Re Trenholm

IN THE MATTER OF:

THE DEALER MEMBER RULES OF THE INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

AND

THE BY-LAWS OF THE INVESTMENT DEALERS ASSOCIATION OF CANADA

AND

DANIEL MURRAY TRENHOLM

2009 IIROC 40

Investment Industry Regulatory Organization of Canada
on behalf of
Investment Dealers Association of Canada
Hearing Panel (Nova Scotia District)

Heard: July 8, 9 and 10, 2009 in Halifax, Nova Scotia
Decision: September 6, 2009
(41 paras.)

Hearing Panel:
Stewart McInnes (Chairman), Edward Cleather, Nancy Ross
Appearances:
Dianne Iannetta, Counsel for IIROC
Michelle Awad, QC, Counsel for Daniel Trenholm

DECISION

The issue is whether;

¶ 1 During the period October 2001 to February 2004, the Respondent failed to properly perform his role as a gatekeeper in the capital markets, contrary to Rule 29.1 (then by-law 29.1) and Rule 1300.1(a) (then Regulation 1399.1(a)) when dealing with a group of related clients by:

> I, facilitating certain transactional activity in five related accounts without making diligent inquiries to ensure the legitimacy of the transactions in circumstances which should have called the transactional activity into question. Because it was peculiar, suspicious or appeared to be consistent with market manipulation, deception or other improper market related activity.

¶ 2 During the period October 2001 to February 2004, the Respondent accepted trading instructions in respect of four client accounts from a person not authorized in writing to provide such instructions for those accounts, contrary to Association Rule 200.1(i)(3) (then, Regulation 200.1(i)(3)).

FACTS

¶ 3 The Respondent has been registered with the IDA since 1977 and a regulated person of IIROC since June 1, 2008. At all material times, he was employed at Lynch Investments Limited ("Lynch") and later at Acadian Securities Inc. ("Acadian") and he is currently employed with Jennings Capital Inc.

¶ 4 The Respondent purchased Rally in his personal accounts at Lynch and later held them in his account at Acadian.

¶ 5 The Respondent was a registered representative for five accounts which it has been alleged were "related":

(i) 2266482 Nova Scotia Limited;
(ii) CMB Energy Corp.
(iii) Glenora Distillers (19994) Ltd.;
(iv) Robert Scott;
(v) Shannon International Resources Inc.

¶ 6 The client application forms and documents for all five related accounts listed the address at 1550 Bedford Highway, Suite 820.

¶ 7 The Respondent has known Jim Matheson since 1996 although he was not a client. Jim Matheson had trading authority and/or gave trading instructions in each of the related accounts although no formal authorization had been signed for this purpose. The Robert Scott account had a handwritten authorization which had been filed contemporaneously with respect to trades. Matheson had been disciplined by the Alberta's Securities Commission in May 1991 for creating false/misleading trade activity through an inventory account and a number of family accounts. The Commission found it to be a very serious case of market manipulation. In June 1991, the Commission ordered that Matheson cease trading in all securities and be denied the use of all exemptions in the *Alberta Securities Act* for a period of fifteen years.

¶ 8 Matheson was the father of Darren Campbell who signed the account opening documents on behalf of 226 NSL and CMB Energy. Matheson was responsible for most of the trading in the Robert Scott account and trading authority over the account of 226. Matheson gave trading instructions on the account of CMB Energy.

¶ 9 Blair Cody was also President and a director of Shannon International Resources and he advised the Respondent that trading instructions could be accepted from Matheson (although no formal authorization was given).

¶ 10 Darren Campbell, the President of 226 NS opened an account with the Respondent at Lynch in November 2001. Although the Respondent did not have documented trading authorization for this account, he took instructions from Matheson. All of the related accounts traded heavily in Rally Energy. The Respondent processed at least one trade in each of the related accounts every month and in some cases there were twenty trades.

¶ 11 In at least one case, one of the related accounts purchased the same number of shares that another related account sold in the same day. eg on March 27, 2002, Robert Scott sold 82,500 shares and Shannon purchased a like amount.

¶ 12 For several of the accounts Rally was involved in one of the first transactions when the account was opened;

CMB Energy

First Account Statement – June 2001
First Trade in Rally – October 2001

226 NS

First Account Statement – November 2001

First Trade in Rally – November 2001

Shannon International

First Account Statement – March 2002
First Trade in Rally – March 2002

Glenora Distrillers

First Account Statement – November 2002
First Trade in Rally – November 2002

¶ 13 Although some of the accounts traded in other securities it is noted that some of the related accounts were 70% or more concentrated in Rally.

¶ 14 It is observed that 226 transferred money directly to the bank account of Rally although the bank account information was not publicly known. Interestingly CMB wired money out to an account at an American bank and received wire transfers in from accounts at other banks. All of the related accounts engaged in transfers of shares of Rally either to other of the related accounts or, or to clients outside the firm. In total, the related accounts transferred or received transfers of Rally 31 times over a 29 month period, although Rally was available for purchase or a sale on a recognized exchange.

¶ 15 Sometimes transfers were done without any apparent consideration and in a period under one month (November 27, 2002 – December 20, 2002) Glenora had the following transfers:

(i) 375,000 common shares came in;
(ii) 300,000 shares came in from Robert Scott;
(iii) 300,000 shares go out to Shannon International; and
(iv) 300,000 shares go out to accounts at RBCDS.

¶ 16 The documents indicate that 30%-50% of the time, the related accounts did not settle their trades in Rally on the settlement date; Robert Scott did not settle his trades in Rally on the settlement date and 226 did not settle one-third of its Rally trades at all on the settlement date. CNB did not settle one-third of its Rally trades on the settlement date and Glenora did not settle one-third of its Rally trades on the settlement date. Shannon did not less than one-third of its Rally trades on the settlement date.

¶ 17 Glenora deposited a share certificate representing 375,000 shares in Rally.

¶ 18 IIROC emphasizes that for several months, the market value of Robert Scott's account was inconsistent with his level of income and CCA profile. Eg., in 2000, Scott identified his total net worth as $400,000; however in October 2001, the market value of Rally in his account was in excess of $500,000.

¶ 19 IIROC suggests the Respondent ought to have been aware (had he made the necessary inquiries) that:

(i) Blair Cody, the President and Director of Shannon, was also an officer and director of Rally at all material times;
(ii) Shannon rented their office from Rally;
(iii) Robert Scott gave Matheson trading authority over his account because Matheson asked him to – Scott did not ask him why;
(iv) all of the money in the Robert Scott account came from Matheson;
(v) Matheson solicited Michael Dunn to purchase shares of Rally from CNB Energy;
(vi) the Rodziks, who received transfer of shares of Rally from the Glenora Distiller's account, were friends of Matheson.

¶ 20 Some of the issues raised are:

(i) why shares of Rally were transferred to parties outside the five accounts – at times, outside of the

Province – when shares were available for purchase on the venture exchange;
(ii) why shares were transferred without any apparent consideration;
(iii) who the parties where who were receiving the Rally shares and the transfers referred to in (i);
(iv) whether there were any restrictions on the shares being transferred;
(v) why third party cheques were being deposited into the account of Robert Scott;
(vi) why a Calgary company (Shannon) wanted to open an account in Nova Scotia;
(vii) why Blair Cody was giving trade instructions to Jim Matheson;
(viii) why was there such intense interest in Rally;
(ix) why Matheson seems to be involved in so many accounts, but didn't have his own account.

THE ALLEGATIONS

¶ 21 The Respondent is alleged to have contravened IIROC Rule 29.1, Rule 1300.1(a) and Rule 200.1(i)(iii) which provides:

> "Dealer members and each partner, director, officer, sales manager, branch manager, assistant or co-branch manager, registered representative, investment representative, an employee of a dealer member (i) shall observe high standards of ethics and conduct in the transaction of their business, (ii) shall not engage in any business conduct or practice which is unbecoming or detrimental to the public interest, and (iii) shall be of such character and business repute and have such experience and training as is consistent with the standards described in clauses (i) and (ii) or as may be described by the Board of Directors."

¶ 22 Rule 1300.1(a) provides:

"Each member shall use due diligence:

a. to learn the essential facts relative to every customer and to every order or account accepted;"

¶ 23 Rule 29.1 provides:

> "For the purposes of disciplinary proceedings pursuant to the rules, each dealer member shall be responsible for all acts and omissions of each partner, director, officer, sales manager, branch manager, assistant or co-branch manager, registered representative, investment representative and an employee of a dealer member; and each of the foregoing individuals shall comply with all rules required to be complied with by the Dealer Member."

¶ 24 Rule 200.1(i)(iii) provides:

> "As required under Rule 17.2 every Dealer Member shall make and keep current books and records necessary to record properly its business transactions and financial charts including, without limitation:
>
> (i) a record in respect of each cash and margin account;
>
> (ii) where trading instructions are accepted from a person or a corporation other than the customer, written authorization or ratification from the customer naming the person or a company;
>
> But, in the case of a joint account or an account of a corporation, such records are required only in respect of the person or persons authorized to transact business for such an account;"

¶ 25 The panel recognizes that the primary goal of security legislation is the protection of the investing public and one of the most important means in achieving goal is to ensure that registrants know their clients. Indeed in the conduct and practices handbook, the "know your client" rule is described as the "cardinal rule" and is the cornerstone of all dealings with clients. It is axiomatic that registrants determine the essential facts relative to

every order and account and reference is made to the following passage in the handbook (2000 version):

> "A group of clients is trading in a particular security and the security is not one normally followed by the IA and/or the member firm's research department. The IA must particularly note that one of the group has trading authority for some or all of the others. In addition, the IA must remain alert to detect other indications that the clients are connected and are acting in concert. This might include use of the same mailing address, same employer, or same last name or phone numbers. Similarities in the timing and pricing of orders would be another clue. Clients engaging in this conduct may be manipulating the price of the stock by trading among themselves or maybe attempting to give the appearance of an active market."

¶ 26 Registrants must be sensitive to the "cardinal rule" in ensuring that registered representatives act as "gatekeepers" for the industry and this enhances the integrity of the capital markets. Gatekeeper obligations have been imposed by courts because registrants are in a unique position, and even better than regulators, to effectively monitor market activities and to apply their knowledge to spot any potential impropriety. *Re: Pacific International Securities Inc.*, 2006 BCSECCOM 532 at par. 330.

¶ 27 To ensure the integrity of the markets, registrants must know the character and financial circumstances of their clients, so that they do not unwittingly become conduits for inappropriate or abusive trading. *Re: LOM (Holdings) Ltd.*, 2005 BCSECCOM 144 at par. 14.

¶ 28 There is important discussion of the role of gatekeeper in *Re: Pacific* at par. 332:

> "Even if a registrant is not directly involved in an unfair or inequitable activity, the registrant is expected to be inquisitive and pro-active in dealing with such activities that are carrying on by others and of which the registrant is or should be aware. Registrants should refuse or accept instructions from clients who, in the registrant's judgment, are engaged in a legal, unfair or abusive trading activities."

THE STANDARD TO BE MET

¶ 29 The conduct at issue must amount to something more than mere inadvertence or negligence. *Re: Babb* (2000) I.D.A.C.D. No. 39 at p. 34 and *Re: Finklestein*, (2005) I.D.A.C.D. No. 34 at p. 11.

¶ 30 Negligence is not likely to be a basis for discipline unless it is gross or habitual, or both. For negligence to be considered gross, the conduct of the registrant must "diverge widely from that of a reasonable person". However, conduct which does not demonstrate moral turpitude can, nevertheless, amount to conduct unbecoming. *Re: Ng* (2007) I.D.A.C.D. No. 47 at pp. 37-38 and the following discussion at p. 44 is instructive:

> "We have considered all of the evidence. In the light of Mr. Ng's overall dealing with the subject accounts, we are particularly troubled by the salient facts to which we have just referred. While it may be that no one of them, individually, would constitute gross negligence, we think that their accumulative effect is overwhelming. We have reached the conclusion that his conduct shows a wide divergence from that of a prudent registered representative in attempting to fulfill his obligation to know his client and to ensure that any order was within good business practice. We, therefore, find that Mr. Ng was grossly negligent. Gross negligence in the performance of Mr. Ng's obligations, in this case, clearly amounts to conduct unbecoming."

¶ 31 A registrant need not be certain of impropriety before gatekeeper obligations are triggered.

> "Ratchfall and Patterson failed to meet these obligations. They knew there was "high probability" that Houge was acquiring the Orlando stock with the intention

of manipulating its price. It was their responsibility to make due inquiry to satisfy themselves that Hogue's intention were legitimate. Had they been unable to satisfy themselves on that point, it would have been their duty not to proceed with the trades. *Re: Ratchfall*, 2001 BCSECCOM 652 at par. 23."

¶ 32 A registrant must satisfy himself that there are reasonably legitimate reasons for a transaction.

> "Based upon the totality of the evidence presented at the hearing, that particularly the evidence given by Tobin in the IBA interview, we are satisfied that Tobin either didn't know, or was not prepared to admit to the reasons for the transfers, and thus he caused the words 'for services rendered' or a facsimile to be written on the transfer request. In the result, we are satisfied that either Tobin "authorized" the transfer without making any diligent inquiries to determine the reason behind the transfer of the shares, or he was reckless and indifferent to the reason.
>
> We are satisfied that by facilitating the transactional activity in the accounts, without reasonable assurances that there were reasonably legitimate reasons for the transactions, Tobin failed to adequately perform his duty as a gatekeeper for the security industry (2007) IDAC.d. No. 9 at par. 49, 76-78."

¶ 33 A registrant must be alert to clients who are trading beyond their means, and investigate whether the clients are really being used as nominees for undisclosed principles. In such situations, the registrant is expected to take appropriate actions, such as notifying their employer firms or appropriate regulators, declining to engage in trading activities inconsistent with the client's financial information recorded in the account documents, or rectifying client documents to correctly record the true beneficial ownership *Re: Wenzell* 2005 ABASC 91 at par. 53.

¶ 34 A registered representative must make reasonable inquiries and be reasonably satisfied where a duly diligent person would do so in similar circumstances *Re: Kasman and Anderson* at par. 41 and also p. 34-38. The following diligence is required when accepting trades:

(i) the propriety or purpose of the trade must be questioned;
(ii) on a periodic basis, the client trading reflected in the client account should be considered and analyzed;
(iii) transfers of shares without consideration should be questioned. Diligent inquiries should be made to determine the reason behind the transfer of the shares.

¶ 35 Although every dealer member is required to have compliance personnel, the obligations imposed on the registered representatives are to be observed independently of any firm obligations. The Respondent has suggested that because his branch manager and the carrying broker, BMO Nesbitt Burns failed to raise the issues that are the subject of this compliant that he did not bear any independent responsibility. Such a defence was rejected in the case of *Re: Ng*.

¶ 36 In *Re: Kasman and Anderson*, the panel stated, at par. 42:

> "He can be greatly assisted by a competent compliance function at his firm. He can reasonably rely on others. But he cannot abdicate his functions by unreasonable reliance on his firm or administrative assistant. The purpose of the compliance function is not to supplant the registered representatives only responsibilities to monitor the clients trading and other activities at the firm."

DISCUSSION

¶ 37 All of the accounts where Matheson gave trading instructions indicated "no" on the client account agreement where asked if anyone else had trading authority over the account. That is the document relied upon by the Department's concern with compliance. Here compliance was not given the necessary information

required to complete its function although there were two inquiries by compliance to the managers of the Respondents firm. The Respondent indicated that he was not concerned with any of the related account activity when questions. The matter was not pursued further.

¶ 38 The Respondent did not give evidence at the hearing. However, his interview conducted pursuant to the rules of IIROC under oath and with counsel compells this Panel to one conclusion. The Respondent either tacitly participated in the questionable activity in the related accounts or he was totally oblivious to questionable activity when any reasonable registrant would have been put on inquiry. A review of the Respondent's transcript dated January 18, 2007 is telling. The Respondent consistently stated that he had no recollection of the reasons or nature of most activity in the related accounts. He volunteered the general relationship of a number of the parties, but would not acknowledge that the volume of trades in Rally under the circumstances presented, caused him to make further inquiries of the propriety and integrity of the trading activity. His denial of any obligation to make inquiries concerning these trades is suspect in light of the fact that he owned a large number of shares and certainly would have been sensitive to the prices and trends concerning the Rally accounts. At least, he should have been put on notice of the suspicious circumstances when questions were raised by compliance on at least two occasions.

¶ 39 The Respondent failed to determine the "essential facts", relative to the relevant orders and accounts, including, *inter alia*:

(i) Who was funding trades;
(ii) Why the trades were being done;
(iii) Why transfers were being done;
(iv) To whom transfers were being made;
(v) What the relationship was amongst the related accounts;
(vi) What the relationship was between the related accounts and the issuer, Rally Energy and as an extension of that Jim Matheson and Rally Energy.

¶ 40 We are satisfied that by accepting trades without proper authorization and without reasonable assurances that there were legitimate reasons for the transactions, the Respondent failed to perform his role as a gatekeeper for the securities industries. The Respondent has long experience in the industry. One can only conclude that his failure to properly monitor his client's activities constitutes a gross negligence and the Panel finds the Respondent is in breach of his duties.

¶ 41 The Panel reserves its decision with respect to penalty and invites counsel to make any written representations to the Panel within the next 10 days.

Stewart McInnes, Chairman

E.J. Cleather

Nancy Ross