Re Questrade Inc.

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

QUESTRADE INC.

2009 IIROC 49
(IIROC File No. 0376/May/07)

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

Heard: April 28, 29 & 30, 2009
Decision: November 6, 2009
(119 paras.)

Hearing Panel:
Thomas J. Lockwood, Q.C., Chair, David W. Kerr, Guenther W. K. Kleberg
Appearances:
Andrew Werbowski & Charles Corlett, for IIROC
Inna Kholodenko, for Questrade Inc.

REASONS FOR DECISION

INTRODUCTION

¶ 1 By Notice of Hearing, dated the 9th day of December, 2008, the following allegations were made against Questrade Inc. ("the Respondent"):

A. From December 2006 to the present, Questrade Inc. ("Questrade") has advertised margin rates below those prescribed by the Investment Dealers Association of Canada ("IDA") and the Investment Industry Regulatory Organization of Canada ("IIROC") minimum standards despite being advised by regulatory Staff not to do so and has thereby engaged in business conduct unbecoming a Member Firm or Dealer Member contrary to IDA By-law 29.1 and Dealer Member Rule 29.1.

B. From December 2006 to the present, Questrade has failed to obtain required margin from its clients despite being advised by regulatory Staff to do so and has thereby engaged in business conduct unbecoming a Member Firm or Dealer Member contrary to Association By-law 29.1 and Dealer Member Rule 29.1.

¶ 2 The Hearing Panel heard evidence in this matter in Toronto, Ontario on April 28, 29 and 30, 2009. Voluminous Written Submissions and Books of Authorities were filed by both IIROC Staff and counsel for the Respondent on May 15, 2009. The parties each filed lengthy Reply Submissions, and in the case of Staff, Supplementary Authorities, on May 22, 2009. The Hearing Panel is indebted to the parties for their thorough and articulate canvass of the issues, both factually and legally.

THE EVIDENCE

¶ 3 The Notice of Hearing contained a number of factual statements which were admitted by the Respondent. They were, in part, as follows:

"A. Registration History

3. Questrade became a member firm of the IDA on April 12, 2001 under the name Questrade Capital Group Ltd. The firm subsequently changed its name to Questrade and has operated as such until present.

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

5. Questrade carries on business as a type 4 introducing broker, and is engaged in three main lines of business:

   i. Proprietary trading;

   ii. On-line discount trading; and

   iii. On-line FX trading.

B. The Regulatory Regime

6. IDA By-law 17.11 (now IIROC Dealer Member Rule 17.11) provides that every Member shall obtain from clients and maintain in respect of its own account such minimum margin in such amount and in accordance with such requirements as the Board of Directors may from time to time by Regulation prescribe. Such minimum margin shall be used for calculations pursuant to Form 1.

7. Form 1 is the Joint Regulatory Financial Questionnaire and Report and is commonly referred to as "the Q". It is a mandatory report that is utilized by Financial Compliance Staff to monitor the financial status of all Firms with financial reporting obligations.

9. IDA Regulation 100.2 (now IIROC Dealer Member Rule 100.2) deals, generally, with margin requirements and prescribes certain calculations which are to be utilized in various sets of circumstances.

10. Specifically, IDA Regulation 100.2(d) (now IIROC Dealer Member Rule 100.2(d)) deals with the margining of unhedged foreign exchange positions of a Member firm or Dealer Member.

12. The purpose behind the setting of margin requirements and prescribing rates to particular financial products is to reflect the assessment of regulatory Financial Compliance Staff ("FC Staff") of the inherent riskiness of that particular product. Margin is a charge against a firm's financial statement capital and is utilized in the calculation of Risk Adjusted Capital ("RAC"). RAC, in turn, is measured to ensure the financial stability of firms and to prevent capital deficiencies or claims against the Canadian Investor Protection Fund ("CIPF").

C. Questrade's Online FX Business

13. In or about May 2004, Questrade contacted representatives of IDA's FC Staff and advised that it was contemplating the introduction of Online FX trading.

14. Between May 2004 and May 2005 FC Staff and members of the IDA's Sales Compliance Staff ("SC Staff") had various discussions with representatives from Questrade regarding its proposed

offering of Online FX contracts to retail clients.

17. Questrade offers two types of FX online trading accounts:

    1. the Standard Account; and
    2. the Mini Account.

    The minimum trading size for both a Standard Account and a Mini Account is one lot. In the case of a Standard Account, one lot is equal to 100,000 units of base currency. The lot for a Mini Account is equal to 10,000 units of base currency."

¶ 4 On some of the facts, the parties differed only slightly and in a manner which was not relevant to our ultimate determination of the issues. For example, Staff alleged that "within either a Standard or Mini Account, a client can trade 18 different currency pairs (i.e. CDN/US, EUR/US, GBP/US)." Questrade countered that it currently offers 37 different currency pairs but accepted the remainder of the statement.

¶ 5 Staff also alleged that "approximately 85% of Questrade's clients' daily transactions are in contracts that involve the seven currency pairs that comprise "the majors" (U.S. dollars, Canadian dollars, Australian dollars, British Pounds, Swiss Francs, Japanese Yen and Euros). As these currencies are the most widely traded, they are considered to be the most liquid. The U.S. dollar is the standard base currency for the majority of Online FX transactions." The Respondent's only disagreement with these statements was that "the percentage of transactions in "the majors" varies."

¶ 6 There were some areas where there was genuine disagreement between the parties. Largely, however, the disagreement was over the meaning or interpretation of events or documents not over their existence. We have considered, at length, the evidence and the submissions of the parties both as to the facts, as well as to the legal conclusions flowing from these facts. What follows is our analysis and conclusions.

¶ 7 Online Forex or FX contracts allow investors to speculate on underlying currency movements, without the need of ownership and physical settlement of the underlying currency. If an individual wants to speculate that a given currency is going to rise, rather than purchasing or holding the currency, he or she can enter into a contract that gives them exposure to that currency's appreciation, which could result in a capital gain. If, on the other hand, an individual believes that a given currency is going to drop, he or she may short-sell that currency.

¶ 8 The FX market is speculative. The Respondent described it as "the largest speculative market in the world."

¶ 9 The Respondent contacted Staff, via e-mail on May 5, 2004, and advised that it was contemplating adding Online FX trading as another service for its clients.

¶ 10 To Staff, the type of business being proposed by Questrade was, at the time, a new and complex financial product. Accordingly, it, correctly in our view, commenced an assessment of both the risk characteristics, as well as the intricacies, of this proposed new financial product.

¶ 11 The evidence is clear that the Respondent was forthcoming in providing both information and documentation to Staff relating to the proposed product.

¶ 12 The communications between Questrade and Staff, in the June to December 2004 period, generally dealt with a series of operational issues concerning the FX business. However, there was a November 24, 2004, e-mail from the Respondent to Staff referring to the alleged margining practices of Refco FX Canada, which the Respondent states "essentially means maximum 200:1 leverage." (Exhibit 2a – Tab 9)

¶ 13 Between December of 2004 and February of 2005, the parties discussed whether Online FX trading constituted a "security" and was, therefore, permitted in Member Firms and was regulated by the IDA.

¶ 14 Throughout, Questrade took the firm position that FX contracts are securities and that, consequently, regulation is a requirement.

¶ 15 By e-mail, dated February 24, 2005 (Exhibit 2a – Tab 17), the IDA advised the Respondent that it had

obtained a legal opinion, which concluded that the FX products being discussed were, in fact, securities. The legal opinion was marked before us as Exhibit 2 – Tab 56.

¶ 16 The February 24, 2005, e-mail further advised Questrade that the IDA was "moving ahead to discuss internally margin rules and other related sales compliance issues."

¶ 17 In December of 2004, Questrade had advised the IDA that it intended to launch its business prior to obtaining IDA approval. It stated that it had a proposal for margin which it felt "adequately reflects the risk with the IDA By-laws and Regulations." (Exhibit 2a – Tab 14 – pages 59-60)

¶ 18 The IDA immediately advised Questrade: "Do not go ahead with the FX trading until you have explicit approval, in writing, from IDA Member Regulation." (Exhibit 2a – Tab 14 – page 61). Despite this warning, Questrade commenced FX trading.

¶ 19 On the issue of margin, the IDA advised that it required time to study the matter from a policy perspective as to how the existing margin rules apply. It stated that it was "inappropriate" for Questrade "to make up rules that you feel "reflect" the risk on a unilateral basis." (Exhibit 2a – Tab 14 – page 59)

¶ 20 Between January and March of 2005, there were a series of discussions and communications between Questrade and Staff regarding the proper application of margin.

¶ 21 On May 12, 2005, the IDA issued Member Regulation Notice ("MR Notice") 0351, entitled "Margin treatment of unhedged foreign exchange positions held in customer accounts." (Exhibit 2a – Tab 59 – pages 302 – 305). At the Hearing, as well as in the subsequent Written and Oral Submissions, there was considerable discussion of MR Notice 0351 and its appropriate applicability to Questrade.

¶ 22 On May 25, 2005, in response to a specific request from Staff, Questrade advised the IDA that it had been applying margin, as per MR Notice 0351, since January of 2005.

¶ 23 In July of 2005, IDA Staff commenced its 2005 Field Examination of Questrade. A copy of the Field Examination was sent to Questrade by letter, dated January 17, 2006. No "findings" were made in this report regarding client account margin. (Exhibit 2a – Tab 26 – pages 130 – 146)

¶ 24 A "finding" is a regulatory issue, which requires a written response from a Member Firm with a timetable for correcting the alleged regulatory deficiency noted in the finding.

¶ 25 In May 2006, Staff commenced its 2006 Field Examination of Questrade. This Field Examination noted Questrade's treatment of client account margin. (Exhibit 2a – Tab 28 – page 150)

¶ 26 By letter, dated December 15, 2006, a copy of this Field Examination Report was conveyed to Questrade and a "finding" was made as to "Online FX Client Margin" as follows:

> "We discovered that clients trading Online FX contracts at the firm are extended leverage up to 200 times their account equity. This practice is not in compliance with regulatory minimum margin requirements on FX positions held by clients.
>
> The IDA regulatory FX margin requirements are explained in Member Regulation Notice MR 0351 dated May 12, 2005 – "Margin treatment of unhedged foreign exchange positions held in customer accounts". This resulted in the member firm setting "house" margin rates that were substantially lower than the IDA minimum prescribed margin rates.
>
> As a result, client positions were found to be under margined based on regulatory FX margin rates for which the member firm provided for client margin out of its own capital. This is unacceptable on the basis that IDA rules do not permit client accounts to trade while under-margined. The client accounts must be appropriately margined or otherwise restricted from further trading except for liquidating trades to reduce the margin deficiency in the account.

We require that Online FX customer trading comply with IDA margin requirements." (Exhibit 2a – Tab 32 – pages 162 – 163)

¶ 27 By an e-mail, dated December 19, 2006, Questrade acknowledged that it had received the "finding". (Exhibit 2a – Tab 33 – page 64)

¶ 28 In our view, it is from this point in December of 2006 that we should consider whether the Allegations set out in the Notice of Hearing have been established. It is at this point that the regulatory Staff advised the Respondent not to engage in certain types of conduct.

¶ 29 The issue for determination is whether, after this date, the Respondent engaged in this conduct and, if so, whether it was entitled to do so.

¶ 30 By letter, dated January 15, 2007 (Exhibit 2a – Tab 34 – pages 167A, B & C), the Respondent wrote to Paul Bourque, Senior Vice President, Market Regulation of the IDA, *inter alia*, describing some of its then current practices and outlining its position with respect to the requests of the IDA concerning the margining of client accounts.

¶ 31 The letter stated, in part, as follows:

> "OTHER FINDINGS
>
> Online FX Client Margin
>
> Questrade has always diligently followed the IDA rules and regulations and wish (sic) to continue to be compliant in the case of forex spot trading . . .
>
> In response to the IDA's finding that Questrade should not offer 200:1 leverage to clients, (emphasis added) we wish to discuss two issues, the current state of the regulatory regime and the current state of the business environment.
>
> Regulatory Regime
>
> The audit letter first refers to regulation MR0351 which sets the margin rate for currency pairs. (emphasis added) Questrade calculates margin on all client accounts held overnight based on MR0351 and reduce our risk adjusted capital for deficiencies. We wish to note that MR0351 does not address any requirement for a client to have sufficient funds in his or her account prior to placing a trade . . .
>
> Business Environment
>
> We believe that unless Questrade can offer 200:1 leverage, we will not be able to compete with the unlicensed American firms. While other member firms may have no issue with complying, many of our competitors have U.S. affiliates where their Canadian clients can open accounts. Questrade has no such luxury.
>
> Conclusion
>
> Questrade wants to remain a compliant firm and we are willing to sit down with senior IDA personnel and discuss how to proceed with this issue. We understand that margin rates as set out in MR0351 are designed to represent the risk inherent in the foreign exchange spot trading business. We believe that the capital charges assessed on overnight positions, based on the margin rates, help ensure the viability of our business by restricting the overall exposure the firm has to any particular currency.
>
> However, we do not agree that the general public interest is best served by restricting members from offering 200:1 leverage when a Canadian resident can easily switch their account to an unlicensed American firm via the internet."

¶ 32 From this letter, it appears clear that in January of 2007, Questrade was offering clients 200:1 leverage

and was not collecting margin from clients but was instead reducing its risk adjusted capital for any margin deficiencies.

¶ 33 Mr. Bourque, of the IDA, immediately responded to the Questrade letter by letter, dated January 23, 2007, addressed to Edward Kholodenko, the Questrade Chief Executive Officer. A copy of his letter was filed before us. (Exhibit 2a – Tab 37 – pages 173 – 174)

¶ 34 In this letter, Mr. Bourque stated, in part, as follows:

> ". . . , I want to reiterate our position that the regulatory FX margin rates set out in MR0351 provide for the margin application for FX spot trading. Until any proposed changes to the FX margin rates are approved by the FAS, the IDA Board, the CSA and implemented for all IDA member firms, we cannot permit any margin application that sets "house margin" rates that are lower than prescribed IDA regulatory margin rates. Any member proposal to amend those minimum rates must follow a committee process.
>
> The current IDA requirement does not require the collection of minimum margin prior to executing a trade. However, a firm must collect the initial margin requirement in accordance with our minimum margin requirements, irrespective of whether the position is ultimately closed out prior to collection of the margin. If not, the client would be "free riding". This practice is contrary to By-law 29.1.
>
> In respect to the business environment issue, we acknowledge the fact that there are unlicensed entities operating in Ontario that do not have the same leverage restrictions that apply to an investment dealer. We have advised the OSC of this matter and provided them with a legal opinion to support FX spot trading as a security. To my knowledge, the OSC has taken no action to require the registration of these entities.
>
> Given the commercial and competitive aspects of FX spot trading business operating in Ontario and other provinces I recommend you ask the Investment Industry Association of Canada to review this issue on behalf of the industry."

¶ 35 Questrade then requested an opportunity to meet with IDA Staff to discuss various outstanding issues. This meeting occurred on February 9, 2007.

¶ 36 Subsequent to the meeting, the parties exchanged correspondence, in which they outlined what each felt had been discussed at the meeting. (Exhibit 2a – Tab 41 – pages 181 – 182)

¶ 37 Questrade agreed to review its OTC spot FX contract specifications as it acknowledged that the contracts did not call for "actual settlement in accordance with IDA rules, which require that margin from the client is due on settlement date."

¶ 38 At the February 9, 2007, meeting, the IDA "requested a timeline for when Questrade would comply with, amending all advertising to feature regulatory minimum margin rates and make all efforts to obtain regulatory minimum margin requirements from clients by end of settlement date." The IDA advised the Respondent that it assumed that settlement date was the same as trade date until the settlement date could be demonstrated to be otherwise.

¶ 39 The IDA's confirmatory letter of February 28, 2007, reiterated its request for a timeline for compliance with "regulatory minimum margin rates and requirements."

¶ 40 On or about March 7, 2007, IDA Financial Compliance Staff put all firms that offer Online FX contracts on notice that:

(i) they must amend all advertising to feature regulatory minimum margin rates; and

(ii) they must obtain regulatory minimum margin on trade date and margin calls should be made and collected promptly if margin drops below regulatory margin rates.

¶ 41 On March 8, 2007, Ciro Mirabella, Senior Manager, Financial Compliance, wrote to Dean Percy, the Chief Financial Officer of the Respondent, on the subject of Online FX Service Providers. He pointed out what IDA Members must do in terms of margin requirements when they deal with Online FX Service Providers that do not qualify as Regulated Entities or Acceptable Counterparties. (Exhibit 6)

¶ 42 On March 20, 2007, Mr. Percy provided a draft response to Mr. Mirabella's letter of March 8, 2007, his e-mail of February 28, 2007, as well as Mr. Bourgue's letter of January 23, 2007. In a covering e-mail, Mr. Percy advised Mr. Mirabella that "Questrade wishes always to be compliant with IDA rules and regulations. However, the revised requirements will be so detrimental that if fully implemented as proposed, we will effectively have to shut down the business." (Exhibit 2a – Tab 43 – pages 187 – 191)

¶ 43 The draft letter provides a background, an analysis of what it states are the "revised compliance requirements" and why it disagrees with same. The letter concludes by stating that: "If the IDA still considers that Questrade is not in compliance with the current rules and regulations, we respectively request written explanations to the following questions together with specific references to the IDA Rule Book."

¶ 44 On March 29, 2007, Louis Piergeti, Vice President, Financial Compliance at the IDA, responded to Mr. Percy's draft letter stating, *inter alia*, as follows:

> "As you can appreciate FX spot trading is a unique business line that has been introduced into the operations of certain IDA member firms without much advance IDA scrutiny.
>
> In the absence of specific product rules, our regulatory approach is to find product analogies to help guide our regulatory decision given to member firms on the application of IDA rules. Where there are rule deficiencies in need of change, we have an industry committee process with member firm representation in which changes are requested, studied by IDA staff, recommendations made, approved by the IDA Board and implemented following publication for public comment and CSA approval.
>
> To require specific response to your questions targeted at exploring the IDA application of traditional security "settlement" rules and debate their applicability to FX spot or CFDs (Contracts for Differences) is not constructive or appropriate. We both know that these products do NOT fit the traditional settlement date rules created for equities and bonds.
>
> Instead, my approach is to acknowledge the uniqueness of FX spot and CFDs as different from equities and bonds – with some similarity to futures contracts. The basic fact that there will never be any intention by either party to the contract to settle with delivery of the underlying security or currency makes them different than equities and bonds and requires us to establish regulatory guidance as to how to apply existing IDA rules to them.
>
> **To summarize, we have not in any way changed our fundamental position as previously communicated to you in applying IDA minimum FX margin rates for open FX customer positions, and requiring the collection of margin deposits from clients upon entering into FX contracts, including the prompt collection of margin calls, as required, in the event of adverse market movements.**
>
> **Please consider this e-mail as my response to Mr. Percy's letter and take it under "advisement".."** (Exhibit 2a – Tab 50 – pages 231 – 232)

¶ 45 On April 5, 2007, Edward Kholodenko responded to Mr. Piergeti's e-mail of March 29, 2007, stating, in part:

> "In response to your e-mail below we do not want to seem that we are argumentative or difficult. We feel as though the IDA, through sheer will and its power as a regulator is trying to force a decision on us that is unjust and not

rooted in the IDA Rules and Regulations."

Mr. Kholodenko then proceeded to set out Questrade's position in detail with numerous references to the IDA position as outlined in Mr. Piergeti's e-mail.

Mr. Kholodenko ended his e-mail as follows:

> "Questrade has been threatened with an enforcement action and as a consequence we have the right to argue and defend ourselves, our business and livelihoods from, in our opinion, an unjust approach to regulation.
>
> We look forward to an amicable resolution of these issues." (Exhibit 2a – Tab 50 – pages 228 – 231)

¶ 46 On April 6, 2007, Mr. Piergeti responded to Mr. Kholodenko, in part, as follows:

> "The application of collection of margin deposits from the client as previously communicated to you has not, and will not change.
>
> It is obvious that we are at a stalemate where you agree to disagree with our regulatory position on a go forward basis. At this point, IDA Compliance is left with no option but to refer this matter to the Investigative and Enforcement process for case assessment. This is the only alternative mechanism left for Compliance to deal with this matter." (Exhibit 2a – Tab 50 – page 228)

¶ 47 On April 24, 2007, the Investment Industry Association of Canada ("IIAC") wrote to the IDA and the Ontario Securities Commission advising that they had been approached by a number of member representatives who expressed concerns "with respect to margin rates that the IDA requires be imposed on clients in the case of spot foreign exchange (FX) trading." (Exhibit 2a – Tab 53)

¶ 48 It is interesting to note that the approach of the IIAC was not that the IDA was improperly imposing margin rates on the firms but that its capital rules placed IDA firms at a significant disadvantage to unregistered foreign and domestic non-IDA-regulated firms that facilitate spot FX transactions but are subject to considerably lower margin rates than IDA-regulated firms.

¶ 49 The IIAC submitted a request for an amendment to Regulation 100.2(d)(iv) to make it consistent with the requirements on unregistered foreign and non-IDA-regulated firms for similar foreign currency trading/FX spot contracts.

¶ 50 By the time of the Hearing before us, the Respondent was the only IDA member firm not complying with the request of the IDA regarding margin rates on FX spot contracts.

ISSUES

¶ 51 During the course of the oral portion of the Hearing, as well as in the subsequent written argument, there were a large number of issues argued before us. In our view, a number of these issues were not before us for determination.

¶ 52 The Notice of Hearing states that "the purpose of the Hearing is to determine whether Questrade has committed the following contraventions that are alleged by the Staff of IIROC."

¶ 53 There then follows two allegations, each of which have both a factual and legal component. The issues for determination, as we see it, are the following:

A. From December 2006 to the "present", which we take to be December 9, 2008, the date the Notice of Hearing was issued, did Questrade advertise margin rates below those prescribed by IDA and IIROC minimum standards, despite being advised by regulatory Staff not to do so?

B. Included in the first issue is the legal question of whether, in the circumstances of this case, there were any properly "prescribed" minimum standards.

C. Assuming that issues A and B are decided in favour of IIROC, does this conduct constitute engaging in "business conduct unbecoming a Member Firm or Dealer Member contrary to IDA By-law 29.1 and Dealer Member Rule 29.1"?

D. From December 2006 to December 9, 2008, did Questrade fail to obtain required margin from its clients despite being advised by regulatory Staff to do so?

E. Included in the fourth issue is the legal question of whether, in the circumstances of this case, was any margin "required" to be obtained from clients.

F. Assuming that issues D and E are decided in favour of IIROC, does this conduct constitute engaging in "business conduct unbecoming a Member Firm or Dealer Member contrary to Association By-law 29.1 and Dealer Member Rule 29.1"?

DECISION

¶ 54 The Respondent did not take issue with the assertion, made by Staff, that, during the relevant period of time, it advertised margin rates with guaranteed leverage of "100:1 – 1% margin" on its Standard Accounts and "200:1 – 0.5% margin" for its FX Mini Accounts. Its argument was, rather, that it was entitled to do so and, inferentially, should this Hearing Panel conclude that it was not so entitled, it did not engage in "conduct unbecoming" because of its history of open and honest dealings with Staff.

¶ 55 Exhibit 2a – Volume 2 – Tab 65 was identified in cross-examination by Dean Percy, the Chief Financial Officer of Questrade, as being a copy of a printout from the Questrade website. (Transcript pages 474 – line 13 and following)

¶ 56 This website clearly advertises "initial margin requirements" or leverage as being 100:1 or 1% of the U.S. Dollar ("USD") trade value on standard accounts and 200:1 or 0.5% of the USD trade value on mini accounts.

¶ 57 An explanatory note provides that:

> "Margin is the US dollar down payment you must deposit with Questrade in order to trade a larger sum of currency. For example, if you would like [to] buy 10,000 USD/JPY in your mini account, you must have $50 USD in your account (10,000 x 0.005). Multiply your account balance by the leverage ratio and you get the account's total USD buying power. For example, a deposit of $250 USD will give you the power to control up to $50,000 USD . . ."

¶ 58 Mr. Percy indicated that, over time, the website has acquired more detail but that it, at the date of the Hearing, still advertised margin rates with leverage of 200:1. (Transcript – pages 476 – 477, line 3)

¶ 59 By letter, dated December 15, 2006, the IDA forwarded to the Respondent a copy of the 2006 Field Examination Report (see Exhibit 2a – Tab 32, page 163) which documented the 200:1 leverage and advised that "this practice is not in compliance with regulatory minimum margin requirements on FX positions held by clients."

¶ 60 Despite a request by Staff that "online FX customer trading comply with IDA margin requirements", Questrade continued to advertise the 200:1 leverage rates on the basis that it felt that it was entitled to do so.

¶ 61 Thus, in our view, the factual elements of issue A have been clearly established.

¶ 62 Likewise, Questrade did not take issue with the assertion by Staff that, during the relevant period of time, it did not make efforts to collect from its clients the amount of margin which the IDA advised that it was required to do, again on the basis that it disagreed with Staff's interpretation of the requirements.

¶ 63 The process followed by the Respondent was to determine, on a daily basis, the margin requirement for each FX client position in accordance with IDA Member Regulation MR0351 – Regulation 100.2(d). The margin requirement for each client was then summed up and compared to the balance of the client's account to

determine if the account was undermargined.

¶ 64 If the account was undermargined, Questrade provided, out of its own firm capital, the difference necessary to meet the minimum regulatory requirements. There was no attempt to collect the undermargined amount from the client. Instead, the firm took a "hit" on its Risk Adjusted Capital.

¶ 65 In cross-examination (Transcript – page 472, line 2, to page 474, line 8), Mr. Percy agreed that this was a correct description of the process followed by the Respondent.

¶ 66 The Respondent was aware, as early as December 15, 2006, that the IDA disagreed with this practice. In addition, in the letter of January 23, 2007, from the IDA (see Exhibit 2a – Tab 37 – page 173), Questrade was advised that "a firm must collect the initial margin requirements in accordance with [the IDA's] minimum margin requirements, irrespective of whether the position is ultimately closed out prior to collection of the margin. If not, the client would be "free riding". This practice is contrary to By-law 29.1."

¶ 67 The Respondent did not agree with the position taken by Staff and thus, throughout the relevant period of time, continued its practice of not collecting from clients the amount of margin which the IDA insisted was required.

¶ 68 Thus, in our view, the factual elements of issue D, as set out in paragraph 53, have been clearly established.

¶ 69 We now turn to one of the issues what was contested between the parties – namely whether, in the circumstances of this case, there were any properly "prescribed" minimum standards.

¶ 70 Pursuant to paragraph "c" of its Recognition Order, IIROC was required to "establish, administer and monitor its rules, policies and other similar instruments (Rules)." Paragraph "d" of the same Order required it to "enforce compliance with its Rules by Dealer Members and others subject to its jurisdiction."

¶ 71 Before the creation of IIROC on June 1, 2008, the IDA had a similar mandate.

¶ 72 IIROC Transition Rule No. 1.2 adopted as Rules those "regulatory By-laws, Regulations, Forms and Policies" of the IDA that were in force and effective immediately prior to June 1, 2008. Transition Rule No. 1.2.3 adopted "all regulatory notices, bulletins, directives and guidance provided by the IDA to IDA Regulated Persons in force and effect immediately prior to June 1, 2008."

¶ 73 As Questrade became a member firm of the IDA on April 12, 2001, and a regulated person of IIROC on June 1, 2008, there is no doubt that it was, at all material times, subject to the applicable By-laws and Rules of both the IDA and IIROC.

¶ 74 The argument of Staff was that the regulatory regime prescribing minimum margin requirements for unhedged foreign exchange positions, which Staff submitted included Online FX transactions, is set out in three interrelated provisions: By-law 17.11, Regulation 100.2(d) and Form I.

¶ 75 IIROC Dealer Member Rule 17.11 provides that:

> "Every Dealer Member shall obtain from clients and maintain in respect of its own account such minimum margin in such amount and in accordance with such requirements as the Board of Directors may from time to time by Regulation prescribe. Such minimum margin shall be used for calculations pursuant to Form I."

¶ 76 The Form I referred to in the Rules, is the Joint Regulatory Financial Questionnaire and Report ("J.R.F.Q.R."), which Questrade and all other Member Firms were required to complete and file on a regular basis.

¶ 77 Dealer Member Regulation 100.2(d) deals with unhedged foreign exchange. It states, in part, that:

> ". . . unhedged foreign exchange positions of a Dealer Member or customer of a Dealer Member shall be margined in accordance with this Regulation 100.2(d). Foreign

exchange positions are monetary assets and liabilities (as defined) and shall include currency spot transactions, futures and forward contracts, swaps and any other transaction which results in exposure to foreign exchange rate risk." (emphasis added).

¶ 78 In our view, it is clear that Regulation 100.2(d) applies to Online FX transactions, such as being conducted by the Respondent. It would appear that the Respondent would agree as to its applicability as it argued that Regulation 100.2(d)(iv) excluded margin requirements for cash balances, but did not contemplate offering equity/debt security positions via a real time online trading platform such as the one Questrade was offering.

¶ 79 Questrade's argument for the exclusion of margin requirements on "cash balances" in Regulation 100.2(d)(iv) is based on its interpretation of Regulation 100.2(d)(iv)(c), which provides, in part, as follows: "The margin required in respect of foreign exchange positions (excluding cash position) held in the accounts of customers who are classified as other counterparties . . . " (emphasis added) which are denominated in a currency other than the currency of account, shall be calculated according to a formula set out in the subsection. In our view, a proper reading of this provision is not that no margin is required in respect of cash balances, as contended by Questrade, but rather that the required margin, if any, is calculated in the normal fashion and not as set out, for the security portion of the account, in the remainder of the subsection.

¶ 80 Regulation 100.2(d)(i) sets out the specific margin rates of unhedged foreign exchange positions based on four currency groups that are defined in subsection (v).

¶ 81 Regulation 100.2(d)(iv) mandates that "unhedged foreign exchange positions of customers shall be margined in accordance with Regulations 100.2(d)(i), (ii) and (v) . . ."

¶ 82 Note 1 of Schedule 4 of the J.R.F.Q.R. states, in part, that, "Each firm shall obtain from clients . . . such minimum margin in such amount and in accordance with such requirements as prescribed by the Joint Regulatory Bodies." The Joint Regulatory Bodies are defined as the three Canadian Stock Exchanges and the IDA.

¶ 83 In our view, if, in fact, there is a positive requirement to collect margin from clients, that requirement cannot be met by the Member Firm taking a capital charge against its Risk Adjusted Capital.

¶ 84 On May 12, 2005, the IDA released Member Regulation Notice 0351. This Notice references Regulation 100.2(d)(iv) and stated that it was intended "to provide further guidance on the margin treatment of foreign exchange positions held in customer accounts."

¶ 85 In our view, this Notice was issued to assist Members in the interpretation, application of and compliance with already existing Rules. It did not create a new Rule.

¶ 86 Louis Piergeti, currently the Vice-President of Financial and Operations in Business Conduct at IIROC, testified that Regulation 100.2(d) originally had margin rates across the board of 5% for unhedged foreign exchange positions. He testified that the industry did not find that rate to be acceptable on the basis that different currencies have different volatilities and different foreign exchange restrictions. Thus, studies were done and the rates were adjusted. (Transcript – page 172)

¶ 87 Mr. Piergeti also noted that the rules were originally intended to deal only with sophisticated investors, institutions, regulated entities and banks. He testified that, to the extent that retail customers were involved in foreign exchange, it was for the purpose of hedging their positions. (Transcript – page 173)

¶ 88 Mr. Piergeti advised that MR0351 was issued, in part, to confirm that Regulation 100.2(d) did apply to retail clients. (Transcript – page 173)

¶ 89 MR0351 stated clearly that "all foreign exchange positions in a customer account other than cash positions are subject to a margin requirement."

¶ 90 Much was made by the Respondent at the Hearing and in its written submissions of Note 2 at the end of this Member Regulation Notice, which stated that:

> ". . . the positions created as a result of entering into spot foreign exchange contracts are an example of foreign exchange positions that do not have a margin requirement."

¶ 91 In cross-examination, Ciro Mirabella, the current Director of Financial Compliance at IIROC, testified that the purpose of this Note is to indicate that foreign exchange contracts do not have margin requirements "elsewhere" but that the margin requirements are defined in Regulation 100.2(d). (Transcript – pages 116-117)

¶ 92 We accept the sworn testimony of Mr. Mirabella, whose credentials and expertise were never questioned. We suggest, however, that a clarification of this Note might be considered.

¶ 93 The lowest margin rate found in Rules 100.2(d)(i), (ii) and (v) for unhedged foreign exchange positions is 1%. That is for a Group I currency, which we were advised is the US Dollar. There is no permissible 0.5% client margin rate or a leverage of 200:1.

¶ 94 Therefore, we are unanimously of the view that Questrade advertised margin rates, which were below the minimum regulatory requirements, despite being advised by regulatory Staff not to do so.

¶ 95 We find issue B in favour of Staff.

¶ 96 With respect to issue E, we are also unanimously of the view that Questrade was under a positive obligation to collect margin from clients.

¶ 97 Dean Percy, the Chief Financial Officer of Questrade, testified that no attempts were made to collect margin from clients (Transcript – page 474). The firm simply took a capital charge against their Risk Adjusted Capital.

¶ 98 The Rules are clear that margin must be collected from clients. While there may be no requirement to collect initial margin, a Member Firm cannot engage in a practice of never collecting margin or even making an attempt to do so.

¶ 99 Therefore, issue E is found in favour of Staff as well.

¶ 100 There were a number of issues raised by Questrade during the course of the Hearing and in its written submissions, which we do not need to consider at length, in light of our findings and analysis.

¶ 101 Questrade argues that, as there is no true settlement date in an Online FX transaction, there is no requirement to collect margin. However, Questrade did advertise margin rates, albeit ones below the statutory minimum. Questrade also calculated margin requirements from its client accounts and, instead of collecting, it took a charge against its Risk Adjusted Capital. It seems clear that Questrade, at all times, was aware that there was a margin requirement with respect to client accounts.

¶ 102 Questrade argued forcefully and repeatedly that there must be a level playing field in order for it to compete successfully in the Online FX marketplace with other unregulated entities. This argument presupposes rules, the application of which put Questrade at a competitive disadvantage.

¶ 103 It may well be that there should be changes to the existing Rules and/or enforcement proceedings taken against the unregulated entities. These are not matters before us for consideration. In any event, they do not justify the Respondent failing to comply with the existing Rules.

¶ 104 Likewise, Questrade's stated preference for the rules of the National Futures Association, in preference to those of the IDA or IIROC, does not constitute a justification for their actions.

¶ 105 It is the regulator which formulates the Rules which must be followed. If a Member Firm prefers the rules of a different regime, it should lobby for change. It does not have the option of ignoring the Rules of its regulator because it believes that different rules or rates are preferable.

¶ 106 Also, the failure of the 2005 Field Examination to making a "finding" with respect to the margin issue cannot be a justification for the failure of Questrade to comply with the regulatory requirements after being given specific notice to do so in December of 2006. As noted in paragraphs 26-28 (*supra*), we have considered

the Allegations against Questrade starting on December 19, 2006, when it acknowledged that it had received the letter from the IDA of December 15, 2006, enclosing a copy of the 2006 Field Examination Report and specifically requiring the Respondent to comply with the IDA minimum prescribed margin requirements.

¶ 107 Finally, our findings make it unnecessary for us to consider the "estoppel" request of Questrade, set out in its written argument. In any event, we have grave doubts that this Hearing Panel has any equitable jurisdiction to grant an equitable remedy even if we were inclined to do so, which we are not.

¶ 108 The final question for consideration is whether the conduct, which we have found to have been established, on the part of the Respondent, constitutes "business conduct unbecoming" as that term is used in IDA By-law 29.1 and Dealer Member Rule 29.1.

¶ 109 Member Rule 29.1 provides, in part, as follows:

> "Dealer Members and each partner, Director, Officer, Supervisor, Registered Representative, Investment Representative and 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 prescribed by the Board."

¶ 110 Questrade argues that IIROC Staff has failed to demonstrate that the Respondent acted contrary to Rule 29.1. Its arguments are threefold:

1. There is no evidence that Questrade caused a detriment to the public interest.
2. There was no detriment to its clients.
3. There was no detriment to its solvency.

¶ 111 In our view, the continuing refusal of Questrade over the two year period of the Allegations to comply with the published Rules of its regulatory body is contrary to the public interest. The public has a legitimate expectation that the Members of a regulatory regime will obey the published rules and regulations.

¶ 112 Up to the middle of December of 2006, there was a vigorous and healthy discussion between Questrade and its regulator as to the appropriate margin treatment for the Respondent's new and innovative product. This type of interaction is to be encouraged.

¶ 113 However, when the Respondent was told in December of 2006 to cease its then current practices with respect to the advertised margin rates and the non-collection of margin from clients, it made a deliberate decision to ignore these requests.

¶ 114 The actions of the Respondent were not negligent. They were deliberate.

¶ 115 Other IIROC Members chose to follow the Rules and work through the IIAC, their industry Association, to seek modification or amelioration of the Rules. The Respondent chose a different course.

¶ 116 The fact that there was, apparently, no harm to clients or to the firm's solvency, is not determinative of the issue as to whether the conduct in question was "unbecoming" under Rule 29.1

¶ 117 In our view, the conduct was "unbecoming" and constituted a wide divergence from the conduct which would reasonably be expected of a Member of the IDA or IIROC.

¶ 118 Without Rules, a regulatory organization cannot protect the public interest. When Rules are promulgated and published, they are to be followed. A deliberate refusal to follow the Rules, in the circumstances of this case, constitutes conduct unbecoming.

¶ 119 We find that Allegations 1 and 2 in the Notice of Hearing have been established.

DATED as of the 6th day of November, 2009.
Thomas J. Lockwood, Q.C., Chair
David W. Kerr, Industry Representative
Guenther W. K. Kleberg, Industry Representative