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.

2010 IIROC 17

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

Heard: January 7, 2010
Decision: April 13, 2010
(47 paras.)

Hearing Panel:
Thomas J. Lockwood, Q.C., Chair
David W. Kerr
Guenther W. K. Kleberg

Appearances:
Andrew Werbowski & Charles Corlett, for IIROC
Robert Brush & Clarke Tedesco, for Questrade Inc.

PENALTY DECISION

A. INTRODUCTION

¶ 1 In our Reasons for Decision of November 6, 2009, we found that:

(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 We found that this conduct was deliberate.

¶ 3 On January 7, 2010, we convened a Penalty Hearing in Toronto, at which time, we received into evidence, the following:

(a) an Affidavit of Edward Kholodenko, sworn January 7, 2010, outlining steps taken by the Respondent after receipt of the Reasons for Decision.

(b) an Affidavit of Ricki Newmarch, sworn January 6, 2010, attaching a Bill of Costs in the amount of $73,162, along with an electronic Time Report, setting out both the hourly rates and the time spent by various members of the IIROC Staff with respect to the investigation and prosecution of this matter.

¶ 4 The Respondent objected to the late delivery of this Bill of Costs and the related material. The Respondent, however, provided fulsome written submissions with respect to the issue of costs and declined an offer by the Hearing Panel for additional time.

¶ 5 Both parties filed extensive written submissions and Books of Authorities. They also each made lengthy oral submissions on January 7, 2010. The Hearing Panel is indebted to the parties for the thoroughness of their preparation and the professional nature of their presentations.

B. GENERAL PRINCIPLES

¶ 6 The parties did not differ markedly on the principles which were to guide us in determining the appropriate penalty to be imposed upon the Respondent. They did differ, however, on what the outcome should be when these principles were applied to the facts as found by the Hearing Panel.

¶ 7 It is clear that a Hearing Panel's main concerns in determining an appropriate sanction are:

(a) Protection of the investing public;

(b) Protection of IIROC's membership;

(c) Protection of the integrity of the IIROC process;

(d) Protection of the integrity of the securities markets; and

(e) Prevention of a repetition of conduct of the type under consideration.

Re Derivative Services Inc., [2000] I.D.A.C.D. No. 26.

¶ 8 A Hearing Panel should also consider both general and specific deterrence, although the Respondent argued that general deterrence should not be used as an independent basis for increasing the penalty. The parties did, however, agree that general deterrence can be achieved if a sanction strikes the appropriate balance by addressing a registrant's specific misconduct, but is also in line with industry expectations.

¶ 9 As was stated by the Hearing Panel in *Re Mills*:

> "Industry expectations and understandings are particularly relevant to general deterrence. If a penalty is less than industry understandings would lead its Members to expect for conduct under consideration, it may undermine the goals of the Association's disciplinary process: similarly, excessive penalties may reduce respect for the process and concomitantly diminish its deterrent effect. Thus the responsibility of the District Council in a penalty hearing is to determine a penalty appropriate to the conduct and respondent before it, reflecting that its primary purpose is prevention rather than punishment."

Re Mills, [2001] I.D.A.C.D. No. 7, at para. 6

¶ 10 There was also disagreement between the parties as to what weight, if any, should be given to the "Disciplinary Sanction Guidelines". This is a Staff-generated document which, while clearly not binding on us,

could be used, in a normal circumstance, to secure a sense of industry expectation. Of more relevance would have been any previous IDA/IIROC disciplinary Decisions. However, the parties agreed that there are no previous Decisions on point and that this, ultimately, is a case of "first principles" in the regulatory environment.

C. SUBMISSIONS OF THE PARTIES

1. Staff's Position:

¶ 11 IIROC Staff sought the following sanctions:

(i) Payment of a fine to IIROC in a sum sufficient to address the regulatory goals of specific and general deterrence; and

(ii) Payment of investigation and prosecution costs in the amount of $60,000.

¶ 12 It is noted that, while Staff made a specific dollar submission with respect to the issue of costs, it made no such recommendation with respect to the fine.

¶ 13 Staff also did not seek any of a reprimand, a suspension or a termination of any of the Respondent's rights and privileges or any terms and conditions, although these potential sanctions were open for consideration by the Hearing Panel under sections 20.33 and 20.34 of the Dealer Member Rules.

¶ 14 In making its penalty submissions, Staff employed the "Key Considerations When Determining Sanctions", contained in the Disciplinary Sanction Guidelines, as follows:

(a) Harm to Clients, Employer and/or the Securities Market

Staff submitted that, in this case, the harm is to the integrity of the securities market itself. Confidence in the public markets is shaken when Dealer Members, such as Questrade, fail to comply with published rules and regulations.

(b) Blameworthiness

The fact that the Respondent's conduct was found by the Hearing Panel to be deliberate was submitted as a significant aggravating factor.

(c) Extent to which the Respondent was enriched by the Misconduct

Information was provided to the Hearing Panel at the Penalty Hearing with respect to the Respondent's gross income, net profit, average FX income and profit margin during the 35 month period, between December of 2006 and December of 2009.

Staff conceded that the Respondent would have received at least a portion of this income if it had complied with appropriate margin rates during the period in question but submitted that the Respondent was enriched by its misconduct and that it was appropriate for the Hearing Panel to take this into consideration in arriving at the appropriate penalty.

(d) Prior Disciplinary Record

Staff pointed out that the Respondent has previously been subjected to two disciplinary sanctions since it joined the former IDA in April of 2001. These two prior matters concerned risk adjusted capital offences and were settled without the necessity of a contested Hearing:

(i) In the first case ([2002] I.D.A.C.D. No 49), the Respondent was fined $20,000 and required to pay $4,500 in costs by Order of an Ontario District Council, dated December 2, 2002.

(ii) In the second case, on September 4, 2008, an IIROC Hearing Panel accepted a Settlement Agreement pursuant to which the Respondent agreed to pay a $30,000 fine and costs in the amount of $2,500.

(e) Acceptance of Responsibilities, Acknowledgement of Misconduct and Remorse

Subsequent to the release of the Hearing Panel's Decision, on November 6, 2009, the Respondent advised Staff that it regretted its non-compliance. However, according to Staff, it indicated that it wished to reserve its right to have a Hearing and Review of this Decision until such time as the Penalty Hearing has been completed. While Staff acknowledged the Respondent's entitlement to reserve these rights, it found it to be somewhat inconsistent with a genuine acknowledgement of misconduct.

(f) Credit for Co-operation

Staff acknowledged that the Respondent co-operated with the investigation but noted that regulatory rules require such co-operation and, thus, it submitted that its value as a mitigating factor is somewhat limited.

(g) Voluntary Rehabilitative efforts

Staff noted that the Respondent only undertook rehabilitative efforts and became compliant as a result of this disciplinary process when it had little option (other than to disregard the Decision of the Hearing Panel). While Staff acknowledged that the Respondent has now taken corrective action, it submitted that these actions are not properly described as truly "voluntary".

(h) Multiple incidents of misconduct over an Extended Period of Time

Staff submitted that the failure to obtain required margin occurred in relation to every client that traded Forex and was undermargined at any time during the 3 year period covered by the Notice of Hearing.

¶ 15 Staff's conclusion was that the Hearing Panel must impose a sanction which dissuades the Respondent and other firms from engaging in conduct which violates a rule on the basis of an "alternative interpretation" and does so with only modest risk. Staff submitted that, at the end of the day, if proven wrong (as was the case here), a firm should not be left with only a small "traffic ticket" or "cost of doing business" consequence. To impose a very modest sanction would, in Staff's view, invite Dealer Members to violate rules on the basis of a cost-benefit analysis. This invitation would, Staff submitted, be fundamentally inconsistent with the Hearing Panel's observation that "without rules, a regulatory organization cannot protect the public interest."

¶ 16 With respect to the issue of costs, Staff submitted that its bill of costs, in the amount of $73,162, should be reduced to $60,000 to reflect the fact that certain of the costs may have been incurred with respect to matters not directly related to the case before the Hearing Panel.

2. Submissions of the Respondent

¶ 17 The Respondent filed a lengthy Affidavit by Edward Kholodenko, reflecting the steps taken by the Respondent subsequent to receipt of the Hearing Panel's Decision in November of 2009. These steps included:

(a) Updating its website to reflect the rates upheld by the Hearing Panel.

(b) Sending out notification to its Online FX clients, informing them of the increase in margin rates applicable to their accounts.

(c) Contacting its software provider to change the margin rates to reflect the rates upheld by the Hearing Panel.

(d) Ensuring that its system automatically obtains the required margin from its clients.

(e) On November 27, 2009, IIROC compliance staff conducted a "mini-audit" to verify that the changes had been made. According to Mr. Kholodenko, this "mini-audit" revealed no breaches of IIROC's Rules, including the Rules which this Hearing Panel found the Respondent to have previously breached. The position of the Respondent is that it is now fully compliant.

¶ 18 The Respondent submitted that its violation of the Rules was at the lower end of the range of seriousness, and was primarily the result of a good faith disagreement between it and Staff with respect to what requirements were set out in the Rules and the applicability of specific Regulations to Spot FX.

¶ 19 Questrade highlighted, in its submissions, that its conduct involved no allegations or findings of

unethical behaviour, fraud, or client loss and that it did not attempt to hide its actions during the relevant period or at any stage of the proceedings.

¶ 20 The Respondent submitted that it intended at all times to be a Member in good standing and compliant with the Rules. To the extent that it did not comply, Questrade stated that it regretted that non-compliance and took immediate steps to bring itself into compliance once it received this Hearing Panel's Decision.

¶ 21 It submitted that the essence of the dispute was a good faith disagreement between Staff and Questrade over the regulation of Spot FX, which was not regulated by Rules that were specifically formulated for Spot FX. The Respondent suggested that if, in fact, Spot FX will be the subject of specific regulations in the future, the current dispute is the result of a "lag" in regulation, and not the result of a bad faith attempt by Questrade to circumvent the Rules.

¶ 22 To the extent that the Respondent knew that it had not followed IIROC Staff's regulatory opinion, such non-compliance was, it was submitted, not hidden from IIROC.

¶ 23 The Respondent further submitted that this was not a case where it was guilty of many separate breaches of different Rules over a long period of time. It stated that it is not a repeat offender and does not have a culture of non-compliance with the Rules.

¶ 24 The Respondent submitted that the threat of future non-compliance by it is virtually non-existent.

¶ 25 In its Penalty submissions, the Respondent stated that a Spot FX trade is a contract for the delivery of two currencies at a spot price without the physical delivery of the currency. It submitted that Spot FX contracts are considered to be Contracts for Difference ("CFD") because the only asset exchanged is the difference in price between two contracts.

¶ 26 The Respondent's position was that the nature and structure of Spot FX trading was novel to IIROC at the time when Questrade sought approval for the product. It submitted that, while CFDs had existed since the 1990s, Spot FX had not been considered from a policy perspective by IIROC or the Ontario Securities Commission prior to May 2004 and it had not been previously regulated by IIROC.

¶ 27 The Respondent also submitted that the Hearing Panel should take into consideration, in assessing penalty, that various IIROC Members traded in Spot FX Contracts from 2004 onwards. In addition, several American and offshore entities were offering Spot FX Contracts in Ontario, without seeking regulatory approval.

¶ 28 The Respondent also stated that it had no obligation to adjust its practices simply because Staff requested it to do so. Once the Hearing Panel made its Decision, the Respondent took immediate steps to correct its practices.

¶ 29 Given the unique circumstances of this case, the Respondent submitted that the "length" of the Respondent's non-compliance should not be considered in the normal manner. It suggested that the length of the non-compliance is more a function of the length of the Hearing process, over which the Respondent had no control, than of repeated misconduct by the Respondent.

¶ 30 The Respondent submitted that, while the Hearing Panel found that consideration of harm to the public was not a relevant consideration at the Hearing on the Merits, it is definitely relevant to the determination of sanctions. Questrade reiterated its previous submission that:

(a) There was no evidence that it caused a detriment to the public interest (other than the Hearing Panel's finding that non-compliance with the Rules was, in itself, contrary to the public interest);

(b) There was no detriment to its clients; and

(c) There was no detriment to its solvency.

¶ 31 It was, further, submitted that the risks already inherent in IIROC's enforcement process are sufficient to deter Members from taking frivolous or unmeritorious positions in respect of the recommendations of Staff.

The Respondent stated that this case involved what the Hearing Panel found to be "a new and complex financial product" which Staff admitted "[does] not fit the traditional settlement date rules created for equities and bonds".

¶ 32 Given Questrade's good faith efforts to comply with the Rules, notwithstanding this specific instance, the Respondent submitted that a suspension was not warranted in this case.

¶ 33 In its oral submissions, the Respondent suggested that a fine in the $25,000 to $50,000 range would be appropriate.

¶ 34 With respect to costs, the Respondent submitted that only minimal costs should be awarded. It submitted that the Respondent co-operated with Staff throughout the course of the investigation and Hearing of the matter. It brought no Interlocutory Motions, nor did it attempt to evade the Disciplinary Hearing.

¶ 35 It submitted that, in a case such as this one, it would be inappropriate to make a severe cost award as that could have a chilling effect on a future Respondent's willingness to raise full answer and defence to allegations of misconduct.

¶ 36 The Respondent produced a number of IDA and IIROC precedents, indicating that Hearing Panels generally award only a fraction of Staff's total costs.

¶ 37 The Respondent submitted that a cost award of $15,000 would be appropriate.

D. CONCLUSION

¶ 38 We have carefully reviewed the appropriate guiding principles, the extensive written and oral submissions of the parties, as well as the nature and length of the misconduct in question.

¶ 39 We concur with Staff's position that, in all of the circumstances, this is not an appropriate case for either a suspension or a termination of the rights and privileges of the Respondent. We, also, do not believe that, apart from the imposition of a fine and an award of costs, there should be the imposition of any other terms or conditions on the Respondent.

¶ 40 As we stated in our Reasons for Decision: "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."

¶ 41 It was the conduct of the Respondent, subsequent to the middle of December of 2006, which formed the basis for our Reasons for Decision. In considering the appropriate Penalty, we have also taken into account the conduct of the Respondent subsequent to the release of our Decision. Part of that conduct consisted of the Respondent taking steps to comply immediately with our Decision.

¶ 42 There is no arithmetical formulation to arrive at the appropriate fine in a case of this nature. The conduct of the Respondent was deliberate and extended over a lengthy period of time, during which it earned income, some of which it would not have received if the appropriate Rules had been followed.

¶ 43 It is important that the Respondent be deterred from engaging in such conduct in the future and that a message be sent to others in the industry outlining the consequences which will follow if other Dealer Members seek to engage in identical or similar activities.

¶ 44 We are also mindful that this is the third occasion, since April of 2001, that the Respondent has been subjected to sanctions.

¶ 45 As we found that the Respondent's conduct was not only deliberate but continued on for a significant period of time, we would normally impose a substantial fine, in an amount up to three times the pecuniary advantage enjoyed by the Respondent for the period in question. While, as indicated, we have been provided with dollar amounts of revenue earned by the Respondent during the period of non-compliance, it is difficult to estimate how much of that revenue would have been earned if the Respondent had carried on its foreign exchange spot trading in compliance with the requirements. However, even sharply discounting the figures

would have resulted in a fine substantially higher than what we have concluded is appropriate.

¶ 46 After careful consideration, we have determined that a fine in the amount of $150,000 is appropriate. We decided on this reduced level of fine largely because of certain mitigating circumstances, which, in our opinion, are important. Firstly, the Respondent did co-operate fully with IIROC Staff for many months prior to the period set out in the Notice of Hearing. Secondly, we concur with the Respondent's argument that its actions were at the less egregious end of the spectrum of conduct unbecoming. Thirdly, once the Panel released its Decision in November of 2009, the Respondent took the appropriate steps to comply immediately with same. Fourthly, there was no harm to individual clients.

¶ 47 With respect to the issue of costs, we have thoroughly examined the submissions and suggestions of the parties. After such consideration, and in light of the discretion granted to the District Council to require the Respondent to pay the whole or part of the costs of the proceedings and any related investigation, we impose a cost award in the amount of $50,000.

DATED as of the 13th day of April, 2010.

Thomas J. Lockwood, Q.C., Chair

David W. Kerr, Industry Representative

Guenther W. K. Kleberg, Industry Representative