options trading within the firm. The DROP has overall and ultimate responsibility for approving the opening of new option accounts, including authorizing the level of option trading activity that can be executed within the accounts. Secondly, the DROP has overall responsibility to "ensure that all recommendations made for any options account are and continue to be appropriate for the client and in keeping with his or her investment objectives." This ongoing duty of supervision includes an obligation to carry out daily reviews as well as monthly reviews of trading of options to at least the minimum levels described in Policy No. 2.

¶ 58 In order to carry out his duties, the DROP is responsible for establishing and maintaining procedures for account supervision and shall ensure that the handling of customer's business relating to options is in accordance with the By-laws, Regulations, Rulings and Policies, including, in particular, Regulations 1300.1, 1300.2 and 1900.2(a).

¶ 59 As stated above, Mr. Croft was of the opinion that there should be quantified minimum conditions before giving Level 4 options approval. Mr. Levy was of the opinion that criteria for a Level 4 authorization should not have to be quantified and related directly to minimum quantifying conditions, but did recognize that there are suitability and financial considerations when granting Level 4 approval. While this Panel is of the opinion that there is benefit to have quantified minimum conditions before granting various levels of options approval, of necessity, such conditions would have to be described in a very general way, having regard to the numerous factors that impact suitability, and would be at most guidelines that could trigger further inquiry. The lack of quantified minimum conditions is not, standing alone, a basis to find a failure to meet the DROP's supervisory obligations.

¶ 60 In addition to the responsibilities of the DROP, the Branch Manager and the ROR also have responsibilities. An ROR must know his or her client and all recommendations made to that client must be suitable. The Branch Manager must approve accounts that are opened and the Branch Manager must also review all option daily trading activity for suitability, exercise limits, concentration, commission activity and

exposure of uncovered positions. While the ROR and the Branch Manager have separate obligations in relation to options accounts, the DROP retains "overall responsibility for the opening of new option accounts and the supervision of account activity to ensure that all recommendations made for any account are and continue to be appropriate for the client and in keeping with his/her investment objectives" (Association Policy No. 2).

¶ 61 This Panel finds that the DROP should at the account opening stage, in relation to suitability, make a determination whether options trading is suitable for the client, and if so at what level, having regard to:

- The client's trading and investing experience;
- The client's personal circumstances and financial characteristics, including occupation, income and net worth;
- The client's stated investment objectives and risk tolerance; and
- The client's ability to understand and afford the risks of option trading.

¶ 62 When reviewing options trading for suitability after the account opening, the DROP should also consider:

- The trading profit and loss in the account and overall trading activity;
- The appropriateness of option trading strategies employed in the account and the amount of capital or margin required;
- A review of the account opening documentation when necessary to compare option trading activity, the riskiness of the option strategies employed (the potential profit versus loss) to the client's stated goals, risk tolerance and objectives;
- Concentration of options activity in the account, having regard to all holdings in the account;
- The appropriateness of the commission generating activity resulting from options trading in an account;
- The knowledge and experience of the ROR. Where the ROR has less than six month's experience in the industry the DROP should take steps to obtain on a timely basis completed copies of all forms required to be completed in relation to the close supervision requirement so that the DROP is aware of any red flags or concerns with respect to the ROR;
- Where either the Branch Manager or the ROR are new to their positions, the DROP should place increased attention to the options trading activity in the accounts under their control or supervision; and
- Where an options trading strategy is at a level that exceeds the approved level, then the DROP should, in almost all cases, speak to the Branch Manager or the ROR and obtain particulars of why the trade is requested and determine whether the trade is suitable for the client. While isolated trades outside of the option level approval for that client can be allowed by the DROP in the reasonable exercise of his or her discretion, the DROP must appropriately document the decision and the reasons for the decision. Repeated trading outside of option approval levels for the account should not be allowed.

K. THE RESPONDENT'S REVIEW OF OPTION ACCOUNTS IN THE PERIOD 2001 TO 2003

(i) Account Opening

¶ 63 The Respondent agreed that at all material times he was responsible for option account agreement approvals and determining the option authorization codes. He did not create written guidelines for minimum requirements to be applied before approving the opening of an option account, nor did he employ a defined set of conditions as a guide for assigning option authorization codes.

¶ 64 The Respondent testified that generally the Options Account Agreement form (the "OA") would be brought to him together with the NCAF. He would review the NCAF details of the client, including their financial and personal details, and as well review the OA information, including objectives, experience and other factors. In his examination-in-chief, the Respondent stated:

> On the basis of those two documents, and the signatures by the Branch Manager and the ROR on the option agreement, in particular, I would decide to approve or disapprove, and make any other notes or notations on the option agreement that I felt were required at that time.

¶ 65 After approving the opening of the options account, the OA and the NCAF would be stored in a filing area. He had access to those records upon request. The documents were stored "some distance from his office."

¶ 66 When asked in examination-in-chief about the factors that he took into account when assigning option approval codes to an account, the Respondent stated that he took into account the information in the NCAF, the OA, the personal financial details of the client, their history, their experience, the length of time they knew the ROR and his general interpretation of the trading objectives of the account. He would assign an authorization code for the account that was in his view appropriate. At all material times, the OA used by Union Securities had the following four levels of options authorizations codes:

- Level 1 - purchase options;
- Level 2 - purchase and sell covered options;
- Level 3 - purchase and sell covered/spread options; and
- Level 4 - purchase, sell covered/uncovered/spread options.

¶ 67 At all material times, the OA form used by Union Securities set out four categories of requested options trading under the heading "Anticipated Option Trades" which the ROR was required to complete in consultation with the client indicating the desired types and level of options trading. The four categories of option trading were listed as:

- Purchasing calls or puts;
- Covered writing;
- Uncovered writing; and
- Spreading or hedging.

¶ 68 With respect to assigning an option authorization code, the Respondent was asked, in examination-in-chief, whether he had "articulated or defined sets of conditions that are necessary for each of the different levels?" He responded, "No, it's very much up to my discretion and evaluation of the details of the client as they are laid out on their documents, the NCAF and the option agreement. Every person is different, every situation is unique."

¶ 69 The Association takes no issue with the forms used by Union Securities or with the options approval codes used by Union Securities. The OA and the approval codes that are used by Union Securities are similar to the option approval forms and codes recommended in the OSC materials. The Respondent, more recently, has developed a new form that has not yet been implemented at Union Securities. The intention of that new form is to draw out more information about the background and experience of the client and about the client's understanding of options. Of note, on the new form, not yet implemented at Union Securities, the uncovered put writing is separated from the uncovered call writing. The form also asks a number of additional questions of the client in an attempt to obtain more information about the options trading experience of the client.

¶ 70 As will be seen from later portions of this Decision, one of the issues in this case arises where the Respondent has assigned a Level 3 options authorization code notwithstanding that the client, in the forms, had requested a Level 2 options authorization code. In that regard, the Respondent, in examination-in-chief, described the process that he followed. He stated:

> Overall, my opinion on covered call writing, or covered writing, in general, and spread writing is that the risks are well defined, and known. Therefore, other than the mechanics of a spread versus a covered call are, effectively, strategies with known risks, and therefore, comparable to one another.
>
> Granted, with respect to Mr. Croft (the Association's expert), there are occasions where spread can be -- can have some exposure but what I adopted as a practice for a period of time was that if I can evaluate in the client's background and anticipated options strategies, I felt that they were equally -- it was equally suitable for them to trade a covered call as it was a spread option in many cases.
>
> Basically, on several occasions, for a period of time, I was allowing and assigning the code 3 for a code 2. My understanding there was that a covered position was a covered position.
>
> One other point is that on numerous occasions, I had approved code 2 where people wanted to do covered writing. Then some time later, they would come back and try to do a spread, or want to do a spread. That involved, basically, going through additional paperwork to add a strategy to their account that they would have been entitled to in the first place. It seemed to be a more efficient way.

¶ 71 Since 2002, the Respondent's practice has changed. Subsequently, when a client requests a Level 2 options code authorization, the DROP will contact the ROR and ask if they anticipate at some future date doing a spread option and if so, "Now would be the time to add that approval level."

¶ 72 The Respondent also gave evidence that in some cases he assigned a lower option approval code than was requested, particularly when there was a request for a Level 4 option approval code. The Respondent was "uncomfortable" with Level 4 approvals, because Level 4 approvals allow for high risk naked call writing by definition. A Level 4 also allows for "relatively conservative uncovered put writing." He described this as a contradiction with the use of the Level 4 code, where you have a conservative strategy - uncovered put writing - as opposed to naked call writing. He was reluctant to issue level code approvals. Now, his practice has changed. Now he simply assigns a Level 4 approval for uncovered put writing.

¶ 73 A significant issue at the Hearing was that a number of options trades in certain accounts were outside of the options approval level of the account. This is a significant issue for Counts 2 through to 5. There are general admissions in relation to this issue in the ASF. Paragraphs 8, 9 and 10 of the ASF state:

> 8. At all material times, the Respondent was aware that options trades outside the level permitted by the recorded options authorization code were not to be executed in client options accounts. The Respondent also states that, at the material times, he was aware that compliance officers or trade desk personnel would in isolated circumstances approve options trades that exceeded the options approval code of the account.
>
> 9. At all material times, the Respondent was aware that RORs and other designated persons at Union could override the electronic trading system to input options trades outside the level permitted by the recorded options authorization code for client options accounts.
>
> 10. At all material times, the Respondent was in receipt of information disclosing option trades which exceeded the option approval level for the client accounts, in most instances, not more than one business day after execution of the options trade outside approval levels.

¶ 74 The Respondent in examination-in-chief, was asked what happened when a Level 4 type trade (an uncovered put) was entered into an account that was only approved for Level 2 or Level 3 options trading. The Respondent testified that if a paper ticket for the trade was issued, then whether the trade was processed or not would depend on the attention paid to the option code by the trader. After the implementation at Union Securities of the Order Management System ("OMS System"), there was a warning built into the system which would produce a flag to the ROR that the trade was not allowed because it exceeded the option level approved for the account. However, the ROR could override that warning. Overriding the warning would send the order to the Chief of Compliance in first instance and then to a secondary compliance level: effectively the trade desk. Either the Compliance Department or the trade desk could allow the trade to go through. There were many examples of trades that were authorized by various people at the trade desk or in the Compliance Department. The Respondent gave evidence about a document produced by the OMS System that tracked an

order for an options trade that fell outside of the approved option levels. The document showed approval by the Compliance Department of Union Securities and then by the trading desk such that the transaction was completed notwithstanding that the order fell outside of the options approval code. In the timeframe from 2001 until 2003, the information disclosing the approval by the Compliance Department and the trading desk of the override would not have been brought to the DROP's attention. Since 2003, Union Securities has implemented a "hard edit" that will not allow the OMS System to accept a request for an options trade that is outside of the authorized options approval limits. When faced with that situation, the ROR must call the DROP or the AROP who can then decide whether to approve the trade or not.

¶ 75 In an e-mail of June 20, 2003, the Respondent wrote to Rahim Rajwani, a Senior Compliance Officer with Union Securities, to bring to Mr. Rajwani's attention the concern that option orders entered through the OMS System can move through the system "without an appropriate option code if the IA does not enter it." In the e-mail, the Respondent advised that the shortcoming of the OMS System adds "to the likelihood of oversights in the supervision process for Branch Managers and the DROP." Further e-mails show that by 2005 the system had a "hard stop" or "hard edit" for all option trading where an option trade is inappropriate for the particular account.

(ii) Account Supervision

¶ 76 The Respondent was asked in examination-in-chief how he conducted his daily reviews. Each morning he would receive an internally generated printout from the Union Securities execution broker for those trades that were executed on exchanges in the United States. This trade summary identified the parameters underlying the options executed and provided "some pretty basic information." Exhibit 87 was entered at the Hearing which consists of copies of trade summaries received by the Respondent. The document discloses, among other things, the quantity of contracts, the symbol, the price and the time of the trade execution. There are checkmarks on the document next to some of the trades. The Respondent's initials and the date of his review are written on some of the documents. He stated that generally he would look over any trade where more than ten contracts were executed. Trades of ten or fewer contracts would also be looked at. For each trade that he reviewed, he would then go to a system called Execlear which is a data system that recorded trades, account information, transaction amounts and some account details, knowledge and the address of the client. Another page of the Execlear system would have financial information about the account, including margin equity. The trade summary provided cumulative totals for trades, and did not indicate the number of individual accounts that were represented by the number of contracts. As an example, the trade summary could show a trade of 50 contracts of a certain option and the trade summary would not disclose whether the summation represented five accounts transacting ten contracts each or some other purchase combination. To get that more detailed information, the Respondent stated that he would have to go to the Execlear system to match the 50 contracts to individual accounts for clearing. He would then have to enter each account number of the five accounts indicated and check them. The Respondent placed checkmarks against some of the transactions on the trade summary. However, his evidence is that he did not "have a particular system that was rigorous, but with a tick on it, it indicated that I definitely looked at them." He also stated that the absence of a checkmark did not mean that he had not observed the information.

¶ 77 When conducting his review, the Respondent said that if there was a concern about any particular trade, he would note that concern on the document. The Respondent was asked in examination-in-chief to describe what he was looking for during the daily reviews. He stated, "Such things as suitability, commissions, overall account turning, excessive trading, basically Policy 2 issues." When asked what factors he took into account when assessing suitability of individual options transactions, he stated, "The personal financial circumstances of each client, their background, their understanding and knowledge of options trading. Their options trading in relation to the other equity trading in their account. Basically, the fundamental matters that dealt with whether the trading that I saw was consistent with the objectives and tolerances that they expressed and indicated on their forms." Earlier in evidence, the Respondent had stated that he did not have on his computer system or in his office, and did not have immediate access to the forms that provided *Know Your Client* information. He was therefore asked how he was able to confirm objectives, risk tolerance and that type of information when he did

not have the forms. He replied that if a question arose that he felt needed a closer look, then he would go to the master file and pull the master file. In some cases, he kept copies of option agreements and NCAFs at his disposal.

¶ 78 He was asked whether, as part of his daily review, he cross referenced every trade against the option approval codes. He acknowledged that he did not do that every time. He viewed the option approval code as a "tool, a reference tool, not absolute, the more important matters to me are the suitability of the trade that I reviewed in relation to other factors I have mentioned earlier."

¶ 79 The Respondent's daily reviews took anywhere from an hour or more depending on what issues arose in the course of the review.

¶ 80 The Respondent admitted that during the material time, in his capacity as a DROP, he never once contacted a client to inquire about trading activities in their options accounts.

L. ANALYSIS OF COUNTS 1-5

¶ 81 The Association takes the position that the Respondent did not meet the supervisory obligations imposed upon the Respondent as a DROP. The Association submits that the Respondent ought to have taken additional supervisory steps which are set out in more detail below. By way of a non-inclusive summary, the Association submits:

- It is not reasonable to allow 162 trades to be processed in the span of a year and a half in 14 client accounts;
- It is not reasonable to allow options trades outside of options approval levels to be repeatedly processed over extended periods of time;
- It is not reasonable to ignore the losses being incurred in the accounts of D.M. and L.B. in the first month the accounts existed and which were managed by an ROR who was under close supervision because he was newly licensed;
- It is not reasonable to expect someone with limited investment knowledge to understand the nuance of a credit spread transaction on a stock index, especially when individual legs of the spread are entered into in a series of transactions;
- It is not reasonable to approve a client for an option level they did not request;
- It is not reasonable to allow a ROR to continue processing trades outside of the options approval level when he had not received the letter from the father of B.S., as requested; and
- It is not reasonable to allow an account to be under margined when the NCAF indicates the client does not have the necessary means to pay.

¶ 82 The Respondent admits that he did not take certain steps suggested by the Association as appropriate but says that, in the facts and circumstances of the case, his failure to take those steps was "not unreasonable." The Respondent says that he acted reasonably in his supervision of the accounts and that the standard to be imposed upon him is not one of "perfection", but one of "reasonableness." This Panel agrees that the standard of conduct imposed on the DROP is not one of "perfection."

¶ 83 The Association submits that there were numerous red flags pointing to questionable client suitability for identified options trading that the Respondent should have investigated and obtained satisfactory explanations and/or taken steps to stop.

¶ 84 Paragraphs 5 to 10 of the ASF state:

> 5. The Respondent has acknowledged that, at all material times, he would maintain close supervision over new client accounts.
>
> 6. At all material times, the Respondent would receive and otherwise had direct access to the original Option Agreement forms and copies of the new client application forms

("NCAF's") for all client options accounts held at Union.

7. The Respondent was not required to review or approve NCAF's. The Respondent did review and approve Option Agreements after the Option Agreement had been signed by the Registered Options Representative and the Branch Manager.

8. At all material times, the Respondent was aware that options trades outside the level permitted by the recorded options authorization code were not to be executed in client options accounts. The Respondent also states that, at the material times, he was aware that compliance officers or trade desk personnel would in isolated circumstances approve options trades that exceeded the options approval code for the account.

9. At all material times, the Respondent was aware that ROR's and other designated persons at Union could override the electronic trading system to input options trades outside the level permitted by the recorded options authorization code for client options accounts.

10. At all material times, the Respondent was in receipt of information disclosing option trades which exceeded the option approval level for the client accounts, in most instances, not more than one business day after execution of the options trade outside approval levels.

¶ 85 In the case of at least two of the accounts in issue (the D.M. and L.B. accounts), the clients had stated investment knowledge of either "poor/nil" or "basic/limited" in the NCAF's. For both client accounts, the stated investment knowledge in the OA's was "limited." Yet the stated investment objectives in the NCAF were "100% venture/speculative" and the risk factors were "100% high." This raises the issue of the reliance that may be placed by the DROP on information stated in the NCAF and the OA's with respect to the client's investment knowledge and objectives. In written argument the Respondent submits that he is entitled to rely upon the information contained in the NCAF. In cross-examination Mr. Croft, the Association's expert, agreed that where an NCAF is signed by the client, that that is in fact a representation to the firm that the information on the form is accurate, and that the client has accurately stated his investment objectives and risk tolerances. The Respondent's counsel states in written argument that "in the absence of other factors, it is submitted that Mr. Van Hee is entitled to rely upon the information contained in the NCAF."

¶ 86 This Panel agrees that some weight must be given to the information in an NCAF signed by the client. However, that does not mean that all information found within the NCAF and OA can be accepted without question, especially where that information may appear contradictory. The information in the NCAF and OA must be looked at individually and in combination with any other information that may provide insight to those with supervisory responsibility in order to better understand the client and his or her investment objectives and risk tolerance. Other information would include but not be limited to the DROP's knowledge of the ROR's experience and trading strategies. Where there are in the NCAF or OA inconsistencies, or information that seems on its face to be contradictory, or even unusual, then a DROP should not accept the information as accurate without further inquiry. That inquiry may, in certain circumstances, require that the DROP contact the client, or arrange for the Branch Manager to contact the client, to confirm that the information in the NCAF and the OA is correct and understood by the client.

¶ 87 Applying the foregoing to the D.M. and L.B. accounts, the Respondent was not entitled to rely, without further inquiry, on a stated investment objective of "100% venture/speculative" and a risk factor of "100% high" where the investment knowledge of D.M. was "poor/nil" and where the investment knowledge of L.B. was "basic/limited." This is particularly so where D.M. was a single person with two dependents with an annual income of $70,000.00 with at most a liquid net worth of $150,000.00. Similarly, L.B. had an annual income of only $40,000.00 and a liquid net worth of $75,000.00. The ability to rely, without question, on the stated investment objectives and risk factors is further weakened by the fact that the Respondent was dealing with an ROR who was newly registered and a Branch Manager that was relatively new to his position.

¶ 88 There are two components to each of the Counts. The first is an allegation that the Respondent failed to adequately supervise the account management and trading activities. The second component is that the Respondent failed to maintain adequate supervision records (evidence). In relation to the second aspect, the Respondent, in paragraph 200 of the ASF, makes the following admission:

> 200. The Respondent failed to take and maintain adequate documentary evidence of inquiries made, replies received and actions taken in respect of queries made to ROR's in the course of carrying out his supervisory duties as the DROP for Union, during the period 2001 to 2003.

¶ 89 There are also a number of other more specific admissions in the ASF on the issue of maintaining supervision records.

¶ 90 In written argument, counsel for the Respondent acknowledges that the Respondent made numerous admissions regarding his failure to maintain adequate notes and records during the material time but then goes on state "however, it is submitted that this does not necessarily mean that Mr. Van Hee contravened any Association By-law, Regulation, Policy or Ruling." As an example, the Respondent refers to the admission made that the Respondent did not maintain adequate notes or records of his various conversations with R.C. or E.L. regarding the D.M. and L.B. accounts. The Respondent's counsel then states in argument "however, there is no regulatory requirement that he do so. It is probably prudent to make such notes and records in appropriate circumstances, and it may be better practice, or even best practice, to do so. However, this does not mean that his failure to better document those discussions is a contravention of any By-law, Regulation, Policy or Ruling." Counsel for the Respondent states that in relation to the D.M. and L.B. accounts, there are notations indicating that the accounts were reviewed and that the Respondent spoke with E.L. who advised him that the clients understood and accepted all trades in their accounts. Further, the Respondent takes the position that to the extent there were deficiencies with respect to the Respondent's record-keeping practices and procedures, those deficiencies were addressed and dealt within the Sales Compliance Review process and "it is in these circumstances unjustified, inappropriate and unfair for the Association to commence enforcement action against Mr. Van Hee for these matters." Counsel for the Respondent then states in written argument:

> It is submitted that the Association has not proven by clear and convincing evidence that Mr. Van Hee's failure to maintain adequate notes and records of his various supervisory reviews is a contravention of the By-laws, Regulations, Policies or Rulings of the Association.

¶ 91 The position taken by the Respondent, having regard to the paragraph 200 ASF admission, and the other admissions in the ASF, is surprising. There is a clear admission that the Respondent failed to make and maintain adequate documentary evidence of inquiries made, replies received and actions taken in respect of queries made to ROR's in the course of carrying out his supervisory duties as the DROP during the period 2001 to 2003. The Respondent now says that this admission does not mean that his failure to document certain matters is a contravention of any By-law, Regulation, Policy or Ruling. That reservation is not made in the admission found in paragraph 200 of the ASF or the other more specific admissions made in the ASF with respect to documenting his supervision. The Respondent then argues that to the extent there is a requirement by Policy No. 2 to document supervision (Policy No. 2, Section IV.B.3 which states "for all reviews evidence should be kept of inquiries, responses and actions"), "this section deals with retail accounts, not options accounts, and refers to monthly reviews. The section has no application to the facts of this case."

¶ 92 Policy No. 2 sets "minimum standards" for retail account supervision. Policy No. 2 applies to all retail accounts, including options accounts. The clients in this case were retail investors. They did not lose that characterization simply because they invested in a particular type of investment. Association Policy No. 2 requires:

- Evidence of supervisory reviews must be maintained. Evidence of the review, such as inquiries made, replies received, actions taken, date of completion etc. must be maintained for seven years and on site for one year;
- Head office account supervision must be carried out. For all reviews by head office, evidence should be kept of inquiries, responses and actions; and
- In relation to option account supervision, the DROP is given overall responsibility for the opening of new option accounts and the supervision of account activity to ensure that all recommendations made for any account are and continue to be appropriate for the client and in

keeping with his/her investment objectives.

¶ 93 Policy No. 2 sets out a minimum standard of conduct and is not intended to set out in detail every possible supervisory requirement with respect to the documentation of supervision. Read as a whole, and in the context of supervisory obligations, Policy No. 2 requires the DROP to create evidence of his supervisory reviews. That evidence must be maintained. There is a clear admission that the Respondent did not maintain adequate documentary evidence of inquiries made, replies received and actions taken in respect of the queries made to ROR's in the course of carrying out his supervisory duties as the DROP. The Association's case against the Respondent on this issue does not fail because it cannot point to a level of detail in Policy No. 2 that sets out every circumstance where evidence of a conversation must be recorded. The fact that the Respondent in paragraph 200 of the ASF admits that he failed to take and maintain adequate documentary evidence of inquiries made, replies received and actions taken in respect of inquiries made to ROR's in the course of carrying out his supervisory duties is sufficient support for a finding that there was a duty to maintain adequate documentary evidence of his reviews and that he failed to do so. That finding is also supported by the evidence. There is no merit to the Respondent's present position that the Association has not proven a failure to maintain adequate notes and records of his various supervisory reviews and that even if he failed to do so, it is not contravention of the By-laws, Regulations or Policies.

COUNT 1

Count 1

The Respondent, at all material times, the Designated Registered Options Principal for Union Securities Ltd. ("Union"), a Member of the Association, failed to adequately supervise the account management and trading activities and maintain adequate supervision records (evidence) relating to the client D.M. and/or L.B. accounts of the Registered Options Representative, E.L., an employee of Union in Calgary, during the period October 2002 to March 2003; in contravention of Association Regulation 1300.1, 1300.2, 1900, and Policy No. 2 and Bylaw 29.1

¶ 94 The admitted facts in relation to the ROR, E.L., and the D.M. and L.B. accounts are described at paragraphs 13 through to and including 67 of the ASF. Those paragraphs are set out below.

II. E. L. — Registered Options Representative

13. At all material times, E.L. was a Registered Options Representative with the Calgary branch office of Union.

14. E.L. became registered to provide investment recommendations, including option trading advice, on October 16, 2002, and was thereafter subject to a six (6) month period of supervision, as required by the Association's regulations for new registrants.

15. The close supervision reports for E.L. were signed by R.T., at all material times a director and officer of Union.

16. R.T. did not conduct supervision of E.L. R.T. signed the close supervision reports on the undertaking from staff in the Union registration department that supervision of E.L. had been completed. None of the close supervision reports bear any notations or concerns regarding E.L. 's trading activities or of specific supervisory follow-up steps or inquiries by the Respondent, or others.

17. At all material times, the Respondent and, S.S., the Branch Manager were the supervisors of E.L., though the Respondent's supervision was limited to options accounts.

18. On May 27, 2003, the Association received two COMSET Reports from Union relating to the receipt by Union of complaints made by D.M. and L.B. against E.L.

19. On October 8/13, 2004, the Association advised the Respondent that they had begun an investigation relating to the Respondent's supervision of E.L. In early 2006, the Association gave notice to the Respondent that enforcement action would be pursued.

20. On November 20, 2002, Union's Chief Compliance Officer, R.C., authorized an increase in E.L.'s trading limit from $35,000 to $50,000 meaning that E.L. was not required to obtain prior approval for trades up to a value of $50,000. The Respondent was aware of this change.

21. On November 22, 2002, at the request of E.L., R.C. authorized a further increase in E.L.'s trading limit to $75,000. The Respondent was aware of this change.

22. The trading in the D.M. and L.B. accounts, for the material time period, is summarized in Appendices # A, B, C, & D.

23. The nature of the trading in the D.M. and L.B. accounts was speculative and aggressive. Within three months of account opening, both the D.M. and L. B. accounts suffered significant losses.

24. As of January 15, 2003, E.L.'s trading activity was restricted such that he was required to obtain approval from management for all trades conducted in his client accounts. The Respondent was aware of and agreed with this decision. The primary reason for placing a trading restriction on E.L. 's trading activity was because of unacceptable losses in the D.M. and L.B. accounts.

25. Union maintained copies of Investment Advisor Monthly Supervision Reports relating to the supervision of E.L., for the months October, November, December, 2002 and January, February, March, 2003.

A. D.M. Accounts

Background

26. D.M. opened accounts with E.L. on October 26, 2002; signing both a New Client Application Form ("NCAF") and an Option Agreement on October 26, 2002. The D.M. accounts opened were a CDN dollar margin account, a US dollar margin long account and a US dollar margin short account (the "margin accounts) and a RSP account. The relevant information from the NCAF and the Option Agreement contained the following information:

NCAF, dated October 16, 2002

Age	47
Marital status	Single
Dependents	2
Occupation	Project Manager
Past Experience	Stocks and mutual funds
Annual Income	$70,000.00
Net Worth	$430,000.00 ($150,000— Liquid/$280,000 — Fixed)
Investment Knowledge	Poor/Nil
Investment Objectives	100% Venture Speculative
Risk Factors	100% High
Other Accounts	N/A

Option Agreement, dated October 26, 2002

Investment Knowledge	Limited
Investment Objectives	50% Growth/50% Trading Profits
Anticipated Options Trades	Purchasing Calls & Puts/Covered Writing/Spreading or Hedging
Past Experience	Stock Options — Limited Stocks — Limited

27. The Branch Manager, S.S., approved the opening of the D.M. accounts and signed the NCAF on October 28, 2002, and signed, without dating, the Option Agreement for the D.M. accounts.

28. On October 30, 2002, the Respondent signed the Option Agreement for the D.M. accounts and assigned a Level 3 options authorization code for the option account.

29. The Option Agreement shows an Anticipated Option approval of Level 3.

30. On October 31, 2002, D.M. made an initial deposit of $70,000 to the CDN Margin account. On November 5, 2002, the sum of $20,776 was transferred into D.M.'s CDN Margin account and on November 29, 2002, D.M. withdrew $2,000. D.M.'s net cash investment was, therefore, $88,776. The D.M. account sustained losses of approximately $30,000 as of November 30, 2002.

31. The Respondent reviewed the November 2002 monthly trading summaries for the D.M. accounts and was aware that the pattern of options trading was high risk.

32. The Respondent contacted E.L. about the November 2002 trading in the D.M. accounts. Further, the Respondent received and accepted E.L.'s explanation that D.M. wanted to day-trade actively and take risks. The Respondent did not maintain adequate notes or records (evidence) supporting this communication with E.L.

33. On or about December 5, 2002, the Respondent contacted Union's Chief Compliance Officer, R.C., and indicated concerns about the trading in options and equities in the D.M. accounts. Further, the Respondent has stated that he received and accepted R.C. 's advice that R.C. and the Branch Manager, S.S., were watching the D.M. accounts. The Respondent did not maintain notes or records (evidence) supporting this communication with R.C.

34. The Respondent reviewed the January 2003 monthly trading summaries for the D.M. accounts and was aware that the value of the D.M. accounts had declined significantly.

35 The Respondent contacted E.L. in early January 2003 to discuss the trading in the D.M. accounts. Further, the Respondent has stated that he received and accepted E.L. 's assurances that everything was okay with the D.M. accounts. The Respondent did not maintain adequate notes or records to support this communication with E.L.

36. On or about January 15, 2003, the Respondent prepared a summary of the profits and losses on options trades for the D.M. account. The Respondent calculated the total option account losses to the D.M. accounts at $30,594.00. The Respondent provided the summary of profits and losses to R.C. (Union Compliance).

Analysis for the D.M. Accounts:

37. The D.M. margin accounts incurred a collective loss of approximately $70,000.00 in approximately three (3) months (October 26, 2002, to February 10, 2003). This loss represented 79% of the original amount of $88,776.66 invested in the three margin accounts and 42% of D.M.'s stated liquid assets of $150,000.00.

38. For each of the three (3) months, November 2002, December 2002, and January 2003, commissions from the D.M. margin accounts exceeded $1,500.00.

39. Commissions paid compared to assets available for investment in the D.M. margin accounts, for the relevant time period, is illustrated in the chart below:

Month	Commissions Earned	Exchange Rate	Commissions CDN	Avg. Assets Under Admin	%
Nov 2002	$4,741.35 US	1.5683	$7,435.85	$64,273.37	11.57
Dec 2002	$1,882.62 US	1.5726	$2,960.61	$43,066.45	6.87
Jan 2003	$990.30 US	1.5195	$1,579.76	$22,523.52	7.01
Total	$7,614.27 US	N/A	$11,976.22	$129,863.34	N/A
Average	$2,538.09 US	N/A	$3,992.07	$43,287.78	8.48

40. D.M. paid commissions in the amount of $11,976.22 CDN for trades executed in the D.M. margin accounts over the three (3) month period, which equates to 8.48% of the average equity of D.M. 's margin accounts for the three (3) month period.

41. During the period October 26, 2002 to February 28, 2003, E.L. executed a total of 142 trades in client accounts. Approximately 58 (40.85%) of those trades were executed in the D.M. margin accounts. At the material time, E.L. had approximately eight (8) clients excluding himself and his parents, but including D.M.

42. During the period October 26, 2002, through February, 2003, there were 38 options trades, including buys and sells executed in the D.M. margin accounts. Of the options trades executed in the D.M. margin accounts, 34 options trades, including buys and sells, were comprised of 10 or more contracts.

43. The number and types of options trades executed in the D.M. account were relevant factors and signals to the Respondent to take supervisory steps, including making inquiries of E.L. regarding the suitability of the options trading in the D.M. accounts

B. L.B. Accounts

Background

44. L.B. opened accounts with E.L. on November 18, 2002; signing both a New Client Application Form ("NCAF") and an Option Agreement on November 18, 2002. The L.B. accounts opened were a CDN margin account and a US margin account (the "margin accounts") and a RSP account. The relevant information from the NCAF and the Option Agreement is set out below:

NCAF, dated November 18, 2002

Age	40
Marital status Dependents Occupation	Married 2 Flight Attendant
Past Experience	Stocks, bonds and mutual funds
Annual Income	$40,000.00
Net Worth	$325,000.00 ($75,000 — Liquid/$250,000 — Fixed)
Investment Knowledge	Basic/Limited
Investment Objectives	100% Venture/Speculative
Risk Factors	100% High
Other Accounts	N/A

Option Agreement, dated November 18, 2002

Investment Knowledge	Limited
Investment Objectives	100% Trading Profits
Anticipated Options Trades	Purchasing Calls & Puts/Covered Writing/Spreading or Hedging
Past Experience	Stocks — Limited Bonds - Limited

45. L.B. deposited $160,523.04 cash into the L.B. accounts. On November 21, 2002, L.B. made an initial deposit of $84,523.04 and on December 9, 2002, L.B. made a further deposit of $76,000 into the L.B. accounts.

46. F.B., the spouse of L.B., was the primary contact for E.L. to discuss trades for the L.B. accounts. An Authorization to Trade Only form was executed by L.B. on November 18, 2002, authorizing F.B. to provide trade instructions for the L.B. accounts.

47. F.B. had previously traded in equities, mutual funds, and bonds. F.B. had no experience with trading in options, at the time that the L.B. accounts were opened and options trading strategies commenced.

48. The Branch Manager, S.S., approved the opening of the L.B. accounts and signed the New Client Application Form on November 19, 2002, and signed, without dating, the Option Agreement.

49. On November 20, 2002, the Respondent signed the Option Agreement for the L.B. accounts and assigned a Level 3 options authorization code.

50. On November 25, 2002, the Respondent signed a copy of the Option Agreement executed by L.B. on November 18, 2002, updating the Option Agreement by assigning a Level 4

options authorization code. The update was not entered into the Union client account database.

51. The Option Agreement shows an Anticipated Option approval of Level 3.

52. There were no changes to the personal and financial circumstances of L.B. noted on the updated Option Agreement.

53. Respondent had a discussion with E.L. shortly after the L.B. account was opened and accepted advice from E.L. that F.B. had requested an increase to Level 4 options trading for the L.B. account. The Respondent did not maintain notes or records of this communication with E.L.

54. The Respondent reviewed the November and December 2002 monthly trading summaries for the L.B. accounts and was aware that the pattern of trading in the L.B. accounts was high-risk.

55. After reviewing the December monthly statement for the L.B. account, the Respondent contacted E.L. about the trading activity in the L.B. account. The Respondent did not maintain notes or records of this communication with E.L.

56. On or about January 15, 2003, the Respondent prepared a summary of profits and losses of options trades for the L.B. account. The Respondent calculated the total L.B. options account losses at $10,679.00.

57. A trading restriction was imposed on E.L. as of January 15, 2003, in part due to unacceptable losses in the L.B. account. This decision was formally made by R.C. and agreed to by the Respondent

Analysis for the LB. Accounts:

58. The L.B. margin accounts incurred a collective loss of approximately $43,000.00 CDN in a period of less than three (3) months (November 19, 2002 to January 2003). This loss represented 27% of the original amount of $160,523.04 invested in the margin accounts and 57% of L.B.'s net liquid assets of $75,000.00 indicated on the NCAF.

59. During the months of November 2002 and December 2002, commissions from the L.B. margin accounts exceeded $1,500.00 CDN. In the month of January 2003, commissions from the L.B. accounts were $1,397.94 CDN.

60. Commissions paid compared to total assets under administration in the L.B. margin accounts for the relevant time period is illustrated in the chart below:

Month	Commissions Earned	Exchange Rate	Commissions CDN	Avg. Assets Under Admin	%
Nov 2002	$2191.25 US	1.5683	$3,436.54	$81,688.96	4.2
Dec 2002	$2506.42 US	1.5726	$3,941.60	$106,268.88	3.7
Jan 2003	$920.21 US	1.5195	$1,548.26	$124,276.38	1.25
Total	$5,617.88 US	N/A	$8,926.40	$312,252.22	N/A
Average	$1,872.63	N/A	$2,975.47	$104,084.07	2.86

61. L.B. paid total commissions in the amount of $8,926.40 CDN for trades executed in the L.B. margin accounts over the approximately three (3) month period, which equates to 2.86% of the average value of L.B.'s margin accounts for the three (3) month period.

62. The L.B. accounts were traded more actively than most of the other client accounts under E.L.'s management. During the period October 26, 2002, to February 28, 2003, E.L. executed a total of 142 trades in client accounts. Of those trades, 42 (29.58%) were executed in the L.B. margin accounts. At all material times, E.L. had approximately eight (8) clients excluding himself and his parents, but including L.B.

63. During the period November 25, 2002 to February 2003, there were 29 options trades (buys or sells), executed in the L.B. margin accounts. Of the options transactions executed in the L.B. margin accounts, 26 options trades (buys or sells) were comprised of 10 or more contracts.

C. Summary (E.L. clients — D.M. and L.B.)

64. The Respondent reviewed the December 2002 monthly summaries for the D.M. and L.B. accounts and was aware that the value of the D.M. and L.B. accounts had decreased.

65. As of December 31, 2002, the net equity in the D.M accounts was $27,586 CDN, using a conversion rate of $1 US = $l.5683 CAD, and the net equity in the L.B. accounts was $133,719, using a conversion rate of $l = $1.5726 CAD.

66. As of January 31, 2003, the net equity in the D.M. accounts (other than her RSP account) was $17,461 (compared to the net amount invested of $88,776) and the net equity in the L.B. accounts (other than her RSP account) was $114,834 (compared to the net amount invested of $160,523).

67. The Respondent admits that he did not take the following steps during the material time:

(a) Did not contact D.M. to confirm that she fully understood and accepted the nature of and risks associated with the trade strategy employed in her accounts;

(b) Did not contact L.B. to confirm that she fully understood and accepted the nature of and risks associated with the trade strategy employed in her accounts;

(c) Did not contact E.L. to discuss the suitability of level 3 options trading for the clients D.M. and/or L.B, prior to approving the Options Agreements for these client;

(d) Did not contact the Branch Manager, S.S., to communicate his concerns about the trading activity in the L.B. accounts;

(e) Did not impose or make recommendations to impose restrictions on the trading activities of E.L. prior to January 15, 2003; and

(f) Did not maintain adequate notes or records (evidence) of supervisory activities relating to the D.M. and/or L.B. accounts.

(i) The Association's Submissions Applicable to Both the D.M. and L.B. Accounts

¶ 95 The Association makes the following submissions in relation to Count 1:

- The OSC material, set out earlier in this decision, states that the writing of index options is an activity that has to be "very closely monitored" and that "approval should only be given to the most experienced and well financed clients" and further that "some firms may even prohibit retail clients from writing indexed options due to its excessive risk.";
- The evidence of Mr. Croft which speaks of the unique risks associated with index options, including:

  (iii) Cash settled instruments with no underlying physical delivery of a security;

  (iv) American style options, such as those exchange traded index options traded by Union Securities' clients during the relevant period can be exercised at any time; and

  (v) Index options can have additional timing risk;
- The additional evidence of Mr. Croft is that the trading in the D.M. and L.B. accounts generally reflected excessive, unprofitable trading, raised concentration issues and supervisory concern related to conflicting S & P 100 directional positioning taken in the two accounts;
- E.L. was an inexperienced and newly licensed ROR who should have been kept under close supervision. The Respondent claimed that he paid closer attention to E.L.'s activity since he was a new ROR, although the Respondent did not have any direct involvement with respect to reviewing and preparing the required close supervision reports;
- The Respondent was aware that E.L.'s trading limits were raised from $35,000 to $50,000 and then to $75,000 within two days, all within less than two months of E.L.'s registration as a new ROR. The Respondent stated that he did not authorize those changes. The effect of the changes was that E.L. could enter a trade at the revised limits without having any requirement for the

Compliance Department to review that trade. The increases to the trading level were made by R.T., the Chief Compliance Officer for Union Securities. When asked what reaction he had to the increase to the trade limits, the Respondent answered "surprise". The Respondent further stated during his cross-examination that he was surprised because it would be "somewhat unusual for a new broker to be given those limits.";

- The Respondent was also aware that S.S., the Branch Manager for E.L., was an inexperienced Branch Manager;
- While the Respondent was aware that there continued to be option trades in both the D.M. and L.B. accounts after the January 15, 2003 decision to restrict E.L.'s trading activity, he reviewed the trades but did not question any of them. The D.M. and L.B. account statements reveal that there were S & P 100 Index options trades, ranging from two to 10 contracts executed on or after January 15, 2003 in the D.M and L.B. account;
- It was a concern to Association staff that the purchase of 5,000 shares of Imclone shares (settlement date, November 20, 2002 for $57,000) represented more than 50% of the total funds on deposit in the account. On the same date, there was a sale of the 5,000 Imclone shares, evidencing day trading. Further, the 5,000 Imclone shares were then repurchased (settlement date, November 22, 2002) for $63,000. Again, the value of the trade represented greater than 50% of the account funds;
- The purchase of 10 November S & P 100 460 puts on November 15, 2002, closing out the November 5, 2002 sale of the November S & P 100 460 puts was also a concern. With the purchase of the November 440 S & P 100 puts for settlement on November 4, 2002, the expectation would be for the S & P 100 Index to drop below 440 such that the position would become valuable. On November 21, 2001, there was a purchase of 10 S & P 100 Index December 450 puts for $8,600. The S & P 100 would have to drop below 450 for the position to be valuable. For this option to break even, the S & P 100 would need to drop down to 441.5. Also, on November 22, there was a purchase of 10 December 450 puts, for a total holding of 20 December 450 puts. All of these trades demonstrate that the client had a bearish outlook for the S & P 100 Index;
- In contrast, there was a purchase of 10 December 480 S & P 100 calls on November 27, 2002, in the L.B. account. For that position to be profitable, the S & P 100 Index would need to rise above 480. This trade demonstrates a bullish outlook for the S & P 100 Index as compared to the bearish outlook in the D.M. account;
- Also, in the L.B. account, there was a purchase of 10 December S & P 100 450 puts and a sale of 10 December S & P 100 470 puts (settlement date, November 27, 2002). This is a spread, and for this spread to be profitable, the S & P 100 level needs to stay at or above 470;
- In contrast to the above, in the D.M. account, the client was looking for the S & P 100 to fall below 440, as the account held the 10 December S & P 100 440 puts and 20 December S & P 100 450 puts;
- The above demonstrates what the Association characterizes as a "very apparent conflict between the objectives for the D.M. account versus the objectives for the L.B. account. Basically, the outcome of this situation would be that one client makes a profit and the other takes a loss on their respective opposite positions in the S & P 100 Index." Given that both D.M. and L.B. were clients of E.L., and had similar personal and financial profiles, the Association submits that the expectation would be for those clients to have similar trade objectives and the same trade strategies exercised in their accounts;
- Generally the positions in the D.M. and L.B. accounts were aggressive and resulted in significant

losses;

- The monthly commission reports for the D.M. and L.B. accounts revealed only two notations evidencing that the Respondent contacted E.L. to discuss trading in the D.M. and L.B. accounts, one notation in the D.M. monthly commission report for the period ending November, 2002 and the other notation on the L.B. monthly commission report for the period ending December, 2002; and
- The daily option review sheets for the period November 1 to 30, 2002 reveal the Respondent made no notations specific to the D.M. and L.B. accounts.

(ii) The Association's Submissions Specific to the D.M. Account

- The Respondent admitted in cross-examination that "trading options can be a highly speculative, risk oriented, investment strategy not recommended for the inexperienced investor". The Respondent, at the hearing, confirmed his prior interview evidence that the trading in the D.M. account was "high risk". During his prior interview during the investigation, he gave an opinion as to what the investment knowledge should be of a client that engages in that type of options trading. He stated in his interview "well, they need to have experience in some option trading but they need to understand that there are risks and they presumably, well not presumably, but they are when they open the account and are contemplating transactions, they understand the risks." When that evidence was put to him at the hearing, the Respondent stated that he agrees with his prior statement "but it does not preclude someone without experience undertaking some trades." He was then challenged as to whether he was changing his evidence and was asked "you were asked these questions and you gave these answers under oath?" and then he responded "alright, I will go with that.";
- The NCAF indicates no options experience and the OA indicates limited experience for "stock options" and no experience for "options". The Respondent stated that in his view "stock options" meant equity options as distinguished from bond options or currency options or index options;
- The Association submits that there is an apparent discrepancy between the client's experience as reported on the OA compared to the NCAF. The Respondent, at the hearing, stated that when he reviewed the documents and saw "stock option experience" on the form his understanding at that time was that D.M. had options trading experience. He agreed that he did not ask any questions about the apparent discrepancy between the two documents in relation to D.M.'s investment experience;
- The Association takes the position that the reference to "stock options" on the forms clearly meant equity options offered to employees as long-term incentives, and does not indicate experience in transacting in exchange listed equity or index options;
- The NCAF revealed that D.M. had "poor/nil" investment knowledge;
- The Association referred to interview evidence of D.M., who was not called at the hearing. The transcript of the interview was allowed to be entered as an Exhibit, with the issue of weight to be given to it to be determined. The interview was not conducted under oath and D.M. was not called as a witness to the hearing. The Association submits that the D.M. interview evidence should be "accorded equal weight to the oral evidence entered in this matter". This Panel will not give D.M.'s interview evidence the same weight as oral evidence given under oath and subject to cross-examination. It is given limited weight. The D.M. interview evidence suggests that D.M. understood very little about options trading when she transferred her accounts to E.L. and that while she had stock options through her employment, she had never invested in the stock market prior to accumulating her long-term incentive stock options granted through her employer;

- In cross-examination, the Respondent acknowledged that he was aware from the NCAF and the OA for D.M. that her investment knowledge was "poor/nil". He admitted that as the DROP, D.M.'s lack of investment experience "raises questions". He then acknowledged that those were questions that he "didn't follow up on.";
- The Respondent acknowledged that he had a general recollection of the early trading in the D.M. account. He identified the first two trades as the November 4, 2002 buy of S & P 100 440 puts ($15,465) and the November 5, 2002 sell of S & P 100 460 puts ($6,759) as a concern. His concern was that the trades seemed high in dollar value and were in the S & P 100. He then contacted E.L. and asked him "basically, informally that I noticed the trade on a new account, and what could he tell me about it." In general, the Respondent's recollection was that E.L. stated that the interest in the S & P 100 at the time was related to the second Iraq War and E.L. said that his clients felt that the S & P 100 may respond similarly to the first Gulf War. The Respondent did not maintain any records of that discussion. The Association points out that the Respondent did not mention this inquiry of E.L. during his interview with staff on April 27, 2005;
- In relation to trades on November 11, 2002 in the D.M. account, which were five opening transactions in which the client bought equity options, the Respondent recalled that upon noting those trades, he made an inquiry to R.C. about the trades in the account and the cash or equity in the account at the time. He states that he was reassured by R.C. that D.M. would be putting additional funds into the account;
- The Respondent acknowledged the bearish outlook for the S & P 100 Index for the month of November and into December for the D.M. account and acknowledged that the L.B. account had a bullish outlook for the S & P 100 Index;
- The Respondent agreed that the November 4, 2002 buy of December S & P 100 440 puts followed one day later by the legging into the spread with the sale on November 5, 2002 of the November 460 S & P 100 puts, created a risk for the account of losing $29,000, should the S & P Index drop to 440 or less during the period November 5 to 15, 2002. The Respondent agreed that this transaction was a point of query for a DROP;
- In relation to the Imclone equity positions in the D.M. account, the Respondent agreed that a DROP would have reason to review and query the equity positions, at least after November 25, 2002. The Respondent agreed that the November 25, 2002 purchase of 5,000 Imclone for $66,415 was a large value trade that would be a point of query. The Association refers to other evidence concerning large value trades in the account where the Respondent agreed that there would be a concentration issue and a point of query for the DROP, and also in the Respondent's view a point of query for the Chief Compliance Officer. The Respondent agreed that other than the opening trades and the large value Imclone trades in the D.M. account during the month of November, 2002, he did not query any of the other identified points of query, as described above;
- In the month of December, 2002 in the D.M. account there were three option transactions which resulted in significant losses to the account which should have been areas of query for the DROP;
- The Respondent agreed that looking at the transactions in December 2002 and into January 2003, if looking at the trading in general, there seemed to be a lot of "quick flips in the S & P involving large positions". He agreed that that type of activity is a point of query for the DROP because it is important for the DROP to be assured that the client understands the activity that is going on in the account;
- There were 13 options transactions in December, 2002 and 9 options transactions in January,

2003;

- Mr. Croft characterized the trading in the D.M. account, including S & P 100 Index options trades, as including long calls and puts, which is characterized as a "volatility trade"; trades up to 5,000 shares in Imclone Systems, which he characterized as short term or day trading; and a diagonal spread trade, which he characterized as very complex; and a covered call option trade in Imclone, and a purchase of shares in WorldCom. Mr. Croft noted that the trading in the D.M. account generated "significant commissions equal to about 10.78% of the account's beginning equity" and further stated that there was unprofitable short term trading in the D.M. account, which he suggested would raise a supervisory red flag, particularly where the client has a stated and acknowledged lack of experience;
- The trading in the D.M. account was aggressive and high risk. The Association's analysis of the D.M. account, concludes that the account:

  (vi) Incurred losses of approximately $70,000 in a three-month period (79% of the original deposit of $88,776.66);

  (vii) Incurred commission charges of $11,967.22 (greater than $1,500 per month for three months);

  (viii) Executed 58 trades (40.85% of all trades by E.L.); and

  (ix) Executed 38 options trades;
- The Association submits that with D.M.'s disclosed personal and financial circumstances, coupled specifically with her lack of investment experience and knowledge, there were clear "red flags" to the Respondent in his position as DROP, and should have led to a thorough review by the Respondent of the suitability of D.M. to engage in options trading, at any level;
- The Respondent's approval of the D.M. OA to trade options at Level 3 was a failure to properly execute his duties as the DROP, in that he knew or ought to have known that he was allowing the client to be exposed to trade risks which were not suitable;
- The alleged excessive and unusual trading, with significant losses and excessive commissions in the D.M. account, were supervisory red flags, obligating the Respondent in his role as the DROP to make inquiries and take supervisory steps to control E.L.'s trading and limit "the obviously significant risks to the D.M. account assets.";
- The Association submits that additional areas for supervisory query, in instances identified by the Association and acknowledged by the Respondent in cross-examination, was evidence establishing that the Respondent did not fulfill his duties and general supervisory responsibilities as DROP. On numerous occasions identified by the Association, the Respondent did not make sufficient inquiries of the clients, the ROR or the Branch Manager where evidence of high risk and aggressive options trading was present, when he knew he should have; and
- The Respondent cannot assert, as a defence, that S.S. and R.C. were supervising the D.M. account.

(iii) The Association's Submissions Specific to the L.B. Account

¶ 96 In relation to the L.B. accounts, the Association makes the following submissions:

- L.B. had no options trading experience. F.B. had trading authority over the L.B. account. However, F.B. also had no experience trading options;
- There were frequent S & P 100 Index options trading, involving large positions in the L.B. account during the material time. The Respondent agreed that this would be a point of query for a DROP. The Respondent did query the trades that occurred in early December in the D.M.

account. He also made the same query for the L.B. account;

- The series of options trades that settled November 27, 2002 demonstrate that the client was bullish on the S & P 100 Index, a position contrary to the bearish position in the D.M. account, during the same time period. The Respondent stated that he had no concerns about this;
- Mr. Croft described the conflict in the S & P 100 positions between the two accounts as being "totally contrary to each other in terms of their direction and their bias". Due to the conflict situation, one client would be profitable and the end of the month and the other client would not. In Mr. Croft's opinion, such a situation would raise a question regarding whether the ROR understood what he was doing. Mr. Croft also agreed that E.L. could have been bearish for the S & P 100 during the first part of November and then changed his outlook for the S & P 100 to bullish at the end of November. However, Mr. Croft is of the opinion that if that scenario was true, then he would question why E.L. had not changed his outlook for the S & P 100 for both clients;
- Mr. Croft testified that the observed trading in the L.B. account included day trading in Imclone Systems, covered calls written against Imclone Systems' common stock, S & P 100 Index option trading and purchases of WorldCom stock. He believed the trading was similar to the trading in the D.M. account;
- The analysis for the L.B. account demonstrates:

  (x) Account losses of $43,000 in less than three months (27% of funds deposited);

  (xi) Commissions exceeded $1,500 for each of the three months;

  (xii) 42 trades executed in the account; and

  (xiii) 29 options trades executed in the account;

- L.B.'s personal and financial situation, coupled with her lack of investment experience and knowledge, were "red flags" to the Respondent and should have led to a thorough supervisory review of the suitability of L.B. to engage in options trading at any level;
- The Association witnesses testified that the facts of the excessive and unusual trading, losses and a high level of commissions generated in the L.B. account were supervisory red flags, obligating the Respondent to make inquiries and take supervisory steps as the DROP to control E.L.'s trading and limit the risks to the L.B. account assets;
- The Respondent failed in his duties as the DROP by not making a query with respect to the many "obvious areas of high risk and aggressive options trading when he knew he should have.";
- The Respondent's approval of the L.B. OA to trade options at Level 3 was a failure to properly execute his duties as the DROP, and that he knew or ought to have known that he was allowing the client to be exposed to trade risks which were not suitable;
- The Respondent's subsequent approval of the L.B. account to allow Level 4 option trades, which the Respondent claims was requested by F.B., without any material change in the personal or financial circumstances of L.B., and only five days after the Respondent's approval of the account to trade options at Level 3, is further evidence of the Respondent's failure to make proper inquiries and assessment of the suitability of the client to engage in higher risk option trading. It is also submitted that these facts demonstrate a failure by the Respondent to follow his own policy of not assigning a Level 4 options approval codes to new accounts where the client has limited experience. It is to be noted that no trades at Level 4 were ever executed in the accounts; and
- The Respondent cannot assert, as a defence, that S.S. and R.C. were supervising the L.B.

account.

(iv) Summary of the Association's Position with Respect to the D.M. and L.B. Accounts

¶ 97 The Association, in summary with respect to D.M. and L.B., refers to paragraphs 64 through to 67 of the ASF. The Association submits that:

- The actual trading in the D.M. and L.B. accounts raised many red flags which did not elicit a supervisory response from the Respondent;
- If the Respondent made an inquiry of E.L. concerning the D.M. account in early November, 2002, which the Respondent states was prompted by a concern about the trades, any inquiry was limited to asking E.L. about the trades. The Respondent accepted E.L.'s explanation that D.M. understood and accepted the risks associated with these trades. There was no further inquiry made. In view of the acknowledged disclosure of the client's "basic/nil" investment experience and knowledge, her responsibility for two dependents and her modest financial means, it is submitted that the Respondent should have provided a higher level of supervision. It is submitted that the Respondent should not have simply accepted E.L.'s explanation and that a reasonable supervisory step would have been to ensure that the matter was discussed with the Branch Manager, S.S., and the most effective step would have been to ensure that the supervisor spoke to D.M. and obtained direct information from D.M. to confirm whether she truly understood and accepted the risks of the options trades being undertaken in her accounts at Union Securities;
- The step of discussing the nature and risks of option trades with D.M. and L.B. should have occurred at the time that the accounts were approved for options trading, or the accounts should not have been approved at any level, given the client information disclosed in the NCAFs and the OA's;
- E.L. was a newly registered and relatively inexperienced ROR. There were no assurances that E.L. was sufficiently experienced to be able to explain the complexity and risks of the options trading, or to assess whether the client understood those factors;
- With respect to the Respondent querying E.L. in early December, 2002 due to the identification of large value trades and significant losses in the D.M. and L.B. accounts, the Association notes that the Respondent conceded that his supervisory steps were to ask E.L. about the trades and he accepted E.L.'s explanation that the clients understood and accepted the trading risk. No steps were taken to corroborate that information. The Association submits that E.L.'s explanation did not make sense in light of the personal and financial circumstances of the clients D.M. and L.B.;
- The Respondent states that he noted significant losses in the D.M. and L.B. accounts during his daily review of December 3, 2002 and prepared a profit/loss analysis for the accounts and placed a copy on R.C.'s desk and asked him to look at it and to give the Respondent an opinion on what he felt about the trading in the accounts;
- The Association notes that the Respondent stated that he queried E.L. about the losses in the D.M. and L.B. accounts at the end of December, 2002 or early January, 2003 and received the same response as on the prior two occasions. This time the Respondent was not prepared to accept E.L.'s explanation and he raised the matter to the level of R.C., who requested a profit and loss analysis be prepared to assess client losses and determine suitability. After the Respondent prepared a profit and loss analysis in January, 2003 and forwarded the same to R.C., he left the matter with R.C. and S.S. The Association submits that by this action the Respondent failed to fulfill his supervisory duties as a DROP;
- The Respondent should have recognized from the many supervisory red flags that S.S. was not adequately experienced to supervise the trading activities of E.L. and that he would need to

maintain direct and close supervision over the options trading in the D.M. and L.B. accounts;

- Given the recurring patterns in the accounts, the Respondent's reliance upon the representation by R.C. that R.C. and S.S. were watching the situation of E.L.'s trading in the two accounts was not acceptable. The Association submits that the DROP maintained ultimate responsibility to ensure that the trading in the accounts was suitable at all times; and
- The Respondent had the responsibility to take further and effective supervisory steps to ensure that the D.M. and L.B. accounts no longer traded in higher risk options and that further account losses were minimized.

(v) The Respondent's Submissions with Respect to E.L.

¶ 98 In relation to E.L., the Respondent makes the following submissions;

- Close supervision reports of E.L. were in the approved form and were signed by R.T., a principal of Union Securities. The Respondent submits that there was no requirement for the Respondent to actually conduct closer supervision of E.L. at any material time;
- The increases in E.L.'s trading limits were made by R.C., who was senior to the Respondent in terms of his position and overall responsibility. In argument the Respondent refers to By-law 38 of the Association which describes the rules and responsibilities of the Chief Compliance Officer. By-law 38, paragraph 38.1, states that the Chief Compliance Officer shall be responsible to the applicable self-regulatory organization for the conduct of the firm and the supervision of its employees. Paragraph 38.14 states that the Chief Compliance Officer shall monitor adherence to the Member's policies and procedures as necessary to ensure that the management of the compliance function is effective and to provide reasonable assurance that standards of the applicable self-regulatory organization are met;
- D.M. and L.B. account activity included equity trades which the Respondent submits are not subject to review by the DROP. Therefore, the increases in the trading limit for E.L. was, in the circumstances, a relevant consideration to be taken into account by the Respondent; and
- Admitting that the nature of the trading in the D.M. and L.B. accounts was speculative and aggressive, the Respondent states that "this appears to be what the clients wanted." The Respondent submits that trading was at all times within their stated investment objectives and risk tolerances as noted on the NCAFs which, for both D.M. and L.B., indicated 100% venture/speculative trading and 100% high risk.

(vi) The Respondent's Submissions Specific to the D.M. Account

¶ 99 The Respondent makes the following submissions specific to the D.M. accounts:

- With respect to the first trades in the D.M. accounts, the Respondent noted the high dollar value of the trades and the fact that they were in the S & P 100. The Respondent contacted E.L. to obtain an explanation;
- There were a number of trades of Imclone Systems in the D.M. account that settled November 26, 2002 that were day trades with a combined value of $180,000. The Respondent was not required to view those trades. Those trades would have been reviewed by the Branch Manager and likely by the Chief Compliance Officer, which are relevant factors for the Respondent to take into account;
- On November 15 and 20, 2002 there were equity trades, including day trading in Imclone Systems for total acquisition and disposition costs in excess of $57,000. These equity trades were not required to be reviewed by the Respondent as DROP and would have been required to be reviewed by the Branch Manager and would also have been reviewed by others in Head Office;

- As stated in paragraphs 31 through to 33 of the ASF, which are repeated above, the Respondent contacted E.L. in November, 2002 and on or about December 5, 2002. There is a note made by the Respondent in relation to the December 5, 2002 contact which states "spoke to E.L. Client agreed to all trades and position.";
- There was nothing errant with the Respondent's general practice in relation to the review of client trades during the relevant period. He reviewed the trades for suitability, using the stated personal financial conditions of the client, their objectives, their risk tolerances, their history of trading and knowledge of the options trading. Depending on the seriousness and depth of the matter, he would contact the ROR first in an informal way. If it was a matter that he felt needed to be moved up a step, he would exchange e-mails. If he felt it was beyond simply himself and the ROR having a discussion, he would go to the Branch Manager and/or the Chief Compliance Officer;
- As stated in the ASF, the Respondent on December 5, 2002 spoke to R.C. about the D.M. account and was assured by R.C. that he and S.S. were watching the account. The remaining trades in the D.M. account after December 5, 2002 were all for 10 contracts and it was not a requirement under Policy No. 2 that those trades be reviewed by the Respondent as Policy No. 2 calls for a review of trades in excess of ten contracts;
- The trading of options in the D.M. account in January, 2003 was more limited; and
- Paragraphs 37 through to 43 of the ASF, while mathematically correct, are irrelevant. It is submitted that from a supervisory perspective, one must review trading for evidence for excessive trading activity and commissions. There is no evidence or suggestion that E.L. was charging excessive commissions or churning the account.

(vii) The Respondent's Submissions Specific to the L.B. Account

¶ 100 The Respondent makes the following submissions with respect to the L.B. accounts:

- While the L.B. account received approval for Level 4 options trading, that is irrelevant because the account was never formally coded as Level 4 and there were no Level 4 trades executed in the account (see paragraphs 49 and 50 of the ASF);
- With respect to the pattern of trading in the L.B. account that indicated a high risk pattern of trading, the client, L.B., wanted high risk trading. The NCAF for the account stated 100% speculative/aggressive and 100% high risk. Therefore, the trading activity was not a red flag or warning signal in relation to the stated investment objectives and risk tolerances; and
- Many of the options trades in the L.B. account in November and December, 2002 were profitable. Most of the losses in the L.B. account were not realized until after December 19, 2002.

(viii) Summary of the Respondent's Submissions with Respect to E.L.

¶ 101 The Respondent made the following submissions, in summary, with respect to E.L.:

- The Respondent did supervise the D.M. and L.B. accounts and the trading activity of E.L. during the material time. Evidence of his supervision is found in the daily blotters and monthly commission reports;
- To the extent that there were red flags in relation to the accounts, they were noted by the Respondent and followed up by him. The Respondent spoke with E.L. after the very first trade in the D.M. account. There is written evidence that he reviewed virtually every trade in the D.M. and L.B. accounts;
- The Respondent spoke to E.L. on several occasions about the trading and was advised by E.L.

that the clients were aware of and accepted the trading in their accounts and they wanted to day trade;

- With respect to the apparent conflict between the bearish and bullish positions taken in the two accounts, the index options in the L.B. account were all purchased after November 26, 2002 and were all December positions. The S & P 100 Index positions in the D.M. account were all established prior to November 22, 2002 and some of those were to expire in November, 2002. The Respondent's submission is that "the obvious answer is that the expectation regarding the index changed during the course of the month." It is stated that E.L. expected the index to decline as a result of the Gulf War. When that did not happen by the third week of November, he recommended a different strategy. It is submitted that this is not a red flag and is, in fact, perfectly consistent with information provided to the Respondent in November, 2002 by E.L.;
- E.L.'s electronic notes in respect of the D.M. and L.B. accounts confirmed that he met with the clients to review their background and trading objectives and that he spoke with them frequently regarding the trading in their accounts;
- The Respondent spoke with R.C., the Chief Compliance Officer for Union Securities, and was assured by him that he was monitoring the account with E.L.'s Branch Manager, S.S.;
- In summary, the Respondent asserts that Association's position with respect to the D.M. and L.B. accounts is predicated on the benefit of hindsight and using the standard of "perfection, not reasonableness. The reality is that the clients requested aggressive and high risk trading, all of the trading was consistent with their stated investment objectives and risk tolerances, and the losses did not significantly accumulate until early January, 2003 at which time swift action was taken to restrict the account.";
- The Respondent had no reason to believe that S.S. and R.C. were not reviewing or closely monitoring E.L.'s trading activity. This is not a delegation of responsibility, but is another relevant factor when one asks should the Respondent have done more;
- In all of the circumstances it is submitted that the Respondent's supervision of the accounts was more than reasonable and was at all times in accordance with the By-laws, Regulations, Policies and Rulings of the Association;
- The settlement with Union Securities is a relevant and important fact in examining the allegations in this matter. In it, Union Securities accepted that it failed to supervise the D.M. and L.B. accounts and the trading activity of E.L. It is submitted that S.S., the Branch Manager, was options qualified and that S.S. "alone had the authority and responsibility to supervise both the options trades and the equity trades in the D.M. and L. B. accounts."; and
- R.C. reviewed the accounts but he was not options qualified. Therefore, the Union Securities settlement by necessary implication included both the options and the equity trades in the D.M. and L.B. accounts. There are no proceedings against R.C. or anyone else at Union Securities' Head Office concerning equity trades in the D.M. and L.B. accounts. It is therefore submitted that the Association implicitly accepted in the Union Securities settlement that it is a firm which takes primary responsibility for Head Office supervision. In any event, it is inconsistent and unfair to proceed against the Respondent in these circumstances.

(ix) Analysis And Findings with Respect to Count 1

¶ 102 The Panel accepts substantially all of the arguments of counsel for the Association. The Panel finds that there were numerous "red flags" that were ignored by the Respondent. While the Respondent says that he supervised the D.M. and L.B. accounts and the trading activity of E.L. during the material time, the mere fact that he reviewed the daily blotters and the monthly commission reports does not constitute reasonable supervision. The fact that the Respondent, in his role as the DROP, contacted E.L. on two occasions to obtain

an explanation from E.L. with respect to the trading activity does not constitute reasonable supervision in the circumstances of this case. There were significant "red flags" that required the Respondent to do more in the circumstances. Those red flags are described in the Association's argument, and include:

- The NCAF's for both D.M. and L.B. describe clients with "poor/nil" or "basic/limited" investment knowledge. In the case of D.M., she was single with two dependents. Based on the NCAF information neither client had significant liquid assets that could afford to be put at risk. The OA's describe their investment knowledge as "limited." In contrast, the NCAF's describe investment objectives as "100% venture/speculative" and the risk factors as "100% high." The information in the NCAF's and the OA's provided the clearest of the red flags with respect to the need for supervision. The Respondent admitted in cross-examination that "trading options can be a highly speculative, risk oriented, investment strategy not recommended for the inexperienced investor," an observation that is consistent with the content of the Manual of Union Securities and the OSC material. At the outset of the trading relationship with D.M. and L.B. when presented with the account opening forms, the Respondent should have questioned the suitability for these two clients to be authorized to open and maintain option accounts at Union Securities. This suitability issue is certainly the case when acting as the DROP where the ROR is newly registered and where the Branch Manager was inexperienced. In the circumstances the Respondent should have, at the outset, at least contacted the Branch Manager to have the Branch Manager discuss the matter in more detail with E.L. and the clients to obtain more information to reconcile how options trading and investment objectives of 100% venture speculative were suitable for these two clients with their limited investment experience and the other characteristics disclosed in the account documents. The requirement to supervise in the case of these two accounts was high and there was no high level of supervision. The Respondent's two telephone calls to E.L., and the information provided by E.L., were in the circumstances of this case insufficient to meet his supervisory obligations as the DROP. More was reasonably required in light of the information available to him;

- After the accounts were opened, they should have been very closely supervised. In the circumstances, there was a very inexperienced ROR and an inexperienced Branch Manager. There was excessive high risk unprofitable trading in the accounts. The accounts were not profitable and were generating an exceptional level of commission. Having regard to the liquid assets of the two clients, there was significant risk. While the Respondent recognized some of these concerns, his response was limited to several discussions with E.L., the ROR and contact with R.C. In the circumstances, he should have done more to exercise his supervisory responsibility. At a minimum, he should have raised the issue with the Branch Manager and requested that the Branch Manager discuss the trading activity with E.L. and with the clients. The Respondent's supervision of the trading activity was not, in all of the circumstances, reasonable;

- With respect to the Respondent's argument that he relied on assurances given by R.C. on December 5, 2002 that R.C. and the branch manager, S.S., were watching the account, the Respondent, in his role as the DROP, cannot delegate his responsibility. There is no evidence that the Respondent asked for or ever received any further information from R.C. about the steps taken by R.C. or S.S. to monitor the account. By December 5, 2002, there were enough red flags that the Respondent should not have relied on simple assurances that the account was being watched by others. What is now determined from the *Re Schillaci* decision (*supra*) is that S.S. was not reasonably supervising the accounts;

- With respect to the Association's position that the contradictory positions taken in the D.M. and L.B. accounts constituted a red flag, and that there should have been an expectation for these two clients to have similar trade objectives and the same trade strategies executed in their accounts, this Panel agrees that contradictory positions can be a red flag. However, as is pointed out by

counsel for the Respondent, an answer for that contradiction may be that the expectation regarding the S&P 100 index changed during the period that the two positions were taken. Further, it is possible that two clients can follow conflicting strategies. The lack of consistency in strategies between these two clients is not, in the circumstances of this case, a basis to find a lack of supervision on the part of the Respondent;

- With respect to the inexperience of E.L., the Respondent should have obtained copies of the close supervision reports as part of his supervisory DROP role. While he need not actually conduct the closer supervision of E.L., he should have at a minimum obtained the close supervision reports and reviewed them to ensure that there was actual close supervision being carried out;
- In relation to the increases to the trading limits made by R.C., it is not a defence to the allegations of failing to supervise to suggest that R.C. made that decision alone. R.C. may well have made the decision to increase the trading limits. The Respondent was, however, "surprised" by the increases and this was a red flag that should have prompted much closer supervision of the trading activity of E.L.;
- With respect to the Respondent's submission that while the L.B. account received approval for Level 4 options trading, that fact was irrelevant because the account was never formally coded as Level 4 and there were no Level 4 trades executed in the account, this Panel finds that the Respondent's submission has no merit. The fact is that the Respondent approved the account for Level 4 trading. Whether it was coded in the system or not is of little consequence. Based on the information available to the Respondent at the time that the account was opened, there was a serious question about suitability for any options trading, let alone Level 4 options approval; and
- While supervision of equity trades is not a direct responsibility of the DROP, the fact that there were trades of Imclone Systems in the D.M. account that were day trades with a combined value of $180,000.00 was a factor that the Respondent should have been aware of and which was a red flag with respect to these two accounts.

¶ 103 The Respondent's argument that the settlement with Union Securities is a relevant and important fact when examining the allegations in this matter is rejected. The settlement with Union Securities provides no defence to the Respondent. A firm may take responsibility for head office supervision. That does not relieve the Respondent, in his capacity as a DROP, from responsibility for failing to supervise. There is no inconsistency or unfairness to proceed against the Respondent in the circumstances of this case. The Respondent had responsibilities to supervise and his limited supervisory efforts were not reasonable in the circumstances.

¶ 104 To conclude, this Panel finds in relation to Count 1 that the Respondent has failed to reasonably supervise and has also failed to maintain adequate supervision records (evidence) relating to his supervision.

COUNT 2

Count 2

The Respondent, at all material times, the Designated Registered Options Principal for Union Securities Ltd. ("Union"), a Member of the Association, failed to adequately supervise the account management and trading activities, and maintain adequate supervision records (evidence), relating to, all or any of, twelve (12) client accounts of the Registered Options Representative, S.B., an employee of Union in Regina, Saskatchewan, during the period 2002 to 2003; in contravention of Association Regulation 1300.2, 1900, and Policy No. 2 and Bylaw 29.1.

¶ 105 The agreed facts in relation to the clients of S.B. are found at paragraphs 68 through to and including 143 of the ASF (see Schedule "1"). The trading in the accounts is summarized in the appendices to the ASF.

¶ 106 The allegation in relation to the S.B. clients is that seventy-four Level 4 options trades in the 12 client accounts were allowed to be executed when those accounts had not been approved for Level 4 options trading.

The options trades for the various S.B. accounts are summarized in Appendix F of the ASF. Many involve a put option strategy with Dynegy shares, but a number of the impugned trades are not related to Dynegy.

¶ 107 The Association requested a written statement from S.B.'s Branch Manager, R.T., for each account, indicating R.T.'s process for reviewing and approving OA's and detail on what supervision was conducted in relation to the options trades executed in each of the 12 accounts. The Association requested a written statement from the Respondent for each account indicating his process for reviewing and approving the OA's and a statement explaining why the accounts were approved for options strategies that were not applied for and further why the Respondent felt the approved options strategies were suitable for each of the clients given their personal and financial circumstances.

¶ 108 S.B. was not called as a witness. Letters from S.B. to the Association dated June 26, 2003, in relation to a number of clients, were entered as an Exhibit. Each of the letters refers to the strategy employed in relation to the Dynegy stock. S.B. states that the stock had characteristics that his clients looked for when buying equities. Selling the uncovered puts on Dynegy was a means of acquiring the stock below the current market price while at the same time generating option premium income.

¶ 109 R.T. was not called as a witness. His letters of June 30, 2003 to the Association were entered as an Exhibit. The letters from R.T. refer to a number of clients. R.T. states in the letters that he discussed with S.B. the put option strategy on Dynegy common stock and that S.B. advised that he had discussed the strategy with the clients and that the clients were "owning the stock at the specified strike price less the dollar amount realized from the sale of the option premium." In each of the letters R.T. states that having regard to the personal and financial characteristics of each of the clients "the potential stock acquisition strategy was deemed to be suitable and met the clients' investment objectives".

¶ 110 Also entered as an Exhibit at the hearing were letters prepared, after the investigation commenced, by each of the clients, other than T.G. who had made a complaint. Each of the letters confirm that the clients were advised of and approved all of the trades in their accounts, that they were fully advised of the risks before engaging in the uncovered put writing strategy, and that the strategy was suitable for their objectives.

¶ 111 The Respondent testified that he had a "general understanding of what the trades were about, and what S.B.'s strategy was there." He believed that Dynegy was an undervalued stock, that Dynegy paid a dividend in the past and that it was "an opportunity value play". He understood that S.B.'s clients had been with S.B. for a long period of time and that they were all interested in buying the Dynegy stock. The uncovered put strategy was one that S.B. felt was appropriate for the clients. The intention was to purchase Dynegy at a discount by writing what would be termed in his language "security puts". This understanding came from a discussion that the Respondent had with S.B. in relation to another account. In that instance, S.B. had requested that the Level 3 options approval be upgraded to a Level 4 options approval and that was the explanation given for that particular request. The evidence of the Respondent on that issue is:

> Q. Do you have any specific recollection in relation to those trades?
>
> A. I have my general understanding of what the trades were about, and what Mr. Birkeland's strategy was there.
>
> Q. Was that your general understanding?
>
> A. That Dynegy was an undervalued stock and it paid a dividend. It was an opportunity value play. The intention was that all of his clients had been with him for a long period of time. They were all interested in acquiring the stock. The uncovered put was strategy that he felt was appropriate for the clients and the particular circumstances of Dynegy. So the intention was to purchase Dynegy at a discount by writing what would be termed in his language security puts.
>
> Q. To step back for a moment, where do you get this understanding from?
>
> A. It came primarily from a discussion that I had with him over another account that is not included in this package but was originally one of the enquiries. I had initially given the account a code 3, and I upgraded it to a 4. His explanation to me was why he wanted it upgraded to a 4 level.

¶ 112 In examination-in-chief, the Respondent was referred to a letter prepared by his former counsel, which provided further information with respect to the Dynegy put writing strategy. The Respondent stated at the hearing that the information in the letter was accurate. Some of the information in the letter of his former counsel is:

(xiv) Of the various S.B. accounts that employed the Dynegy trading strategy, all but one had the equity available to purchase Dynegy shares in the event the price did fall and the short puts in their account were exercised;

(xv) The Respondent was aware that S.B. was a knowledgeable and experienced ROR who serviced medium and high net-worth sophisticated clients, many of whom had previous options trading experience;

(xvi) In early June, 2002, the Respondent and S.B. had detailed discussions about the Dynegy put strategy in relation to another account that was first opened on June 6, 2002 as a Level 3 options account and was upgraded on June 13, 2002 to a Level 4 options account. The upgrade was for the purpose of writing puts;

(xvii) The Respondent understood and was comfortable with the Dynegy put writing strategy and viewed it as prudent in light of the nature of the underlying strategy, and the income that would be derived from writing the puts; and

(xviii) The letter states "in effect the missed codes on the S.B. accounts is a matter of form as the trades were suitable, were reviewed by (the Respondent) to see if they were suitable and were determined by (the Respondent) to be suitable."

¶ 113 No enforcement action was ever taken against S.B. There was no investigation concerning the conduct of R.T.

¶ 114 In correspondence dated July 15, 2003 from the Respondent to the Association, in relation to covered writing, the Respondent states that option Level 2 and 3 both allow covered writing. He then stated in the correspondence:

> As a rule, I assign option code 3 to any account that is eligible to trade covered option positions. This simplifies the paperwork on file and does not unnecessarily restrict the client for future transactions.

and then further stated in summary the following:

> Option code 3 is assigned to most clients who qualify and anticipate covered option writing.
>
> Option code 4 is not assigned to clients indicating LIMITED experience without additional information from the ROR.
>
> Option code 2 is assigned to all RRSP accounts

¶ 115 At the Hearing the Respondent gave evidence in chief about this issue. He stated:

> …as I said earlier the options department was involved in the processes in trying to adopt practical measures that address concerns of the industry as well as facilitate the clients and the ROR's doing the business they choose to do. The difficulty, again, one of serious difficulties stems from my uncomfort with option code Level 4. At the time, my unfamiliarity with a number of the new ROR's, the new clients coming into Union Securities, the new branches, as we were growing. As I said here in this letter, I don't assign uncovered writing code 4 to new accounts that have limited experience. Primarily, as I explained in there was that any qualifications or I needed qualification as to what they were going to do under code 4, and what limited experience actually meant. I addressed those issues with the new option agreement, as best one can with the document.
>
> I did run into flak from the ROR's and the Branch Managers over this policy and

that the experienced ROR's and the Managers that brought clients that had been doing these practices for a number of years felt that I should be more liberal in allowing uncovered put writing than I was being by not assigning code 4. Over time we worked out our understanding, and I do now assign code 4 if I know, in particular, that the purpose of the code 4 is to write uncovered put writing.

¶ 116 The Respondent also gave the following evidence:

Q. We have seen in cases, a situation where the client requested level 4, but you assigned a lower approval code level, whether it was a level 2 or a level 3. Can you explain that practice, and in particular reference to the time period 2001 to 2003?

A. In 2001, as you recall, and 2002, Union experienced a high increase in number of offices, RORs and clients. A lot of these clients had sufficient, or a considerable experience in options trading.

It was a practice of many of the new RORs to fill out an option agreement and tick off things that they were not quite used to being able to do at the other firms that they had been with. To me they were all new, they were new clients and new RORs, a wave of clients that were doing trading that we had not really done at Union Securities before.

In 2000, we had 10 RORs that primarily were buying calls and puts, and some covered writing. I have always been uncomfortable with code 4, because code 4 allows for high risk, naked call writing by definition. It also allows for relatively conservative uncovered put writing.

There is this constant conflict that I have with RORs, and it is common, I have had this discussion with other people in the industry. There is a real contradiction in having this code 4 where you have a conservative strategy, which is uncovered put writing versus the naked call writing. I was reluctant to issue code 4.

In many cases, I assigned a code 3 with the anticipation, after discussion with a number of people, including, if I can say the auditors, that in 2001, as ways of getting around the exposure, assigning, allowing somebody to do uncovered put writing, yet restricting them from doing naked call writing.

The 4 code was problematic because our system has no way of differentiating the naked call from an uncovered put, they are both uncovered trades. What I mean by differentiation, I mean that there is no easy way for me to spot a client account with a code 4 to know whether they are permitted to write a naked call or do an uncovered put.

Q. I think you started to say, but has your practice changed in assigning level 4 or level 3 since 2003?

A. Yes, because it was hard for me to track and distinguish the difference between whether this client with a code 4 was allowed to do a naked call, or an uncovered put. I decided it was -- my practice was assigning code 3, simply resulted in too much trouble which is why I am sitting here with you today. Now I simply assign a code 4.

As a matter of policy that I always had at Union Securities is that naked call writing is only permitted on a case by case basis. I currently use code 4 for uncovered put writing.

Q. Okay. You heard Mr. Croft give evidence where I believe, it was his practice that he would assign level 4, but write on the form, "Uncovered puts only"?

A. I tried that and that was, I discussed with colleges around town that do that. Also, again, that was a subject that we discussed with the auditors, or I discussed with the auditors.

To me, it was not useful because I don't have the files, I don't have KYC

information available to me electronically, and the only way I can access the KYC information is to go to the main file room, pull the documents out and look at them.

I do retain some option agreements for individuals. On the basis that, it is simply impractical for me to maintain a separate file, or filing system for all option approved accounts. I simply don't have the room for it, I don't have the means to update it on a timely basis. My only source for KYC information is to go to the master file.

CLIENT T.G.

(i) The Association's Submissions

¶ 117 The Association refers to paragraphs 72 through to 79 of the ASF:

72. The Association received the complaint of T.G., in two communications from the Saskatchewan Securities Commission (now, the Saskatchewan Financial Services Commission), dated December 30, 2002 and January 28, 2003.

73. T.G. opened margin, RSP and options accounts with S.B.

74. The T.G. NCAF was dated February 15, 2001. Information from the T.G. NCAF, includes:

- Investment Knowledge: Basic/Limited
- Investment Experience: Stocks, Bonds, Options & Mutual Funds

75. The T.G. Option Agreement was dated February 13, 2001. Information from the T.G. Option Agreement, includes:

- Investment Experience: Limited for Stock Options, Stocks, Bonds & Options
- Anticipated Options: Level 2
- DROP Approval: Level 2

76. The Respondent signed the T.G. Option Agreement and assigned a Level 2 options authorization code for the option account.

77. During the period June to September 2002, S.B. executed three (3) Level 4 options trades, (short puts) in the T.G. account. These options trades were all 10 contracts.

78. The T.G. account sustained losses as a result of the three (3) uncovered options trades. The uncovered options trades were reversed or expired and T.G. was compensated for the losses by Union.

79. At no time, was there an update to the T.G. Option Agreement to Level 4, to allow for uncovered option trades.

¶ 118 The OA for T.G. shows that T.G. was 42 years of age when the OA was executed, had an approximate annual income of $26,000.00 and an approximate net worth (exclusive of family home) of $80,000.00.

¶ 119 The Association submits that T.G. requested and the Respondent assigned a Level 2 options approval to the account but thereafter allowed three Level 4 options trades to be executed in the account. The Level 4 trades were naked short put options in Dynegy. The Association submits that the Respondent did not exercise his responsibility as a DROP to ensure that the interests of the client were protected and, in particular, did not take supervisory steps to ensure that the trading for the client's account was in line with the options approval level that he had assessed as suitable for the client.

¶ 120 While not specifically addressed in the Association's submissions, Mr. Croft, the Association's expert, reviewed the June, 2002 month-end statement for the account of T.G. and noted the following:

A. The June 2002 month-end statement for the account of T.G., the net equity at June 2002 month-end was $18,946.15. The Canadian margin account was holding three mutual funds valued at $18,010.35. It had a negative cash value of Canadian $8,433.80.

At the same time, the U.S. account was long 900 shares of Dynegy, with a market value of U.S. 6.48 translated into the Canadian dollars, $9,799.51. That was short 10 Dynegy, July 750 puts, which obligated the account to purchase an additional 1,000 shares of Dynegy at U.S. $7.50 per share, which equates to $7,500 U.S. or $11,300.03 Canadian exposure.

Q. **MS. MCLAUGHLIN:** I'm sorry, to interrupt, just to assist the panel, you may want to follow along at Tab 63 of the book of agreed documents.

THE CHAIRMAN: That is page 63.

MS. MCLAUGHLIN: Book 1 at page 63.

THE CHAIRMAN: Fine.

MS. MCLAUGHLIN: Are we ready? I am going to ask you to go back over that so that the panel understands where you're taking the trades from in the T.G. account, and them move into your observations and review them?

A. If you go to page 3 of Tab 63, if you notice at June 24th, there was an expiry of 9 Dynegy $10 calls. They, of course, would have been covered by the 900 shares of Dynegy stock held in the same account. They expired worthless.

You will notice the sale on the 26th of June, the sale of 10 puts, Dynegy July $7.50 puts. As you follow down, the security holdings coincide with what I said in my report. There was a negative cash balance of minus $8,433.80. Then you will notice the three mutual funds, Dynamic, CI and Templeton. The value of the mutual funds being $18,010.35.

On page 4, you will see the security holdings in the U.S. account. You will see the 900 shares of Dynegy with the market value of $6,480. You will see the 10 short puts on Dynegy, July $7.50. You will see that that has a negative value of $1,000 in the account.

From the perspective of underlying exposure in the U.S. account, we are long 900 shares of Dynegy stock and we are short 10 puts which has an underlying exposure of an additional 1,000 shares of Dynegy stock, meaning our total exposure to Dynegy at this point is 1,900 shares.

If we take the underlying exposure of the Dynegy puts and we pair that with the long Dynegy stock, based on the exposure, we have exposure of Canadian $21,141.53, or the exposure, to put it another way, is $2,195.38 greater than the net equity in the account at June 2002 month-end.

In my opinion, that frames this as a more aggressive position, not one simply designed to produce income and acquire stock at below current market value.

OTHER S.B. CLIENTS

¶ 121 As stated in paragraphs 80 and 81 of the ASF, the Association conducted a review of 11 other S.B. client options accounts. In the 11 accounts, S.B. effected 90 Level 4 options trades when the accounts were not approved for Level 4 options trading. The 11 clients signed letters addressed to R.T. providing consent to a specific option strategy employed by S.B. and accepting the Level 4 options trades executed in their accounts. These letters were sent in June, 2003 and October, 2003, after the investigation had commenced.

CLIENTS G. & E.B.

(i) The Association's Submissions

¶ 122 The Association refers to paragraph 82 through to 86 of the ASF:

82. The G. & E.B. NCAFs are both signed and dated May 24, 2001. Information from the G. & E.B. NCAF, includes:

- Investment Knowledge: Basic/Limited
- Investment Experience: Stocks, Bonds, Options, Mutual Funds & Short Sales
- Account Objectives: 70% (Income) & 30% (Long Term)
- Account Risk Factors: 70% (Low) & 30% (Medium)

83. The G. & E.B. Option Agreement was dated January 2, 2002. Information from the G. & E.B. Option Agreement, includes:

- Investment Experience: Limited for Stock Options, Bonds & Options. Extensive for Stocks and None for Commodities
- Account Objectives: 50% (Security) and 50% (Income)
- Anticipated Options: Level 2
- DROP Approval: Level 3

84. The Respondent signed the G. & E.B. Option Agreement and assigned a Level 3 authorizations code for the options account.

85. During the period June to September 2002, S.B. executed four (4) Level 4 options trades (short puts), in the G. & E.B. account. These options trades were all 10 or more contracts.

86. At no time, was there an update to the options authorization code of the G. & E.B. Option Agreement to allow for uncovered options trades.

¶ 123 The submissions of the Association with respect to G. & E.B. are:

- The Respondent agreed that the NCAF for these clients demonstrates that they were retired, had "basic/limited" investment knowledge, had no percentage allocated to "venture/speculative" in the NCAF account objectives section, no percentage allocated to "high risk" in the risk tolerance section and collectively had an annual income of less than $50,000;
- The clients requested Level 2 options approval but were assigned a Level 3 options approval by the Respondent. The Respondent agreed that Level 3 options trades could be more complex and riskier than Level 2 options trades "at the extreme end of the spectrum";
- The Respondent agreed generally that Level 4 options trades were not suitable for G. & E.B. although he felt that Level 4 uncovered put writing, which he assessed at a lower risk, was suitable for the clients. Four Level 4 options trades (all Dynegy) were allowed in the account;
- The Respondent did not compare the account options approval code with the trade activity in the account; and
- The Respondent acknowledged that he allowed the G. & E.B. account to be exposed to high risk trading when the NCAF and OA did not indicate that such trading was agreed to. The Association submits that the Respondent did not properly exercise his responsibility as DROP to ensure the interests of the clients were protected and, in particular, did not take supervisory steps to ensure that the trading in the clients' account were in line with indicated investment objectives and investment risk tolerance for the account, and the options approval level that he had assigned as suitable for the clients.

CLIENT L.B.

(i) The Association's Submissions

¶ 124 The Association refers to paragraphs 87 to 91 of the ASF:

87. The L. B. NCAF is signed and dated February 16, 2001. Information from the L.B. NCAF, includes:

- Investment Knowledge: Basic/Limited
- Investment Experience: Stocks, Options, & Mutual Funds
- Account Objectives: 60% (Income) 40% (Long Term)
- Account Risk Factors: 50% (Low) & 50% (Medium)

88. The L.B. Option Agreement was dated February 16, 2001. Information from the L.B.

Option Agreement, includes:

- Investment Experience: Limited for Stock Options, Stocks, Bonds & Options
- Anticipated Option: Level 2
- DROP Approval: Level 3

89. The Respondent signed the L.B. Option Agreement and assigned a Level 3 authorization code for the option account.

90. During the period June to September 2002, S.B. executed four (4) Level 4 options trades (short puts) in the L.B. account. These uncovered options trades were all 10 contracts.

91. At no time, was there an update to the options authorization code of the L.B. Option Agreement to Level 4, to allow for uncovered options trades.

¶ 125 The Association made the following submissions with respect to L.B.:

- The Respondent agreed that the NCAF for the client demonstrates that the client had "basic/limited" investment knowledge, had no percentage allocated to "venture/speculative" in the account objectives section, no percentage allocated to 'high risk" in the risk tolerance section and collectively the client and spouse had an annual income of less than $100,000;
- The client requested a Level 2 options approval but the Respondent assigned a Level 3 options approval code;
- Four Level 4 options trades (all Dynegy) were executed in the L.B. account and the Respondent submits this is evidence of the account being exposed to high risk trading in circumstances where the client had specifically indicated in the NCAF and OA that they did not want high risk trading; and
- The Association submits that the Respondent did not properly exercise his responsibility as DROP to ensure the interests of the client were protected and, in particular, did not take adequate supervisory steps to ensure that the trading in the client's account was in line with the indicated investment objectives and investment risk tolerance for the account, and the options approval level that he had assigned as suitable for the client.

(ii) The Respondent's Submissions

¶ 126 The Respondent's submissions with respect to L.B. are:

- The decision to approve the L.B. account for Level 3 is a matter within the Respondent's authority and discretion. Mr. Croft conceded that there is not much difference in risk between a Level 2 and a Level 3 trade. Having regard to the information in the NCAF and the OA, the Level 3 approval was not inappropriate or unsuitable for L.B.;
- With respect to the four impugned trades, all were naked short puts on Dynegy and followed a discussion that the Respondent had with S.B. regarding his Dynegy put writing strategy. The trades were all for exactly ten contracts and were not required to be reviewed by the Respondent as they were not "in excess of ten contracts" as stated in Policy No. 2. The trades took place prior to November, 2002 when the Respondent received new trade blotters; and
- Looking at the trades in the context of the account, the account had about $50,000 in equity at the time of the first impugned trade. There was very little trading in the account. The short puts were all secured by either cash or marginable securities. There was no evidence of a client complaint. There were no red flags and there was nothing remarkable about these trades that should have caused further inquiry on the part of the Respondent.

CLIENT M.B.

(i) The Association's Submissions

¶ 127 The Association referred to paragraphs 92 through to 96 of the ASF:

> 92. The M.B. NCAF was signed and dated March 19, 2001.
>
> 93. The M.B. Option Agreement was dated March 15, 2001. Information from the M.B. Option Agreement, includes:
>
> - Investment Experience: Limited for Stock Options, Stocks, Bonds & Options
> - Anticipated Options: Level 4
> - DROP Approval: Level 3
>
> 94. The Respondent signed the M.B. Option Agreement and assigned a Level 3 authorizations code for the option account.
>
> 95. During the period February to May 2002, S.B. executed five (5) Level 4 options trades (short puts) in the M.B. account. These options trades were all 10 contracts.
>
> 96. At no time, was there an update to the options authorization code of the M.B. Option Agreement to Level 4, to allow for uncovered options trades.

¶ 128 The Association's submissions with respect to M.B. are:

- M.B. requested Level 4 options approval but Respondent initially only gave a Level 3 options approval. Subsequently five Level 4 options trades (only one of which was Dynegy related) were executed in the account; and
- The Association submits that the Respondent did not properly exercise his responsibility as a DROP to ensure the interests of the client were protected and, in particular, did not take adequate supervisory steps to ensure that the trading in the account was in line with the options approval level that he had assessed as suitable for the client;

(ii) The Respondent's Submissions

¶ 129 The Respondent's submissions with respect to M.B. are:

- None of the impugned trades were in excess of ten contracts and all trades took place prior to November, 2002. The trading in the account during the months in question did not generate sufficient commissions to generate a monthly head office review;
- The account had approximately $35,000 in equity and there was very little trading in the account. There was some covered call writing in the account (a Level 2 trade) but there is no evidence of a client complaint or any concerns or inquiries made by the Branch Manager concerning the account;
- The client requested Level 4 trading and therefore it was not necessary to obtain any updated documents from the client and the Respondent had no reason to believe that the client did not understand and accept the requested options trading and risks in the account; and
- And, in short, there were no red flags and there was nothing remarkable about these trades which should have caused the Respondent to make further inquiry.

CLIENT B.C.

(i) The Association's Submissions

¶ 130 The Association referred to paragraphs 97 to 101 of the ASF:

> 97. The B.C. NCAF was signed and dated February 28, 2001. Information from the B.C. NCAF, includes:
>
> - Investment Knowledge: Basic/Limited
> - Investment Experience: Stocks, Bonds, & Mutual Funds

98. The B.C. Option Agreement was dated June 25, 2002. Information from the B.C. Option Agreement, includes:

- Investment Experience: Limited for Stock Options, Stocks, Commodities, Bonds & Options
- Anticipated Options: Level 4
- DROP Approval: Level 3

99. The Respondent signed the B.C. Option Agreement on June 27, 2002, and assigned a Level 3 options authorization code.

100. During the period July to October 2002, S.B. executed three (3) Level 4 options trades (2 short puts; 1 short call) in the B.C. account. These options trades were all 10 or more contracts.

101. At no time, was there an update to the options authorization code of the B.C. Option Agreement to Level 4, to allow for uncovered options trades.

¶ 131 The Association makes the following submissions in relation to B.C.:

- The investment experience for B.C. is indicated as "basic/limited" and past experience is indicated as "none" for options trading, on the NCAF. In contrast, the OA indicates "limited" for experience with options trading. However, it is acknowledged that the OA was completed more than a year after the NCAF and the Respondent indicated that he was satisfied that he could rely on the options trading experience as noted in the OA;
- The Respondent approved the account for Level 3 options trading but allowed three Level 4 options trades (none of which were Dynegy) to be executed in the B.C. account;
- The Association submits that the personal and financial information recorded in the NCAF must accord with the information recorded in the OA. If there is a material change in the client personal and financial information, the NCAF must be updated;
- Upon noting the inconsistency between the past experience information for the client as reflected in the different information in the NCAF and the OA, the Respondent in his role as the DROP was obligated to make an inquiry about the true state of the client's past trading experience and if there had been a change to the experience, to request that the NCAF be updated and signed by the client; and
- The Association submits that the Respondent did not properly exercise his responsibility as DROP to ensure the interests of the client were protected and in particular did not take adequate supervisory steps to determine the actual options experience of the client and did not ensure that the trading in the client account was in line with the options approval level that he had assessed as suitable for the client.

(ii) The Respondent's Submissions

- In relation to the discrepancy with respect to the information in the NCAF and in the OA, the Respondent submits that the OA was completed over one year after the NCAF and that the simple and obvious inference is that B.C. gained some experience with options and commodities in that time frame. In any event, the Respondent submits that "this is not a red flag which merits further review"; and
- When looking at all of the trading activity in the account, the impugned trades do not stand out. There was very little trading in the account at any material time and the equity was about $35,000 and the portfolio was within the client's stated objectives and risk tolerances. There is no evidence of client complaints or Branch Manager inquiries or concerns regarding the account. In short, there were no red flags and there was nothing remarkable which should have caused the Respondent to make further inquiries regarding trading in the account.

CLIENT R., S. & K.C.

(i) The Association's Submissions

¶ 132 The Association referred to paragraphs 102 through to 108 of the ASF:

> 102. The R.S. & K.C. NCAF was dated February 3, 2001. Information from the R.S. & K.C. NCAF, includes:
>
> - Investment Knowledge. Basic/Limited
> - Investment Experience: Stocks, Bonds, & Mutual Funds
>
> 103. The R.S. & K.C. Option Agreement was dated October 28, 2001. Information from the R.S. & K.C. Option Agreement includes:
>
> - Investment Experience: Limited for Stock Options, Commodities, Bonds & Options. Extensive for Stocks
> - Anticipated Options: Level 4
> - DROP Approval: Level 3
>
> 104. The Respondent signed the R.S. & K.C. Option Agreement and assigned a Level 3 options authorization code.
>
> 105. During the period April 2002 to March 2003, S.B. executed seven (7) Level 4 options trades (short puts), in the R.S. & K.C. account. Also, there were nineteen (19) covered put sales executed in the account. These options trades were all ten (10) or more contracts.
>
> 106. Association Staff states that covered put sales are Level 4 options trades.
>
> 107. The Respondent states that covered put sales are Level 2 options trades.
>
> 108. At no material time, was there an update to the options authorization code of the R.S. & K.C. Option Agreement to Level 4, to allow for uncovered options trades.

¶ 133 The Association's submissions with respect to R., S. & K.C. are:

- The NCAF for R.C. reveals that he and his spouse were retired and had annual collective income less than $50,000 and had "basic/limited" investment knowledge and no options trading experience;
- The OA completed in the names of R.C., S.C. and K.C. indicated "limited" for options experience;
- The Respondent stated that he could not recall whether he determined the true trading experience of R.C., having regard to the difference in information in the NCAF and the OA;
- Notwithstanding the "basic/limited" experience of R.C. and approval of Level 3 options trading, he allowed 19 covered put sales and 7 uncovered put sales (four of which were Dynegy) to be executed in the client account;
- The Respondent claims that trading in the account was suitable in that he understood K.C. to be the son of R.C. and S.C. and was to inherit the financial net worth of his parents and collectively they were trading in the account. No records were produced to support that understanding;
- The Respondent agreed that as a DROP when information on the NCAF does not match the information on the OA, he needs to query the discrepancy and request an update to the account documentation;
- The personal and financial information recorded in the NCAF must accord with the information recorded in the OA. Where there are three clients to one option account, there is a need to understand the investment knowledge and experience of all three prior to assigning an options approval level. Trading in the account must be suitable for all three clients as beneficiaries of the

account;

- The Respondent, upon noting the inconsistent and/or incomplete information of the investment knowledge and past trading experience of the clients, was obligated to make an inquiry about the true state of the client's investment knowledge and trading experience; and
- The Respondent did not properly exercise his responsibility as DROP to ensure the interests of all three clients were protected and to take adequate supervisory steps to determine the actual options experience of the clients and did not ensure that the trading in the client account was in line with the options approval level that he had assessed as suitable for the clients.

(ii) The Respondent's Submissions

¶ 134 The submissions made by the Respondent with respect to the R., S. and K.C. account are:

- This was a large account with net equity at all material times in excess of $200,000. The account was actively traded but it cannot be said that the trading was either aggressive or speculative. Of the impugned trades, the seven short puts were all executed prior to November, 2002 before the Respondent received new blotter information which allowed him to make more in-depth reviews. In any event, the client requested Level 4 trade approval and there is no evidence the client did not understand and accept the options trading strategy and risk of uncovered put writing;
- The account portfolio was at all times within the stated investment objectives on the client account agreement and the investment objectives and risk tolerances for R.C.;
- The Respondent says that the trading was suitable. K.C. was the son of the other clients and the net worth on the OA was $1,000,000;
- There were no red flags and nothing unusual about this account;
- The sale of a put can be covered if one is short the underlying security. A short sale is not an option trade and therefore not a trade that is subject to review or approval by the DROP. The risk of a short sale is not equal to a risk associated with the linked option. It is associated with the equity trade; and
- One does not short a stock in order to sell covered puts. The sale of the covered puts was obviously a Level 2 trade, just as the OA form states. It is not a Level 4 trade. Notwithstanding that Mr. Croft stated in oral evidence that a covered put sale is a Level 4 trade, that was not placed in his written report and the Association's position is unfounded.

CLIENT R.C.

(i) The Association's Submissions

¶ 135 The Association referred to paragraphs 109 through to 113 of the ASF:

> 109. The R.C. NCAF was signed and dated February 15, 2001. Information from the R.C. NCAF, includes:
>
> - Investment Knowledge: Good
> - Investment Experience: Stocks, Bonds, Options, & Mutual Funds
>
> 110. The R.C. Option Agreement was dated December 17, 2001. Information from the R.C. Option Agreement includes:
>
> - Investment Experience: Limited for Stock Options, Bonds & Options Extensive for Stocks and None for Commodities
> - Anticipated Options: Level 4
> - DROP Approval: Level 3
>
> 111. The Respondent signed the R.C. Option Agreement and assigned a Level 3 options

authorization code.

112. During the period May to September 2002, S.B. executed five (5) Level 4 options trades (short puts) in the R.C. account. These options trades were all 10 or more contracts.

113. At no time, was there an update to the options authorization code of the R.C. Option Agreement to Level 4, to allow for uncovered options trades.

¶ 136 The Association's submissions with respect to client R.C. are:

- The Respondent did not properly exercise his responsibility as DROP to ensure the interests of the client were protected and did not ensure that the trading in the client's account was in line with the options approval level that the Respondent had assessed as suitable for the client. The five Level 4 trades were all Dynegy related.

(ii) The Respondent's Submissions

¶ 137 The Respondent's submissions with respect to R.C. are:

- R.C. was a wealthy, educated, semi-retired professional with annual income in excess of $100,000 and extensive experience trading stocks, with limited experience in options. He requested Level 4 trading approval for uncovered writing. There is no reason to believe that R.C. did not understand or appreciate the options trading strategy or risk levels in his account;
- At all material times R.C.'s account had in excess of $325,000 in equity and he held a broad range of securities in a relatively diversified portfolio. All of the impugned trades were short puts of Dynegy and were consistent with S.B.'s strategy that he inform the Respondent about; and
- The trades were within the requested trading level. They were relatively insignificant in the context of the overall portfolio and trading history of the account. They were within the client's stated investment objectives and risk tolerance and there is no evidence of any client complaint or any concerns or inquiries made by the Branch Manager. In short, there were no red flags.

CLIENT A.F.

(i) The Association's Submissions

¶ 138 The Association referred to paragraphs 114 through to 118 of the ASF:

114. The A.F. NCAF was dated April 8, 1999. Information from the A.F. NCAF, includes:

- Investment Knowledge: Good
- Investment Experience: Not stated

115. The A.F. Option Agreement was dated June 4, 2001. Information from the A.F. Option Agreement includes:

- Investment Experience: Limited for Bonds & Options, Stocks (Extensive)
- Anticipated Options: Level 4
- DROP Approval: Level 3

116. The Respondent signed the A.F. Option Agreement on June 6, 2002, and assigned a Level 3 options authorization code.

117. During the period June to September 2002, S.B. executed five (5) Level 4 options trades (short puts) in the A.F. account. Four (4) of these options trades were 10 or more contracts.

118. At no time, was there an update to the options authorization code of the A.F. Option Agreement to Level 4, to allow for uncovered options transactions.

¶ 139 The Association submits that the Respondent did not properly exercise his responsibility as DROP to ensure the interests of the client were protected and, in particular, did not ensure that the trading in the client's

account was in line with the options approval level that he had assessed as suitable for the client.

(ii) The Respondent's Submissions

¶ 140 The Respondent's submissions are:

- A.F. was a high net worth individual with extensive trading experience in stocks and limited experience in options. Four of the five impugned trades involved Dynegy, a strategy of S.B. that the Respondent was aware of;
- The account had at all material times less than $50,000 in equity, representing less than 10% of the client's net liquid assets as stated on his NCAF. The trading was minimal and the account consisted primarily of cash. The naked put sales were cash secured; and
- The trading in the account was within the stated investment objectives and risk tolerances on the NCAF (including 30% speculative and 30% high risk securities). There were no red flags and nothing unusual about the trading in the account.

CLIENT M.H.

(i) The Association's Submissions

¶ 141 The Association referred to paragraphs 119 to 123 of the ASF:

> 119. The M.H. NCAF was dated March 15, 2001. Information from the M.H. NCAF, includes:
>
> - Investment Knowledge: Basic/Limited
> - Investment Experience: Stocks, Bonds, & Mutual Funds
> - Account Objectives: 50% (Income), 30% (Long Term) and 20% (Short Term)
> - Account Risk Factors: 60% (Low) and 40% (Medium)
>
> 120. The M.H. Option Agreement was dated May 2, 2001. Information from the M.H. Option Agreement includes:
>
> - Investment Experience: Limited for Stock Options, Stocks, Bonds & Options
> - Account Objectives: 50% (Income) & 50% (Growth)
> - Anticipated Options: Level 2
> - DROP Approval: Level 3
>
> 121. The Respondent signed the M.H. Option Agreement and assigned a Level 3 options authorization code.
>
> 122. During the period May to September 2002, S.B. executed five (5) Level 4 options trades (short puts) in the M.H. account. These options trades were all 10 or more contracts.
>
> 123. On June 20, 2003, the M.H. Option Agreement was updated to allow for Level 4 options trades.

¶ 142 The submissions made by the Association are:

- The NCAF demonstrates that M.H. had "basic/limited" investment knowledge, no options trading experience, no percentage allocated for "venture/speculative", no percentage allocated to "high risk" trading and annual income for M.H. and his spouse was less than $50,000;
- The OA indicates past experience as "limited" for options experience;
- With respect to the conflict between the past experience for options experience as noted on the NCAF and the OA, the Respondent did not take any steps to determine the true options trading

experience of the client;

- The Respondent agreed that the client had only requested Level 2 options approval but he assigned a Level 3 options approval code to the account. He allowed uncovered put sales to be executed in the M.H. account;
- Personal and financial information recorded on the NCAF must agree with the information recorded on the OA. The Respondent was obligated to make an inquiry about the true state of the client's past trading experience and if there had been a change to the experience to request that the NCAF be updated and signed by the client. The DROP cannot simply choose to rely on one piece of information to the exclusion of any conflicting information;
- The uncovered options trades at Level 4 in the account is evidence of the account being exposed to high risk trading and circumstances where the client had specifically indicated she did not want venture/speculative and high risk trading; and
- The Respondent did not properly exercise his responsibility as a DROP to ensure the interests of the client were protected.

(ii) The Respondent's Submissions

¶ 143 The Respondent's submissions are:

- The NCAF shows the client as a high net worth individual (in excess of $500,000) within excess of $100,000 to invest in securities and who was not an inexperienced investor. The account at all times had no less than $100,000 equity;
- All of the impugned trades were short puts in Dynegy, a strategy S.B. used for a number of his clients and which the Respondent was aware of. In May , 2002 the client purchased 1,000 shares of Dynegy which is consistent with the short put strategy of acquiring the stocks; and
- The trades were at all times consistent with the trading history and the investment objectives and risk tolerances for the account. There were no red flags and nothing unusual that should have caused the Respondent to make further inquiries.

CLIENT SY.K.

(i) The Association's Submissions

¶ 144 The Association referred to paragraphs 124 to 130 of the ASF:

> 124. The Sy.K. NCAF was dated February 27, 2001. Information from the Sy.K. NCAF, includes
>
> - Investment Knowledge: Good
> - Investment Experience: Not Stated
> - Account Objectives: 70% (Income), 25% (Short Term), 5% (Venture/Speculative)
> - Account Risk Factors: 60% (Low) % 40% (Medium)
>
> 125. The Sy.K. Option Agreement was dated February 4, 2001. Information from the Sy.K. Option Agreement includes:
>
> - Investment Experience: Limited for Stock & Bonds
> - Account Objectives: 50% (Income) & 50% (Growth)
> - Anticipated Options: Level 2
> - DROP Approval: Level 3
>
> 126. The Respondent signed the Sy.K. Option Agreement and assigned a Level 3 options

authorization code.

127. During the period May to March 2003, S.B. executed four (4) Level 4 options trades (short puts) in the Sy.K. account. Also, there were five (5) covered put sales executed in the account. Four (4) of these options trades were for 10 or more contracts.

128. Association Staff states that covered put sales are Level 4 options trades.

129. The Respondent states that covered put sales are Level 2 options trades.

130. At no time, was there an update to the options authorization code of the Sy.K. Option Agreement to Level 4, to allow for uncovered options trades.

¶ 145 The Association's submissions are:

- The client and spouse were retired with investment experience noted as good and 5% was allocated to "venture speculative" trading but no percentage was allocated for "high risk" trading;
- The Respondent agreed that a 0% high risk trading designation with an indication of 5% for venture/speculative trading is inconsistent and that such an inconsistency would be an area for supervisory review;
- There were four uncovered put sales and five covered put sales executed in the account notwithstanding the account was designated for Level 3 options approval. The Respondent claims that covered put sales are Level 2 but agreed that the four uncovered put sales were not suitable for this client. When asked whether he queried these trades he admitted "no, I may not have seen these trades"; and
- The Respondent did not properly exercise his responsibility as a DROP and did not ensure that the trading in the client account was in line with the options approval level assessed as suitable for the client.

(ii) The Respondent's Submissions

¶ 146 The Respondent's submissions are:

- The NCAF shows a net worth of $250,000 and that both the client and their spouse had an annual income of $45,000 each. At all material times they had invested less than $50,000. She was short 300 shares of Electronic Arts prior to April, 2002 and there was very little trading in the account;
- Four of the impugned trades were short puts on Dynegy, consistent with S.B.'s trades for his other clients; and
- The short puts of Electronic Arts were all for three contracts and would not have been reviewed by the Respondent. In any event, the short sales occurred prior to April, 2002. The Respondent repeats and relies on his earlier submissions with respect to covered put sales in the K.S. & R.C. account. There were no red flags and there was nothing unusual about the impugned trades.

CLIENT D. & J.P.

(i) The Association's Submissions

¶ 147 The Association referred to paragraphs 131 to 135 of the ASF:

131. The D.P. NCAF was signed and dated February 9, 2001. The J.P. NCAF was signed and dated February 21, 2002. Information from the J.P. & D.P. NCAF's, include:

- Investment Knowledge: Good (Both)
- Investment Experience (J.P.): Stocks, Bonds, Options, Mutual Funds & Short Sales
- Investment Experience (D.P.): Stocks, Bonds, Mutual Funds & Short Sales

132. The D. & J.P. Option Agreements were dated April 2, 2001. Information from the D. & J.P. Option Agreement includes:

- Investment Experience: Limited for Stock Options, Stocks, Bonds & Options. None for Commodities
- Anticipated Options: Level 2
- DROP Approval: J.P. - Unknown (Section not completed); D.P. - Level 3

133. The Respondent signed the D. & J.P. Option Agreements and assigned a Level 3 options authorization code.

134. During the period January to November 2002, S.B. executed nineteen (19) Level 4 options trades (9 short calls; 10 short puts) in the D. & J.P. account. These options trades were all 10 or more contracts.

135. At no time, was there an update to the options authorization code of the D. & J.P. Option Agreement to Level 4, to allow for uncovered options trades.

¶ 148 The Association's submissions are:

- The NCAF and OA for J.P. indicate some or "limited" experience in options trading. The NCAF for D.P. indicates no options trading experience. The OA for D.P. indicates "limited" options experience. The Respondent did not query the discrepancy in the D.P. options experience information as recorded on the NCAF and OA;
- There were ten uncovered calls and nine uncovered puts (six of which were Dynegy) executed in this account (Level 4 trades) notwithstanding that the clients had only requested Level 2 options approval trading and the Respondent had only assigned a Level 3 options approval to the account;
- The Respondent was uncertain whether he had cross-checked all of the option positions in the account with the assigned options approval code for the account and thus he allowed all 19 Level 4 options trades to be processed; and
- The DROP had a duty upon noting the inconsistency between the information in the NCAF and OA for client D.P. to make inquiries. The Respondent did not properly exercise his responsibility as a DROP and did not ensure that trading in the client's account was in line with the options approval level that he had assessed as suitable for the clients.

(ii) The Respondent's Submissions

¶ 149 The Respondent's submissions with respect to this client are:

- Each of D.P. and J.P. had a net worth in excess of $500,000 and a combined annual income of $150,000. At all material times they had net equity in their account in excess of $100,000 consisting of fixed income securities and mutual funds and limited partnership units and other assets. The trading in the account was active but not overly aggressive or risky and the portfolio was generally within their stated investment objectives and risk tolerances; and
- There was no evidence of any client complaint or any inquiries or concerns expressed by the Branch Manager. There were no red flags or unusual trading activity.

CLIENT D.T.

(i) The Association's Submissions

¶ 150 The Association referred to paragraphs 136 to 140 of the ASF:

136. The D.T. NCAF is signed and dated February 28, 2001. Information from the D.T. NCAF, includes;

- Investment Knowledge: Good

- Investment Experience: Stocks, Bonds, Options, Venture Capital, & Mutual Funds

137. The D.T. Option Agreement was dated January 11, 2002. Information from the D.T. Option Agreement includes:

- Investment Experience: Limited for Stock Options, Commodities, Bonds & Options. Extensive Stocks
- Anticipated Options: Level 4
- DROP Approval: Level 3

138. The Respondent signed the D.T. Option Agreement and assigned a Level 3 options authorization code.

139. During the period June to September 2002, S.B. executed three (3) Level 4 options trades in the D.T. account. These options trades were all 10 or more contracts.

140. At no time, was there an update to the options authorization code of the D.T. Option Agreement to Level 4, to allow for uncovered options trades.

¶ 151 The Association submits that the Respondent did not properly exercise his responsibility and did not take adequate supervisory steps to ensure the trading in the client account was in line with the options approval that he had assessed as suitable for the client. All impugned trades were in Dynegy.

(ii) The Respondent's Submissions

¶ 152 The Respondent's submissions with respect to D.T. are:

- D.T. had a net worth in excess of $1,000,000, an annual income in excess of $300,000 and a liquid net worth of more than $250,000. The NCAF shows 50% high risk and 20% venture/speculative trading;
- The client requested a Level 4 trade approval. The Association takes issue with three trades which were each selling short puts of Dynegy during the period June to September, 2002; and
- At all material times D.T. had less than $75,000 equity in his account (a fraction of his net worth). The account was not actively traded. Short puts were all Dynegy options, a strategy known to the Respondent. The short puts were covered by cash or securities in the account. There was no evidence of any client complaint or concerns. There were no red flags or unusual activity.

SUMMARY OF THE ASSOCIATION'S SUBMISSIONS WITH RESPECT TO S.B. CLIENTS

¶ 153 The Association's summary of submissions with respect to the S.B. clients includes admissions found at paragraphs 141 to 143 of the ASF. Those paragraphs state:

141. At all material times, the Respondent knew, or ought to have known, of S.B.'s options trading strategies, the options authorization codes and specific options trading activity of each, or any of the identified twelve (12) S.B. client accounts.

142. The Respondent did not take or maintain adequate notes or records (evidence) of his conversations with S.B.

143. The Respondent admits that he did not take the following steps during the material time:

(a) Did not speak with all or any of the twelve (12) S.B. clients;

(b) Did not cross-reference every options trades executed in each, or any, of the twelve (12) accounts with the options authorization code for the particular client account;

(c) Did not contact S.B. to discuss whether updates to the options authorization code for any, or all, of the twelve (12) client options accounts was required and appropriate, upon becoming aware that options trades outside options trading approval elects had been executed in those accounts;

(d) Did not contact the Branch Manager, R.T., (who was options qualified) to discuss whether updates to the options authorization code for any, or all, of the identified twelve (12) client options accounts was appropriate, upon becoming aware that options trades outside options trading approval levels had been executed in those accounts;

(e) Did not restrict or make recommendations to restrict trading activity in any, or all, of the identified twelve (12) client accounts, upon becoming aware that options trades outside options trading approval levels had been executed in those accounts;

(f) Did not cancel options trades outside options trading approval Levels that were executed in each, or any, of the identified twelve (12) S.B. client options accounts; and

(g) Did not maintain adequate records (evidence) of supervisory activities relating to the S.B. client options accounts.

¶ 154 The Association points out that the Respondent did not speak with S.B. about the Dynegy put strategy specifically in relation to each of the twelve S.B. clients. It was discussed in relation to one client account. However, the Respondent had a general understanding of the Dynegy naked put trades executed in the S.B. client accounts and of S.B.'s strategy for those trades. The Respondent believed that the strategy was an opportunity to purchase Dynegy at a discount by writing "security puts" and that S.B.'s clients were interested in acquiring the Dynegy stock.

¶ 155 The Association further submits that the Respondent admitted that the unapproved trades were allowed in the S.B. client accounts due to his failure to cross-reference those trades with the option approval codes for each account. The Association submits that had he done so then he would have "in all likelihood" requested updates to the client OA's. The Association states that the Respondent suggests that he can assess client suitability for trades applying a "general test for suitability", involving a review of trading in the account and equity in the account and his "belief in what the strategy was". The Respondent has no specific recollection of reviewing any of the identified unapproved trades executed in the S.B. client accounts. The Association submits that allowing 90 Level 4 options trades in the twelve client accounts without those accounts being properly coded for those option trades was in the circumstances not reasonable.

¶ 156 The Association notes that after its investigation relating to the S.B. client accounts there were no further option trades executed in the S.B. client accounts with the exception of two client accounts. The Respondent asked each of the eleven S.B. clients if they wanted their OA's updated to allow for the continuation of the options trading and only two agreed to have their option approval levels upgraded. The Association submits that had the Respondent offered the upgrades of options approval levels to the S.B. clients during the material time he would have likely received the same refusals as he did upon making those offers after the Association's investigation.

¶ 157 The Association submits that the Respondent should not have allowed all twelve S.B. clients to trade options at Level 4 approval, notwithstanding their respective personal and financial information demonstrated significant variability, translating into variable trades suitability.

¶ 158 With respect to uncovered and covered put sales, the Association states that uncovered and covered put sales are properly Level 4 options trades.

¶ 159 The Association refers to evidence of Mr. Croft with respect to the review of the S.B. Dynegy strategy. Mr. Croft stated that from his review of the trading in the S.B. client accounts there "did not appear to be a great desire to buy the stock". In Mr. Croft's opinion at least some of the trading demonstrated that it was more aggressive than would be expected in a strategy to produce income and acquire the stock below current market value.

¶ 160 In summary, the Association submits that the Respondent did not properly supervise the options trading in the S.B. client accounts as was his responsibility as the DROP. He assigned option approval codes but did not check those approval codes at the time that option trades were executed in the accounts. He did not check

the client's personal and financial information at the time that the trades were processed in order to make a proper determination of trade suitability. Most telling is that the Respondent did not know the specific trade strategy employed in the twelve S.B. client accounts nor had he assessed whether that strategy was suitable for each of the twelve clients, as he had never discussed those issues with S.B. The Association does not dispute that a DROP can exercise discretion to allow a trade outside of approved levels in an option account. However, to knowingly allow unapproved options trades to be repeatedly executed in an options account over an extended period of time is not in the Association's submission an exercise of discretion but rather a failure to exercise the proper supervisory function required of the DROP. Such actions completely ignore the client's best interest, as it employs the assumption that the client understands and accepts the trading in their account without due supervisory oversight, notwithstanding that they did not request that specific trading level and may not fully understand and be aware that such trading is taking place in their account.

SUMMARY OF THE RESPONDENT'S SUBMISSIONS WITH RESPECT TO S.B. CLIENTS

¶ 161 The Respondent acknowledges the admissions made in paragraphs 143 of the ASF. However, the Respondent states that the ANOH did not make an allegation that the Respondent failed to contact any of the DROP clients and describes this as another example of the Association's case evolving over time with the benefit of hindsight. The Respondent admits that he did not take the steps set out in paragraph 143 of the ASF but states that the same were not necessarily or reasonably required in the facts and circumstances of this case.

¶ 162 The Association argues that a number of S.B.'s clients requested Level 2 trading approval but the account was accepted and coded for Level 3 trades. The Respondent states that the Association ignores the eight instances where the client requested Level 4 approval but was only approved for Level 2 or 3. The Respondent also points out that the allegation based on the Respondent granting higher approval levels than requested is not a specific allegation made in the ANOH. Further, assigning a Level 3 approval where a Level 2 approval was requested does not necessarily mean that a Level 3 trade will be executed in the account or, if it was, it would necessarily be unsuitable at the time having regard to the other factors such as the size of the trade, the risk exposure inherent in the spread, the composition of the account at the time and other such factors.

¶ 163 With respect to the issue raised by the Association based on apparent discrepancies regarding the information in the NCAF's and OA's for several clients, the Respondent submits that this is not a specific allegation made in the ANOH. In relation to these apparent differences, the Respondent states that the same can be "easily explained" or in one case, the differences are inconsequential. The Respondent refers to the decision in *Pacific International Securities Inc.*, 2006 BCSECCOM 532 and states that these allegations were made for the first time at a hearing which "demonstrates the pre-disposition to hindsight bias and the reality that, as accepted in the Pacific International case, 'no system of compliance is ever foolproof.'" The Respondent suggests that such errors, particularly of such a minor nature as those listed above, do not merit enforcement action.

ANALYSIS AND FINDINGS WITH RESPECT TO COUNT 2

¶ 164 While there were twelve separate accounts, each with different investment profiles, there are significant common facts which are relied on by the Association. Those common facts are:

- In all cases there was options trading activity outside of the approved levels of option activity. These were not isolated incidents and occurred repeatedly;
- A number, but not all, of the trades outside of the approved options levels were in relation to transactions with Dynegy. While the Respondent had a discussion with S.B. about this strategy, it was not determined by the Respondent whether that strategy was appropriate for all twelve of the client accounts and that strategy was not assessed by the Respondent with consideration of each of the clients' personal and financial information;
- The Respondent had no specific recollection of reviewing any of the impugned trades executed in the S.B. client accounts;

- In the case of some of the client accounts, there were discrepancies between the information in the NCAF and the information in the OA, which was not followed up on by the Respondent; and
- With respect to some of the accounts, the client requested a Level 2 options level approval and the Respondent authorized a Level 3 approval.

¶ 165 At the account opening stage the DROP must assess the information about the client and make a determination as to whether options trading is suitable and if so must assess any trading restrictions to be imposed on the account. The Respondent was required to set an option approval level for each client account based on suitability considerations. Thereafter, the ongoing supervision by a DROP requires a determination of whether trading activity is within the option approval level or not. An important supervisory responsibility of the DROP is to detect whether trades in the account are outside of the approval level previously given by the DROP at the time that the account is opened, or such subsequently amended approval level. While there may be isolated incidents where a DROP can exercise his discretion to approve a trade outside of the options level approval given for the account, such decision should in almost all cases only be made after appropriate inquiries are made of the Branch Manager or the ROR as to the reasons for the trade for that account, and all inquiries should be documented.

¶ 166 At the account opening stage in relation to the S.B. clients, the Respondent stated that he assigned an approval Level 3 "to any account that is eligible to trade covered option positions. This simplifies the paperwork on file and does not necessarily restrict the client for future transactions." He stated that option Level 4 was not assigned to clients indicating "limited" experience without additional information from the ROR. Option Level 2 was assigned by the Respondent to all RSP accounts. His practice has now changed. Now, he uses a Level 4 approval for uncovered put writing.

¶ 167 The determination of an approval level for options trading at the account opening stage, or thereafter, is a critical part of the ongoing supervisory obligations that relate to that account. The assignment of an options approval level to a client is a determination of that client's suitability to engage in various levels of risk when carrying out options trading. The approval level given to that client is intended to restrict the type of options transactions that the client can carry out unless the DROP determines to at a later date allow a specific trade or increase the approval level on a going forward basis. The determination of the appropriate approval level is therefore critical to the ongoing supervision of the ROR by the Branch Manager and by the DROP. The options approval level that is assigned to the account provides the client, the ROR and the other persons with supervisory responsibilities a blackline standard to monitor the suitability of options transactions in the client account. The determination of the appropriate options approval level restricts options trading beyond the approved level unless the DROP approves the specific trade. The determination of the approval level is not to be lightly made, nor is it to be ignored repeatedly to the point that it becomes no standard at all.

¶ 168 In the case of S.B.'s clients, the Respondent has, in relation to the determination of appropriate approval levels, and the ongoing supervision of options trades in client accounts as measured by those approval levels, failed to reasonably exercise his supervisory obligations in relation to the options trading activity of S.B.'s clients, for the reasons set out below:

(b) The Respondent repeatedly allowed Level 4 options trades in 12 client accounts when those accounts had not been approved for Level 4 options trading. This Panel does not accept the submissions of the Respondent that the naked short put trading in Dynegy was in effect a Level 2 options trade. Such trades were Level 4 options trades;

(c) Where a client executes an OA that shows a certain level of anticipated options trading, it is inappropriate to allow a higher level of options trading than requested or anticipated by the client, without the client having further discussions with the ROR and completing a new OA that requests the higher option level approval. If a client requests a certain options level approval, and is granted a higher options level approval, then the client should at a minimum be required to confirm their agreement to that higher approval level by executing a new OA. Otherwise, the client is operating under the understanding that they have agreed to a lower level of options

trading with in most cases a lower level of risk, yet would be exposed to a higher level of risk than they had agreed to. Granting a higher level of options approval than requested or known to the client is not a reasonable exercise of the Respondent's supervisory obligations;

(d) In relation to some of the client accounts, there were inconsistencies between the information provided in the NCAF and in the OA. Personal and financial information recorded in the NCAF must accord with the information recorded in the OA. If there is an inconsistency, then the DROP must ask further questions to explain those inconsistencies and updated NCAF's or OA's must be obtained. It is important that the information provided to the DROP be consistent. If it is not consistent then the information should not be relied on without further inquiry;

(e) For a number of the clients, dealt with in more detail below, the limited experience of the investors, as expressed in the NCAF and OA's, together with the setting of a Level 3 options approval, called for increased supervision by the DROP, which increased supervision was not carried out;

(f) It is not a defence to an allegation of failure to supervise to at a later date come forward with letters from the clients stating that they were advised of and approved of all trades in their account and that the strategy was suitable for their objectives and that they were advised of the risks of uncovered put writing. As stated in *Mills (Re) (supra)*:

> … all of the expert witnesses focus primarily on whether the supervisory actions of Mr. Mills with respect to Mr Long's accounts were sufficient to fulfill his obligations under the Policy. Mr. Mills and Mr. Haldane both testified that the purpose of the coding on a NAAF and of daily and monthly reviews was to see whether trading in the account was suitable. Although a substantial amount of the evidence related to Mr. Long's knowledge, experience and investment objectives, and to the actual suitability of the trading in his accounts in light of his "real" investment objectives, the District Council is of the view that it is not necessary for the Association to prove that the trading was not suitable in order to make out its case. Nor is it a defence to the charge to demonstrate that the trading was in fact suitable or that Mr. Long acquiesced in it. This is not a civil dispute between Mr. Long and Mr. Mills; it is a disciplinary proceeding relating to the quality of Mr. Mills' supervision.

In a disciplinary hearing, an allegation of a lack of supervision should not be defended on the basis of after the fact evidence provided by a client that they had no objection to the trading that took place in their accounts. The question that this Panel must determine is whether there was reasonable supervision, based on the facts known to the Respondent at the critical times, which facts may have required further inquiry by the Respondent;

(g) The Respondent failed to speak to S.B. about any of the options trading outside of approved levels in the 12 client accounts that are subject of Count 2. He had at most a general understanding of S.B.'s strategy with respect to Dynegy, but made no determination about whether that strategy was appropriate for each of the 12 S.B. clients and simply allowed the options trading outside of approved levels to continue. Further, a number of the impugned trades did not even involve Dynegy so any possible defence based on his discussions with S.B. about the Dynegy strategy would not apply to a number of the impugned transactions; and

(h) The Respondent failed to maintain adequate records (evidence) of supervisory activities relating to the S.B. client options accounts.

¶ 169 Below are further findings with respect to some of the specific S.B. accounts:

CLIENT T.G.

- T.G. was a client with "basic/limited" investment knowledge. The NCAF shows 10% allocation to venture/speculative under the heading "Account Objectives" and a 10% allocation to high risk.

She requested Level 2 options approval (covered writing) and that was the approval level given by the Respondent. But thereafter three Level 4 options trades (short puts) were allowed and the trades were all ten contracts. There was never any discussion between the Respondent and S.B. specific to the client T.G. in relation to the appropriateness of these trades. Further, the trades placed T.G. at significant risk having regard to the value of her other investments.

CLIENT G. & E.B.

- This client, as with some other S.B. clients, requested Level 2 options trading approval but the Respondent instead granted Level 3 approval. The client was retired with only "basic/limited" investment knowledge with no percentage of their investment objectives designated as "venture/speculative." There were four Level 4 options trades (short puts) allowed in the account and all were for ten or more contracts. There was no evidence that there were further discussions with the client to advise the client that they had in fact been approved for Level 3 options trading instead of Level 2 options trading that they had requested. As stated above, if a client requests a certain options level approval, and is granted a higher options level approval, then the client should at a minimum be required to confirm their agreement to that higher approval level, and should complete a new OA;
- In addition to the foregoing, the Respondent allowed four Level 4 options trades in the account when the account was only approved for Level 3 options trading. There were no discussions with the ROR specific to this account and these trades. This was not a reasonable exercise of the Respondent's supervisory obligations.

CLIENT L.B.

- The client had only a "basic/limited" investment knowledge with no percentage allocated to "venture/speculative" in the account objectives section of the account documents. Collectively the client and the spouse had an annual income of less than $100,000.00. They requested Level 2 options approval and were assigned Level 3 options approval and then four Level 4 options trades (all Dynegy) were executed in the account. The Respondent should not have assigned a higher level of options approval than requested without the client being advised of that decision and completing a new OA. The Respondent failed to reasonably exercise his supervisory responsibilities when he assigned a higher options level approval than requested and when he failed to ensure that the trading in the account was within the options approval level set for the account.

CLIENT M.B.

- The client requested Level 4 approval and the Respondent made a decision to grant Level 3 approval. Thereafter, five Level 4 options trades were allowed in the account, only one of which was a Dynegy transaction. There was no discussion with the ROR specific to this account before those trades were allowed. The Respondent submits that since the client requested Level 4 options approval, it was therefore not necessary to obtain any updated documents from the client before the Level 4 trades were carried out. This position is not accepted. The DROP has a duty to make a proper determination about the options level approval that is to be given for each account. The Respondent determined that Level 3 approval should be granted and if Level 4 trades were to be allowed in the account, other than on an isolated basis, then the Respondent should have required the client to complete a new NCAF and OA to request the Level 4 options approval. To do otherwise would seriously weaken the supervisory framework that is designed to allow all those with supervisory obligations to determine whether or not a transaction is within approved limits. The Respondent failed to reasonably exercise his supervisory obligations in relation to this account.

CLIENT B.C.

- The client requested Level 4 approval and was given Level 3 approval. Thereafter, three Level 4 options trades (two short puts; one short call) were allowed in the account, none of which were Dynegy. Further, there were inconsistencies between the information provided in the NCAF and in the OA. The NCAF stated that the client's investment experience was "basic/limited" with "none" for options trading. In contrast, the OA indicates "limited" experience with options trading. It is acknowledged that the OA was completed more than a year after the NCAF and the Respondent stated that he felt that he could rely on the options trading experience as noted in the OA. For the reasons above stated, this Panel finds a failure to reasonably supervise the account based on the Level 4 transactions in the account when the account was only approved for Level 3. Further, this Panel also accepts the submissions of the Association that the personal and financial information recorded in the NCAF must accord with the information recorded in the OA. If there is an inconsistency, then the DROP should ask further questions to explain those inconsistencies and updated or revised NCAF's or OA's must be obtained. It is important that the information provided to the DROP be consistent and that if it is not consistent it should not be relied on without further inquiry. This Panel agrees that the Respondent was obligated to make an inquiry about the true state of the client's past trading experience and that his failure to do was not a reasonable exercise of his supervisory responsibilities.

CLIENT R., S. & K.C.

- The clients requested Level 4 approval and were given Level 3 approval. There were seven Level 4 options trades (short puts) and 19 covered put sales executed in the account. The 19 covered put sales were not Dynegy transactions and the nature of these transactions is very inconsistent with an investor with "basic/limited" experience which is what the NCAF discloses for these investors. The nature of these transactions is at a higher trade risk level for options trading and is not consistent with the limited income and experience of these clients. The Respondent submits that trading in the account was suitable since he understood that K.C. was the son of R.C. and S.C. and was to inherit the financial net worth of his parents and that collectively they were trading in the account. As the Association states, no records were produced to support that understanding. The Respondent submits that this was a large account with net equity at all material times in excess of $200,000.00. The amount of equity in the account does not demonstrate that the options trading strategy was an appropriate strategy for people with limited income and investment experience. The Respondent also submits that a short sale is not an option trade and therefore not a trade that is subject to a review or approval by the DROP. That is correct unless one sells puts against it which is what was done in this case. What was employed were linked strategies employed with options since the selling of the put did not mitigate the risk. One cannot separate the option component from the short sale. Contrary to the submission of the Respondent, the transactions were a Level 4 trade and not a Level 2 trade; and

- To conclude with respect to this client, there were a number of Level 4 options trades carried out in the account when the approval level was for Level 3 transactions. There were 19 higher risk covered put sales that would not normally be consistent with clients with limited income and experience and which did not fall within the Dynegy strategy that the Respondent relies on as a defence in relation to other S.B. clients. There were also inconsistencies between the NCAF information and the OA information that required questioning. The Respondent, in relation to these clients, has failed to meet his supervisory obligations.

CLIENT R.C.

- The client requested Level 4 approval and was given Level 3 approval. There were five Level 4 options trades in the account, all Dynegy. The Respondent submits that since R.C. was a wealthy, educated, semi-retired professional with an annual income in excess of $100,000.00 and

extensive experience trading stocks, there was no reason to believe that R.C. did not understand or appreciate the options trading strategy for risk levels in his account. That position mis-states the fundamental issue that this Panel must decide, which is whether the Respondent reasonably exercised his supervisory responsibilities. As stated above, the DROP must determine the suitable option level approval for each account and trades outside of that approval level should not be allowed except in isolated cases and where allowed should be documented. There were trades outside of the option level approval set for this account. The Respondent did not specifically address whether such trades should be allowed based on an exercise of the Respondent's discretion to approve a trade outside of the options level approval. There was a failure to reasonably supervise this account.

CLIENT A.F.

- The account was approved for Level 3 options and there were five Level 4 options trades in the account. Four of the five impugned trades involved Dynegy, a strategy of S.B. that the Respondent stated he was aware of in relation to another client of S.B. For the reasons stated in relation to a number of the accounts above, the Level 4 options trade should not have been allowed without making specific inquiry as to whether such transactions were suitable for this client and the discretion to allow the trade should have been documented.

CLIENT M.H.

- M.H. had "basic/limited" investment knowledge and no options trading experience and no percentage allocated for "venture/speculative". The annual income for M.H. and his spouse was less than $50,000.00. There was a conflict between the past experience for options experience noted in the NCAF and the OA and the Respondent did not take any steps to determine the true options trading experience of the client. The client requested Level 2 options approval but was assigned a Level 3 options approval. Five uncovered put sales (Level 4) were executed in the M.H. account. As stated with respect to other accounts, the Respondent should not have assigned a higher level approval code to the account than requested by the client. There were inconsistencies between the OA and the NCAF that should have been the subject of further inquiry. The five Level 4 options trades outside of the Level 3 options approval were not specifically addressed by the Respondent. The Respondent failed to reasonably exercise his supervisory responsibilities with respect to this account.

CLIENT SY.K.

- The client and spouse were retired and the account documentation indicated 5% allocated to "venture/speculative" and no percentage was allocated to "high risk" trading. There were four uncovered put sales (Level 4) and five covered put sales (Level 4) in the account notwithstanding the account approval level was Level 3. Five covered put sales were not Dynegy. As stated with respect to other S.B. accounts, the numerous Level 4 trades should not have been allowed in the account. The Respondent failed to reasonably exercise his supervisory responsibilities in relation to this account.

CLIENT D.&J.P.

- There were discrepancies between the information found in the NCAF and the OA for client D.P. This was not the subject of a query by the Respondent. There were ten uncovered calls and nine uncovered puts (six of which were Dynegy) which all were Level 4 trades notwithstanding that the clients had only requested Level 2 options approval and the Respondent had assigned a Level 3 options approval. The Respondent failed to reasonably carry out his supervisory responsibilities when he failed to make inquiries with respect to the inconsistency between the information in the NCAF and the OA for D.P. and when he failed to ensure that the trading in the account was within the options approval level determined by him as suitable for the clients.

CLIENT D.T.

- The client had "good" investment knowledge with experience in options. The client requested Level 4 options approval and was granted Level 3 options approval. There were three Level 4 options trades in the account, all Dynegy. All trades were ten or more contracts. The client had a net worth in excess of $1 Million and an annual income in excess of $300,000.00 and a liquid net worth of more than $250,000.00. The NCAF shows 50% "high risk" and 20% "venture/speculative". The client characteristics of D.T. might arguably make out a less forceful case for failing to supervise. However, the fact remains that there was trading outside of the Level 3 approval for this account that was not the subject of an individual inquiry by the Respondent or the exercise of his discretion to allow isolated trades outside of the options approval level, nor was there any documentation in relation to the exercise of that discretion. There was a failure to reasonably supervise the account for the reasons above stated.

¶ 170 For all of the above reasons, this Panel finds that the Respondent, in relation to Count 2, failed to reasonably supervise the accounts of S.B. There was a pattern of a failure to supervise in relation to the clients of S.B. and a failure to supervise the individual accounts. There was also a failure to maintain adequate supervision records (evidence) relating to the 12 client accounts of S.B.

COUNT 3

Count 3

The Respondent, at all material times, the Designated Registered Options Principal for Union Securities Ltd. ("Union"), a Member of the Association, failed to adequately supervise the account management and trading activities, and maintain adequate supervision records (evidence), relating to the client B.S. accounts of the Registered Options Representative, J.E., an employee of Union in Calgary, during the period April 2001 to August 2003; in contravention of Association Regulation 1300.1, 1300.2, 1900, and Policy No. 2 and Bylaw 29.1.

¶ 171 The Association conducted a review of ten other ROR's under the direct supervision of the Respondent during the period 2002 to early 2003. One of the ROR's was J.E. J.E. had a client, B.S. The relevant paragraphs of the ASF with respect to J.E. and B.S. are found at paragraphs 145 through to 162.

ROR - J.E.

145. At all material times, J.E. was employed as a ROR with Calgary branch office of Union.

146. At all material times, the Branch Manager, S.S., and the Respondent were the supervisors of J.E.

J.E. Client - B.S.

147. A NCAF dated May 1, 2001 and an Option Agreement dated April 5, 2001 were prepared and signed for the B.S. account. B.S. was 23 years old and had no investment experience at that time.

148. Information from the B.S. NCAF, includes:

- Investment Knowledge; Good
- Investment Experience: Not Stated

149. Information from the B.S. Option Agreement includes:

- Investment Experience: None
- Anticipated Options: Level 4
- DROP Approval: Level 2

150. The Respondent signed the B.S. Option Agreement and assigned a Level 2 authorization code for the option account.

151. On June 24, 2003, the B.S. Option Agreement was updated to allow uncovered options trades; options authorization code - Level 4.

152. During the period November 2002 to June 2003, J.E. executed twenty-seven (27) Level 4 options trades (short puts) in the B.S. account. Twenty-four of these options trades were 10 contracts. These put options generated profits in the account of approximately $19,469.

153. The options trading in the B.S. account, for the material time period, is summarized at Appendix #G.

154. The Respondent has stated that he verbally approved the execution of uncovered options trades in the B.S. account prior to June 24, 2003, on the basis of information from J.E. that B.S.'s father was trading the account and was a sophisticated investor.

155. Further, the Respondent has stated that he expected and made several requests for a letter from B.S.'s father confirming he was trading the B.S. account and was approximately experienced.

156. The Respondent produced a handwritten note dated August 8, 2003, on an updated email, which shows an exchange between the Respondent and J.E. regarding the status of additional documents for the B.S. account.

157. There was an Authorization to Trade form dated April 14, 2001, authorizing F.S. to give trade instructions for the B.S. account.

158. On May 20, 2003, the Respondent sent an email to J.E., which was copied to his branch manager, S.S. and a Union compliance officer, R.R. In the email, the Respondent made a request of J.E. for updated documents and for J.E. to keep an eye on the options code when doing uncovered positions. The subject line of the email was "B.S. acc#02****4 **[personal identifying information deleted]** not authorized for uncovered option positions".

159. A letter was received from F.S. dated August 21, 2003, declaring that F.S. was the father of B.S., was a sophisticated investor and had been trading in B.S.'s account.

160. The Respondent did not take or maintain adequate notes or records (evidence) of his supervision of the B.S. account.

161. At all material times, the Respondent knew, or ought to have known, of J.E.'s options trading strategies, the options authorization code and specific options trading activity in the B.S. options account.

162. The Respondent admits that he did not take the following steps during the material time:

(a) Did not contact B.S. to confirm that options trading, including uncovered options trading, was a suitable investment strategy for the B.S. account;

(b) Did not cross-reference every options trade executed in the B.S. account with the options authorization code for the account;

(c) Did not restrict or make recommendations to restrict the trading activity in the B.S. account, upon becoming aware that uncovered options trades had been executed in the accounts;

(d) Did not cancel uncovered option trades that had been executed in the B.S. account; and

(e) Did not maintain adequate records (evidence) of supervisory activities relating to the B.S. accounts and, in particular, he did not maintain any records to evidence that he considered and verbally approved the B.S. account for Level 4 uncovered option trades prior to the update to the B.S. Option Agreement in June 2003.

¶ 172 Of note, B.S. was 23 years of age and had no investment experience at the time. Initially, the client was assigned a Level 2 options approval. Within several months, the OA was updated to allow uncovered options trades with a Level 4 options code. In the period November, 2002 until June, 2003 there were 27 Level 4 options trades (short puts) in the B.S. account, of which 24 of those trades were for ten contracts. A fundamental issue with respect to the B.S. account was whether the options trading was suitable, having regard to the lack of investment experience of B.S. In response, the Respondent submits that F.S. was the father of

B.S. and that F.S. was a sophisticated investor and had been trading in B.S.'s account.

(i) The Association's Submissions

¶ 173 The submissions of the Association with respect to J.E. and B.S. are:

- The Respondent stated that he had no specific recollection of approving the B.S. option account;
- The Respondent admitted that B.S. "was a 23 year old young man with no options experience, … for all intents and purposes, very minimal net worth." Initially the B.S. option account was approved for Level 2 trading;
- The Respondent recalled a discussion with J.E., at some point between April, 2001 (the first OA) and June, 2003 (the second OA), where he learned that the father of B.S. was a sophisticated high net worth individual who would be funding and trading the account as a way to assist his son in gaining trading experience;
- The Respondent "verbally approved" the execution of Level 4 options trades prior June 24, 2003 on the basis of the above discussion with J.E., and upon the condition that J.E. obtain from the father a letter "declaring himself to be a sophisticated investor and backing it up. That he was indeed funding this account and instructing his son on what to purchase and what not to, that I would allow him to do it.";
- Thereafter the Respondent deliberately did not change the option approval code from Level 2 to Level 4, so as to remind himself when an uncovered options trade went through the account that he had verbally approved the account for Level 4 trading, but had not received the requested confirmation letter from the father of B.S.;
- By his own evidence, the Respondent allowed Level 4 options trades to be executed in the B.S. account when his assessment at the time of approving the account was that options trades outside of Level 2 were not suitable for B.S.;
- In the Respondent's notations on his daily review of March 17, 2003, in relation to the B.S. account, there were uncovered trades that were being executed and there was a need to "update account to show #4." The Respondent also noted on his daily review of April 14, 2003 that the B.S. account was "not set up for uncovered" trading. The March 19, 2003 daily commission report has a notation in relation to the B.S. account "not authorized" for uncovered options trades;
- The Respondent allowed unapproved options trades to be executed in the B.S. account for months, and when he finally tired of waiting for the F.S. letter he upgraded the B.S. account to reflect a Level 4 options approval code;
- The Respondent acknowledged that he allowed the situation of unapproved Level 4 trades to be executed in the B.S. account to go on "too long";
- The Association says that for the Respondent to allow an unapproved account to continue to trade uncovered options on the basis that the account had already been allowed to conduct unapproved trades for an extended period of time is not conduct which amounts to proper and effective supervision;
- A review of the F.S. NCAF and OA shows F.S. as a sophisticated and knowledgeable investor but it also reveals that F.S. had only requested Level 2 options trading and claimed a net worth of only $50,000.00;
- A reason put forward for the delay in obtaining the letter from F.S. was that F.S. was out of the country for an eight month period and could not be reached. There were 27 trades outside of the Level 2 options approval code during the period November 18, 2002 to June 24, 2003. The

Respondent agreed that based on the trade activity in the B.S. account, someone was providing trade instructions for the account. There were no attempts by the Respondent to speak to F.S. by telephone;

- In short, the Respondent allowed an inexperienced investor (B.S.) to provide trade instructions for the account or allowed F.S. to trade the account when he had not satisfied himself that F.S. was a sophisticated investor and of high net worth. The Association submits that either scenario is unacceptable from a supervisory point of view; and
- The Association says that the word of the ROR, J.E., with respect to the circumstances involving F.S. was not sufficient to meet the required supervisory standard to ensure that the client was aware of and understood the nature of the trading in his account.

(ii) The Respondent's Submissions

¶ 174 The submissions of the Respondent with respect to J.E. and B.S. are:

- A review of the monthly statements is necessary to put the impugned trades in context. Prior to November, 2002, the B.S. account had equity of approximately $20,000.00. There were few trades in the account and some covered call writing. In November, 2002, there was a deposit of $40,000.00 in the account followed by a number of options trades, including short puts, in established companies. At any one time there were very few open positions. The short puts were covered by either cash or marketable securities;
- The trading in the B.S. account did not generate sufficient commissions to require a monthly review. The short puts were all for ten contracts or less and thus, were not required to be reviewed by the Respondent. There is no suggestion or evidence that the trading was excessive or outside of B.S.'s investment objectives (100% speculative/venture) or risk tolerances (100% high risk) as stated in his NCAF and OA. The client initially requested Level 4 trading and there was no indication that the client did not understand or appreciate the nature of the trading or the level of risk;
- There was no need for the Respondent to contact B.S. to determine whether the options trading in the account was suitable. The Respondent was entitled to rely upon the information in the NCAF and the OA together with the information provided to him by J.E. The Respondent's reliance was reasonable and there was nothing which warranted further inquiries;
- There was no client complaint and the impugned trading was in fact profitable;
- While it "may have been preferable for (the Respondent) to better document his inquiries regarding this account, it cannot be said that his failure to maintain adequate notes or records is in itself a contravention of the By-laws, Regulations, Policies or Rulings of the Association." There is evidence that he documented some of his inquiries; and
- The 2001 Compliance Review noted a deficiency with respect to documentary evidence concerning reviews made and supervisory steps taken. The 2003 Compliance Review does not repeat this deficiency and "the obvious inference is that (the Respondent) has adequately maintained notes and records of his supervisory inquiries and steps since at least the fall of 2002 …."

(iii) Analysis and Findings with Respect to Count 3

¶ 175 At the time that the account was opened, the Respondent would have had a copy of the NCAF and of the OA. The NCAF states that B.S. had net fixed assets of $30,000.00 and net liquid assets of $4,000.00 for a total estimated net worth of $34,000.00. He had an approximate annual income from all sources of $25,000.00. He was 23 years of age. The OA contained different information. The OA stated a net worth of $50,000.00 with an approximate annual income of $40,000.00 and a liquid net worth of $10,000.00. The OA stated that there

was no past experience with respect to stock options or stocks or options. The OA stated that the investment objectives were 100% "trading profits." The NCAF stated that the investment objectives were 100% "venture/speculative" and that the account risk factors were 100% high. The NCAF stated that the investment knowledge of B.S. was "good." It is difficult to reconcile that statement with the information set out in the OA that states no past experience with respect to stock options, stocks or options. It is clear that B.S. was an inexperienced investor. The Respondent's initial assessment at the account opening stage was that he would allow Level 2 options approval, notwithstanding that Level 4 options approval had been requested.

¶ 176 Trades then occurred in the account that were outside of the options approval level and in fact were Level 4 trades. The Respondent made a telephone inquiry to the ROR, J.E., and was given an explanation that B.S.'s father was trading the account and that the father was a sophisticated investor. The Respondent requested a letter confirming that B.S.'s father was trading the account and was appropriately experienced. That letter was not forthcoming within a reasonable period of time and the Respondent continued to allow trades in the account outside of the Level 2 approval when he did not have the assurances that he had requested with respect to F.S. This is not a situation where isolated trades were allowed to occur in the account outside of the approved level of options trading. There were 27 trades that occurred in the account outside of the option approval levels in the period November, 2002 until June, 2003. In the circumstances, it was not a reasonable exercise of the Respondent's supervisory obligations to continue to allow trades outside of the approved trading levels to occur without receiving the assurances that he had requested with respect to the involvement of F.S.

¶ 177 With respect to the Respondent's submission that the client initially requested Level 4 trading, and there was no indication that the client did not understand or appreciate the nature of the trading or the level of risk, that submission is not supported by the evidence. The evidence, including the information in the NCAF and the OA, shows that B.S. was an inexperienced investor. The Respondent recognized that fact and that was why he contacted J.E. to discuss his concerns. The Respondent requested written confirmation from the father to document that in fact the father was a sophisticated and knowledgeable investor and that the father was funding the account and instructing the son on what to purchase and what not to. The Respondent recognized, by his actions, that B.S. did not, on his own, have the qualifications to enter into transactions outside of the Level 2 options approval given for the account. In the circumstances, the Respondent should have obtained the written confirmation from F.S. before allowing the Level 4 trades to continue. The period of time that passed before the written confirmation was obtained from the father was inordinate and the delay was inexcusable.

¶ 178 This Panel finds that the Association has established a failure to reasonably supervise the B.S. account, as was the Respondent's responsibility as the DROP. Further, the Respondent has admitted that he did not take or maintain adequate notes or records (evidence) of his supervision of the B.S. account. Even absent this submission, there was a failure to maintain adequate notes or records of the supervision of this account.

COUNT 4

Count 4

The Respondent, at all material times, the Designated Registered Options Principal for Union Securities Ltd. ("Union"), a Member of the Association, failed to adequately supervise the account management and trading activities, and maintain adequate supervision records (evidence), relating to the clients E.&R. B. accounts of the Registered Options Representative, R.L., an employee of Union in Monkton, New Brunswick, during the period September 2001 to May 2003; in contravention of Association Regulation 1300.1, 1300.2, 1900, and Policy No. 2 and Bylaw 29.1

¶ 179 Relevant paragraphs of the ASF in relation to the E.&R.B. accounts under the supervision of the ROR, R.L., are found at paragraphs 163 through to 180.

B. ROR - R.L.

163. At all material times, R.L. was employed as a ROR with the Moncton, New Brunswick branch office of Union.

164. At all material times, the Branch Manager, R.B., and the Respondent were the supervisors of R.L.

R.L. Client -E. & R.B.

165. NCAFs and Option Agreements, dated September 6, 2001, were prepared and signed for the E. & R.B. accounts.

166. Information from the E. & R.B. NCAF, includes:

- Investment Knowledge: Sophisticated (EB), Good (RB)
- Investment Experience: Not Stated (NCAF Deficiency)

167. Information from the E.B. Option Agreement includes:

- Investment Experience: Limited for Stock Options, Stocks, Bonds & Options
- Anticipated Options: Level 2

168. Information from the R.B. Option Agreement includes;

- Investment Experience: Limited for Stock Options, Bonds & Options
- Anticipated Options: Level 2

169. The Respondent signed the E. & R.B. Option Agreement on September 17, 2001, and assigned Level 2 and Level 3 authorization codes to the E.B. and R.B. option accounts, respectively.

170. E.B. and R.B. were 84 years old and 73 years old, respectively, and retired, at the time of execution of the Option Agreement.

171. During the period October 2002 to June 2003, R.L. executed nine (9) Level 4 options trades in the E. & R.B. account. Each of those options trades consisted of 10 or more contracts.

172. The nine (9) Level 4 options trades were all short puts. These trades generated profits for the account of approximately $22,168.

173. The options trading in the E. & R.B. account, for the material time period, is summarized at Appendix #H.

174. The Respondent noted his concerns regarding uncovered options trades in the E. & R.B. accounts on November 22, 2002, and May 21, 2003.

175. The Respondent has stated that, on November 22, 2002, after noting uncovered option trades in the E. & R.B. options accounts, he spoke to R.L. regarding the need to update the options authorization code on the E. & R.B. options accounts.

176. On May 21, 2003, the Respondent updated the E. & R.B. Option Agreements to reflect an options authorization code - Level 4.

177. There was no material change to the personal or financial circumstances of E. & R.B. to support the update to the options authorization code - Level 4.

178. There are no records supporting that the Respondent spoke with R.L. about updating the E. & R.B. Option Agreement prior to May 2003, or at any other time.

179. At all material times, the Respondent knew, or ought to have known, of R.L.'s options trading strategies, the options authorization code and specific options trading activity in the E. & R.B. accounts.

180. The Respondent admits that he did not take the following steps during the material time:

(a) Did not contact E. & R.B. to confirm that options trading, including uncovered options trading, was a suitable investment strategy for their accounts;

(b) Did not cross-reference every options trades executed in the E. & R.B. accounts with the options authorization code of the accounts;

(c) Did not cancel uncovered options trades that had been executed in the E. & R.B. accounts;

(d) Upon becoming aware that uncovered options trades had been executed in the accounts, he did not restrict trading or make recommendations to restrict the

activity in the E. & R.B. accounts pending receipt of an update to the options authorization code of the accounts; and

(e) Did not maintain records (evidence) of supervisory activities relating to the E. & R.B. accounts.

¶ 180 There was one NCAF for E.&R.B. The NCAF shows that the investment knowledge of E.B. was "sophisticated" and investment knowledge of R.B. was "good." The "investment experience" portion of the NCAF was not completed which is a deficiency.

¶ 181 E.B. executed an OA in which investment experience is shown as "limited for stock options, stocks, bonds and options." The R.B. OA shows the same for investment experience. The E.B. OA was approved for Level 2 trading and the R.B. OA was approved for Level 3 trading.

¶ 182 Of note, E.B. and R.B. were 84 years of age and 73 years of age, respectively, and retired. The options trading in the accounts in excess of the approved level of options trading is summarized at Appendix "H" of the ASF. During the period October, 2002 to June, 2003, there were nine Level 4 options trades in the E.&R.B. account. Each trade consisted of ten or more contracts and were all short puts. However, the summary does not disclose the full details of the strategy. The strategy was a synthetic equity long position, as described in more detail below in a summary of Mr. Croft's evidence.

¶ 183 The Respondent noted concerns regarding uncovered options trades in the accounts and those concerns arose in November, 2002 and May, 2003. In November, 2002, the Respondent spoke to R.L. regarding the need to update the options authorization code for the accounts. The accounts were not updated until May, 2003. There had been no material change to the personal or financial circumstances of the clients to support the update to the options authorization code to Level 4.

(i) The Association's Submissions

¶ 184 The submissions of the Association with respect to the E.&R.B. options accounts are:

- The Respondent had no recollection of approving the E.&R.B. options account. He was aware that E.B. was born in 1917 but also believed that R.L. had known E.&R.B. for 16 years and therefore concluded "E.B. was simply one of those senior people that had all their wits about them and was knowledgeable about what he was doing and it was acceptable to me.";
- The Respondent spoke with R.L. in November, 2002 about unapproved options trades in the account. Then there is a notation on the May 24, 2003 daily blotter indicating that the account was executing trades outside of the options approval code level. The Association says that the Respondent approved the update to the option account for Level 4 options trades on the basis that the unapproved options trades had dated back to November, 2002 and had not been subject to adequate supervisory restrictions;
- The Respondent claims that he had a discussion with R.L. in November, 2002 where it was discussed that R.L. would update the account so that it could be approved for Level 4 trading;
- Mr. Croft, the expert called by the Association, testified that the E.&R.B. account was involved in synthetic stock positions. Mr. Croft described the position as being a long call option and short a put option with the same expiration date simultaneously, generally at the strike price but not necessarily. He described it as a bullish strategy, with a risk profile similar to that of owning the underlying stock. Mr. Croft described synthetic stock positions as Level 4 options trades because they involve uncovered puts, that are complex and can be subject to significant leverage. While not noted by Mr. Croft, this strategy is also a commission intensive strategy;
- The Respondent believes that the clients had other equities and funds in their account which could have been sold in the event of assignment of the short puts. This provided an "escape" for the clients. The Respondent believed that the clients understood the consequences and the risk of trading done in their account and he did not consider them to be "unsophisticated investors."

The Association points out that the NCAF and the OA for the client shows limited options experience for both and there was only a request for Level 2 options trading;

- Mr. Croft identified issues of exposure, concentration and leverage associated with the trading and noted that the exposure risk was two times the net equity of the account. Mr. Croft stated that the trading did not reflect that the clients were sophisticated and it was not clear to him from the trading activity whether they recognized the risk and exposure;
- The Association acknowledges that E.B. is noted as being a sophisticated investor, but in light of other contrary information in the NCAF and the OA forms, the DROP should have clarified and substantiated the level of sophistication of the clients and not made assumptions about that issue;
- The proper and only time in which accounts should be upgraded to a higher approval level is when there has been a material change in the personal and/or financial circumstances of the client, and the client is aware of and has requested the upgrade;
- The Respondent has provided a letter on Union Securities letterhead dated May 9, 2007 signed by R.L. and the client E.B. to support his past practice that his clients understood what they were doing and that E.B. was a sophisticated option trader. The Respondent had requested this letter in order to have a formal summary of the E.&R.B. client background after the Association's investigation and well after the approval of the account for Level 2 options trading and the nine Level 4 options trades executed between October, 2002 and June 2003;
- The DROP did not take the appropriate and necessary steps to ensure that the clients understood and wanted the type of options trading that was conducted in their accounts and that there were many red flags signalling that the clients did not understand or want the options trading that was conducted in their accounts; and
- While a DROP can exercise his discretion to allow an unapproved trade to clear in a customer account, to knowingly allow unapproved options trades to be repeatedly executed in an options account over an extended period of time is not an exercise of discretion but rather a failure to exercise the proper supervisory function required of the DROP.

(ii) The Respondent's Submissions

¶ 185 The Respondent makes the following submissions:

- The primary responsibility for supervision over R.L. rests with the Branch Manager, R.B. The Association did not interview R.B. Nor did they seek any information from or interview R.L.;
- In fact, the Respondent assigned Level 3 to the E.B. option account, not Level 2 as stated in the ASF;
- Each of the nine trades was for ten contracts and the Respondent was only required to review options trades in excess of ten contracts. He was therefore not required to review those trades;
- The E.&R.B. account contained $115,000.00 in securities;
- The Association's expert, Mr. Croft, stated that synthetic stock positions provide exposure similar to what one would get by simply owning the underlying shares;
- R.L. provided a written summary dated May 9, 2007 of the background and strategy employed in the E.B. account. It is stated in that letter that E.B. is a very experienced and successful investor with over 50 years of experience who, throughout the 1990's, employed an option strategy to sell out of the money covered call options. The strategy described in the letter is stated to have been carefully explained and discussed with the client. It is stated that E.B. maintained a comfortable level of cash and margin eligible securities and every put sold was for the expressed goal of owning the underlying security. There was a net gain from this trading strategy of approximately

$64,000.00;

- The Respondent did know of R.L.'s options trading strategies and the specific options trading activity in the account. There were no red flags or warning signals which merited further review or inquiry. The client did not complain. The trading strategy was profitable. The trades were at all times within the client's stated investment objectives and risk tolerances as described in the NCAF and OA. The trades were all for ten contracts or less and were not required to be reviewed by the Respondent; and
- The short puts were generally secured by the cash and securities in the account. There was at any one time few open options positions. The real risk that the open options positions would be assigned was minimal.

(iii) Analysis and Findings with Respect to Count 4

¶ 186 E.&R.B. were elderly clients who were retired. The OA stated that they had limited investment experience in stock options, stocks, bonds and options. That information is provided in the OA and together with the NCAF information would have been the only information available to the Respondent at the time of the account opening and at the time of the options account approval or the trading activity. While this experience is called into question by the content of the summary provided by R.L. dated May 9, 2007, that information was not conveyed to the Respondent at the time of the options account approval or the trading activity. In the period from October, 2002 until June, 2003, R.L. executed nine Level 4 options trades in the E.&R.B. account, all of which were outside of the approved options trading limits. The Respondent had concerns about this activity in November, 2002 and then again in May, 2003. He spoke to R.L. regarding the need to update the options authorization code on the E.&R.B. options accounts and the update was not done until May, 2003. When it was done, there had been no material change to the personal or financial circumstances of E.&R.B. to support the increase to the options authorization code to a Level 4.

¶ 187 The trading activity was in synthetic stock positions. That is a sophisticated derivative strategy with risk. It requires a need to supervise actively. This Panel agrees that while a DROP can exercise his or her discretion to allow an unapproved trade to clear in an options account, to knowingly allow unapproved options trades to be repeatedly executed in an options account over an extended period of time constitutes a failure to act reasonably in the supervision of the account. This Panel finds that there was a failure to reasonably supervise and also concludes that the Respondent did not maintain records (evidence) of supervisory activities relating to the E.&R.B. accounts, as is admitted in paragraph 180(e) of the ASF.

COUNT 5

Count 5

The Respondent, at all material times, the Designated Registered Options Principal for Union Securities Ltd. ("Union"), a Member of the Association, failed to adequately supervise the account management and trading activities, and maintain adequate supervision records (evidence), relating to the client S.K. accounts of the Registered Options Representative, T.P., an employee of Union in Toronto, Ontario, during the period September 2001 to February 2003; in contravention of Association Regulation 1300.1, 1300.2, 1900, and Policy No. 2 and Bylaw 29.1.

¶ 188 The relevant paragraphs of the ASF that relate to this Count are paragraphs 181 through to 199.

C. ROR - T.P.

181. At all material times, T.P. was employed as a ROR with the Yonge Street, Toronto, Ontario branch office of Union.

182. At all material times, the Branch Manager, J.D., and the Respondent were the supervisors of T.P.

T.P. Client - S.K.

183. A NCAF dated September 18, 2001, and an Option Agreement dated September 17, 2001, were prepared and signed for the S.K. account.

184. Information from the S.K. NCAF, includes:

- Investment Knowledge: Limited
- Investment Experience: Not Stated

185. Information from the S.K. Option Agreement includes:

- Investment Experience: Limited for Options
- Anticipated Options: Level 4
- DROP Approval: Level 3

186. The Respondent signed the Option Agreement and assigned a Level 2 authorizations code for the options account.

187. The Respondent assessed S.K. as a "beginner" in options trading and made a note of that assessment on the Option Agreement dated September 17, 2001.

188. T.P. originally requested that the S.K. options account be approved for Level 4 options trades.

189. The Respondent has stated that, on or about September 17, 2001, he approved an update to the S.K. Option Agreement for Level 4, uncovered options trading, on the basis of advice from T.P. that S.K. was a close friend, very sophisticated and had been studying options trading.

190. Further, the Respondent has stated that the approval to Level 4 was not coded properly to the account at the time of the update.

191. A second S.K. Option Agreement dated September 17, 2001, was signed by the Respondent as approving the account for Level 3 options authorization code.

192. In February 2003, the Respondent sent an email to T.P. inquiring about the appropriateness of the options authorization code for the S.K. account. The Respondent has stated that T.P. responded by reminding him of an earlier update approval to Level 4 options authorization code.

193. The Respondent did not take or maintain adequate notes and records (evidence) of his supervision over the S.K. account.

194. On or about February 11, 2003, the Respondent updated the S.K. Option Agreement to reflect an options authorization code of Level 4.

195. On all three of the S.K. Option Agreements, it was noted that S.K. had only "limited" experience in options trading.

196. During the period January 2002 to February 2003, R.L. executed thirty-four (34) uncovered options trades in the S.K. account. All but 2 of those trades were for 10 or more contracts.

197. The options trading in the S.K. account, for the material time period, is summarized at Appendix #I.

198. At all material times, the Respondent knew, or ought to have known, of T.P.'s options trading strategies, the options authorization code and specific options trading activity in the S.K. account.

199. The Respondent admits that he did not take the following steps during the material time:

(a) Did not contact S.K. to confirm that options trading, including uncovered options trading, was a suitable investment strategy for the S.K. account;

(b) Did not cross-reference every options trades executed in S.K. account with the options authorization code for the account;

(c) Other than the advice the Respondent has stated he received from T.P. when the option account was opened and the February 10, 2003, email, he did not contact T.P. to discuss whether an update to the options authorization code for the S.K. account was required and suitable, upon becoming aware that uncovered options trades had been executed in the account;

(d) Did not contact the Branch Manager, J.D., to discuss whether an update to the options authorization code for the S.K. account was required and suitable, upon becoming aware that uncovered options trades had been executed in the accounts;

(e) Upon noting that uncovered options trades had been executed, he did not restrict or make recommendations to restrict the trading activity in the S.K. account pending an accurate and completed update to the options authorization code for the S.K. account;

(f) Did not cancel uncovered options trades that had been executed in the S.K. account; and

(g) Did not maintain adequate records (evidence) of supervisory activities relating to the S.K. accounts and, in particular, did not maintain records (evidence) of supervisory review relating to the September 2001 approval of the account options authorization code from Level 2 to Level 3.

¶ 189 T.P. was employed as an ROR in a Toronto, Ontario branch of Union Securities. His client, S.K. had "limited" investment knowledge. The NCAF does not include any entry for "investment experience." With respect to investment experience for options, there is an entry on the OA of "limited for options." When the account was opened it was assigned a Level 2 options approval level. The Respondent assessed S.K. as a "beginner" in options trading and made a note of that assessment on the OA dated September 17, 2001. Shortly after the opening of the options account, the Respondent approved a Level 4 uncovered options trade on the basis of advice from the ROR, T.P., that S.K. was a close friend, very sophisticated and had been studying options trading. The Level 4 approval was not coded properly to the account at the time of the update.

¶ 190 By February, 2003, the Respondent sent an e-mail to T.P. inquiring about the appropriateness of options authorization code for the S.K. account. The Respondent stated that T.P. responded by reminding him of an earlier verbal approval of the account to allow a Level 4 options authorization code. On February 11, 2003, the Respondent updated the S.K. option agreement to reflect an options authorization code of Level 4.

¶ 191 During the period January, 2002 to February, 2003, R.L. executed 34 uncovered options trades in the S.K. account. All but two of those trades were for ten or more contracts. The trading is summarized in Appendix "I" of the ASF. The Respondent admits in the ASF that he did not contact S.K. to confirm that options trading, including uncovered options trading, was a suitable investment strategy nor did he cross reference every options trade executed in S.K.'s account with the options authorization code for the account. Nor did he contact the Branch Manager. Upon noting that the uncovered options trades had been executed, he did not restrict or make recommendations to restrict the trading activity in the S.K. account pending an update to the options authorization code.

(i) The Association's Submissions

¶ 192 The Association submits:

- The account was initially assigned a Level 2 options approval code and at the time the Respondent specifically noted that S.K. was a "beginner" with "no previous experience in options" trading. The Respondent was then told by the ROR, T.P. that S.K. was his friend and was learning about options and wanted to put into practice some of the theories they had been discussing. The Respondent claims that he updated the account to a Level 4 options approval code and relied on the representation of T.P. that he would be careful with the options trading in the S.K. account and that he would approve the account for Level 4 options trading "on an initial basis and see how it went.";
- Mr. Croft, the expert produced by the Association, summarized the trading in the S.K. account as including call options, "short strangles - short a call and a put on the same underlying security with different strike prices." He described short strangle positions as complex volatility trades and explained that there is no bias in terms of stock direction - rather the bias is that the stock will stay within a specific trading range. He described the specific risk with a short strangle

position as "unlimited, as the stock could theoretically rise to infinity which would impact the uncovered call option strategy." He stated that the risks are not readily apparent to unsophisticated investors and explained the volatility as follows:

> As an example, you could have a whipsaw affect on a stock where it didn't reach the range. If I was to use Yahoo as an example, in theory, the stock could jump to $22.50 and fall back to $17.50 in the period of a week and a half, close at $19. In the sense that it never breached either end of that trading range, you would presume that it is an effective strategy. However, that increase in movement would have caused an increase in the volatility assumption that is one of the factors that go into pricing an option.
>
> As the volatility expands, the value of the options expands even though during that period the stock may have been where it was when it started there a week ago, which creates greater risk on the account and a heavy margin requirement, because the margin in these instances is based on the number one factor being the premium, plus or minus the value of the underlying exposure, minus the amount in or out of the money.

- The S.K. NCAF shows the answer "new" to the question "how long have you known the client?" and shows S.K. has a "personal contact." The Respondent claims that he took this information to mean that S.K. was simply a new client. The Association points out the conflict between the answer on the NCAF and the fact that the Respondent was told by T.P. that S.K. was a friend that he had known for a long period of time. The Respondent acknowledged that that discrepancy should have raised the question in his mind as DROP and led to further inquiries concerning the investment experience and knowledge of S.K.;
- During the period January, 2002 to February, 2003, in addition to uncovered puts, there were 19 uncovered calls executed in the S.K. account;
- In February, 2003, when the Respondent received the reply from T.P. advising that the Respondent had previously approved the account for Level 4 options trades, the Respondent simply accepted this advice and without further inquiry, updated the account to a Level 4 options approval code. The Respondent's position with respect to the change was that he was "simply correcting a situation that should have been in place to begin with." The Association submits that this is an implausible explanation and another example of matching the trading activity that had already taken place to the required account approvals; and
- The Association does not dispute that a DROP can exercise his discretion to allow an unapproved trade to stand in an option account. However, to knowingly allow unapproved options trades to be repeatedly executed in an options account over an extended period of time is not an exercise of discretion, but rather a failure to exercise the proper supervisory function.

(ii) The Respondent's Submissions

¶ 193 The Respondent's submissions are:

- The NCAF and OA show that S.K. was 23 years old at the time and wanted a 35% short-term and/or speculative/venture trading with 25% high risk, that his estimated net worth was approximately $515,000.00 and he had an annual income of $125,000.00;
- With respect to allowing Level 4 option approval the evidence of the Respondent is:

> MR. PELLETIER: What is your next recollection with regard to the S.K. option account?
>
> A. (T.P.) and I got in touch. He was -- we discussed the Code 2 authorization that I had given to the account and he explained to me why he requested a code 4 for this account, and why the branch manager, (J.S.) agreed to it. The explanation was that (S.K.) was a personal friend and that (S.K.) had been interested in options theory and (T.P.) himself was a very sophisticated, both futures commodities licensed trader, an IA, as well as options, and ROR. He explained that (S.K.)

wanted to put into practice some of the theory that he and (S.K.) had been discussing for a period of time. That he was intending to be careful with (S.K.) in the way that he engaged in options trading. He would trade on a variety of strategies, principally, which would be at strangles. On the basis of his representation, I decided that if they went easy, and I would say cautious about what they did, I was willing to approve it on an initial basis and see how it went. So, I changed it to a code 4.

- With respect to the trading in the account, the Respondent's evidence is:

  Q. Okay. What other recollections do you have with respect to the S.K. account, and the trading in the account?

  A. I observed the initial trading. I reviewed it with the usual criteria, suitability, in relationship to what I knew about (S.K.) from my discussions, with the documents, as well as my discussion with (T.P.). I generally reviewed all the trading that he did over the period of the year and a half that he was trading, as a matter of course, with the usual criteria that I use when reviewing the trades. I noticed that the trading was relatively modest, that small positions were opened. There were characteristically 3 opening positions a month with some expiries or some closing trades. I felt that it was consistent with what (T.P.) told me he was going to do. I was not concerned that the account was being abused or put into situations that were high risk. Over a period of time, it traded and I developed a comfort level from the trading that I saw, from my knowledge of (T.P.), and I add that in March of 2002, (T.P.) did complete the options supervisors course. He was a very qualified individual, and I had confidence in him and he appeared to be managing the account well.

  Q. Did you ever receive a client complaint with respect to the S.K. account?

  A. Never.

- The trading was at all times within the stated investment objectives and risk tolerances for the account. There were few open options positions at any one time and only a modest amount of cash at risk (generally not more than $15,000.00 to $20,000.00). Most of the impugned trades were for ten contracts or less and would not require specific review by the Respondent. There were no red flags or warnings signals in the S.K. account which warranted further review or inquiry by the Respondent.

(iii) Analysis and Findings with Respect to Count 5

¶ 194 The Respondent claims that very early on he agreed to Level 4 options approval in the account, after receiving information from T.P. about S.K., and recognizing that T.P. himself was a very sophisticated and experienced trader in options and commodities. The Respondent claims that through oversight, the processing of the change to the options approval was not coded properly to the account at the time of the update. It is also noted that the NCAF and OA show that S.K. wanted short-term and/or speculative/venture trading with 25% high risk and that he had a relatively high net worth of approximately $515,000.00 and an annual income of $125,000.00. Notwithstanding that he was a "beginner" in options trading, after receiving the additional information from T.P., the Respondent exercised his discretion to increase the options approval to Level 4. Thereafter his evidence is that he reviewed all the trading in the account.

¶ 195 This Panel finds that the Respondent did, at a very early stage, make the decision to update the account to a Level 4 options approval code. While he may have failed to input that change into the system, that decision was made by him at an early stage. The question is whether or not, having regard to the characteristics of the client, and the information obtained from J.P., such an approval was an unreasonable exercise of his supervisory obligations. Admittedly the client was a "beginner" in options trading. However, this Panel accepts that the Respondent acted reasonably in reliance on the information provided to him by T.P. about S.K. and that the evidence supports that he thereafter monitored the trading in the account. This Panel finds that the Association has not proven a failure to supervise in relation to Count 5.

M. FINDINGS OF THE PANEL ON THE FIVE COUNTS

¶ 196 This Panel is satisfied that the Association has proven its case on Counts 1 through to 4. This Panel

finds that the Association has not proven its case in relation to Count 5. Since there has been a finding that the Respondent has failed to supervise as the designated DROP for Union Securities during the relevant period, and to keep adequate evidence of that supervision, it is necessary to reconvene to consider an appropriate penalty. This Panel directs that the penalty hearing be scheduled at the earliest convenient date and invites counsel to advise the National Hearing Coordinator of their availability so that a penalty hearing can be convened.

DATED this 26th day of November, 2008.

Chair - D. Brian Foster

Peter McWilliams

Bruce Calvin

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