Re CIBC World Markets

IN THE MATTER OF:

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

and

CIBC World Markets Inc

2011 IIROC 38

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

Hearing: June 8, 2011
Decision: June 17, 2011
(15 paras.)

Hearing Panel:
The Honourable Fred Kaufman, C.M., Q.C, (Chair), Selwyn Kossuth, Ron Smith
Appearances:
Andrew P. Werbowski, Senior Enforcement Counsel
Joel Wiesenfeld for the Respondent

REASONS FOR THE DECISION RENDERED AT THE CONCLUSION OF THE HEARING

Introduction

¶ 1 On June 8, 2011, at a hearing, the parties presented the Hearing Panel with a Settlement Agreement, signed on behalf of the Respondent, CIBC World Markets Inc., on May 6, 2011, and agreed to by enforcement counsel on behalf of IIROC on June 2, 2011.

The Agreement

¶ 2 The Agreement provides as follows:

I. INTRODUCTION

1. IIROC Enforcement Staff and the Respondent, CIBC World Markets Inc., consent and agree to the settlement of this matter by way of this settlement agreement ("the Settlement Agreement").

2. The Enforcement Department of IIROC has conducted an investigation ("the Investigation") into the conduct of CIBC World Markets Inc.

3. On June 1, 2008, IIROC consolidated the regulatory and enforcement functions of the Investment Dealers Association of Canada and Market Regulation Services Inc. Pursuant to the Administrative and Regulatory Services Agreement between IDA and IIROC, effective June 1, 2008, the IDA has retained IIROC to provide services for IDA to carry out its regulatory functions.

4. The Respondent consents to be subject to the jurisdiction of IIROC.

5. The Investigation discloses matters for which the Respondent may be disciplined by a hearing panel appointed pursuant to IIROC Transitional Rule No.1, Schedule C.1, Part C ("the Hearing Panel").

II. JOINT SETTLEMENT RECOMMENDATION

6. Staff and the Respondent jointly recommend that the Hearing Panel accept this Settlement Agreement.

7. The Respondent admits that it failed to maintain adequate internal controls to ensure that the OCC change, as described below, was implemented on the system it used to monitor client margin requirements, contrary to IIROC Dealer Member Rule 17.2A.

8. Staff and the Respondent agrees (sic) to the following terms of settlement:

   a) Payment of a fine to IIROC in the sum of $80,000.00.

9. The Respondent agrees to pay costs to IIROC in the sum of $15,000.00.

III. STATEMENT OF FACTS

(i) Acknowledgment

10. For purposes of this Settlement Agreement, Staff and the Respondent agree with the facts set out in this Section III and acknowledge that the terms of the settlement contained in this Settlement Agreement are based upon those specific facts.

(ii) Factual Background

11. The Respondent's back office is supported by Broadridge (formerly ADP) ("Broadridge"). Broadridge provides the back office accounting and bookkeeping system for the respondent. One of the services provided by Broadridge as part of its back office accounting system is the margin evaluation program. This program uses the daily market closing price for each security and calculates the margin required for all of the respondent's client accounts. These calculations are then used by the Respondent to monitor client margin requirements.

12. The Options Clearing Corporation ("OCC") is an equity derivatives clearing organization and clears transactions for put and call options on common stocks and other equity issues, stock indexes, foreign currencies, interest rate composites and single-stock futures.

13. In September 2007 the OCC introduced a change to its long standing methodology for adjusting options contracts when there is a stock split for the underlying security. This was done to simplify the subsequent recalculation of strike prices with the intent to eliminate the rounding of equity strike prices resulting from uneven splits of strikes quoted in fractions. The following chart illustrated the methodology change in a 3:1 stock split situation:

	Before Split Date	**Old Methodology**	**New Methodology**
Option Symbol	ABC	ABC	ABC
Stock Price	$42	$14	$14
Strike	$40	$13 3/8	$40
Premium/Strike Multiplier	100	100	100
Deliverable	100 ABC	100 ABC	300 ABC

Price Formula for Underlying	1.0 X $42=$42	1.0 X $14=$14	3.0X$14=$42
Number of Contracts	1	3	1

14. As illustrated above, the effect of the change was to leave the number of options and strike price the same but change the number of shares deliverable under the contract. This would in turn impact the margin calculation.

15. The OCC delivered notices to all market participants, including the Respondent, regarding the upcoming changes. The notices from the OCC were received by the Respondent's Options and Derivatives Department. The Respondent's Margin Lending Department did not receive any notices from the OCC directly, nor were they forwarded by the Options and Derivatives Department.

16. On July 24, 2008 OCC issued a notice describing the 3 for 1 split of EEM. The notice confirmed that options contracts affected by the EEM split would be adjusted using the new methodology previously announced by OCC.

17. Following the OCC change to the method in which options contracts are adjusted for stock splits, Broadridge implemented a corresponding change on its US system but for its Canadian system the change was left on a list of changes to be implemented in the future. The failure to implement the change on the Canadian system was not discovered by the Respondent until October 9, 2008.

18. As a result of the above, from July 24, 2008 (the date of the EEM stock split) until the error was identified on October 9, 2008, the reported margin requirement on the EEM option positions held in 137 client accounts was too low by a factor of 3. This prevented the proper monitoring [of] the margin requirements for the affected client accounts. Equity positions in the accounts remained correctly calculated. Proper monitoring of the margin available in client accounts was important given the strategy employed in the accounts.

19. In response to the margin miscalculation, the Respondent has acknowledged to affected clients that an error was made and cancelled all transactions in EEM for option positions held in the affected client accounts. The Respondent paid compensation to the clients by early December 2008 in the aggregate amount of US $38 million, without requiring the clients to sign releases of liability. Affected clients maintain that the compensation paid by CIBC is not sufficient and a class action remains pending.

20. IIROC Staff acknowledge that the Respondent has implemented appropriate internal controls to ensure that notices sent by OCC regarding upcoming changes are dealt with in a timely fashion.

IV. TERMS OF SETTLEMENT

21. This settlement is agreed upon in accordance with IIROC Dealer Member Rules 20.35 to 20.40, inclusive and Rule 15 of the Dealer Member Rules of Practice and Procedure.

22. The Settlement Agreement is subject to acceptance by the Hearing Panel.

23. The Settlement Agreement shall become effective and binding upon the Respondent and Staff as of the date of its acceptance by the Hearing Panel.

24. The Settlement Agreement will be presented to the Hearing Panel at a hearing ("the Settlement Hearing") for approval. Following the conclusion of the Settlement Hearing, the Hearing Panel may either accept or reject the Settlement Agreement.

25. If the Hearing Panel accepts the Settlement Agreement, the Respondent waives his/her/its right under IIROC rules and any applicable legislation to a disciplinary hearing, review or appeal.

26. If the Hearing Panel rejects the Settlement Agreement, Staff and the Respondent may enter into another settlement agreement; or Staff may proceed to a disciplinary hearing in relation to the matters disclosed in the Investigation.

27. The Settlement Agreement will become available to the public upon its acceptance by the Hearing Panel.

28. Staff and the Respondent agree that if the Hearing Panel accepts the Settlement Agreement, they, or anyone on their behalf, will not make any public statements inconsistent with the Settlement Agreement.

29. Unless otherwise stated, any monetary penalties and costs imposed upon the Respondent are payable immediately upon the effective date of the Settlement Agreement.

30. Unless otherwise stated, any suspensions, bars, expulsions, restrictions or other terms of the Settlement Agreement shall commence on the effective date of the Settlement Agreement.

Decision

¶ 3 At the conclusion of the hearing, after due deliberation, the Panel accepted the Agreement, with reasons to follow. These, then, are the Panel's reasons for accepting the Agreement.

Reasons

¶ 4 As stated in the Agreement, the Options Clearing Corporation ("OCC") changed its methodology for adjusting options contracts when there is a stock split for the underlying security. The purpose was to simplify the subsequent recalculation of the strike price, with the net effect to leave the leave the number of options and strike price the same but change the number of shares deliverable under the contract.

¶ 5 This was done in September 2007, and notices of the change were delivered to all market participants. These notices were received by the Respondent's Options and Derivatives Department, but were not forwarded by that department to the Margin Lending Department, which did not receive notices from the OCC directly and therefore remained unaware of the change.

¶ 6 Margin requirements, which are calculated daily, are based on services provided Broadridge, which implemented the change on its US system, but not for the Canadian system, leaving this, in the words of the Agreement, for some time "in the future." This failure was not discovered by the Respondent until October 9, 2008 – almost three months after OCC had used the new methodology to adjust its calculations for a 3 for 1 split in a Canadian stock, EEM.

¶ 7 This failure proved to be costly for the Respondent. From the date of the stock split (July 24, 2008), to the date the error was discovered, the reported margin requirement on EEM option positions held in 137 client accounts was too low by a factor of three. As the Agreement points out (in para. 18), "proper monitoring of the margin available in client accounts was important given the strategy employed in the accounts."

¶ 8 Once the error was discovered, the Respondent cancelled all transactions in EEM for option positions held in the affected clients' accounts and paid compensation in the aggregate amount of US$ 38 million, without requiring waivers. A class action for further compensation is pending.

Was the agreed upon penalty adequate?

¶ 9 IIROC's Sanction Guidelines suggest a minimum fine of $25,000 for dealer members who fail to establish and/or maintain adequate internal controls. Such controls consist "of the policies and procedures established and maintained by management to assist in achieving its objective of ensuring, as far as practical, the orderly and efficient conduct of the entity's business." This is not what happened here.

¶ 10 However, the Guidelines are but a starting point, and each case must be considered on the specific facts.

In this case, there was a serious failure over a significant period of time to maintain adequate controls to ensure that the OCC change was implemented on its system, causing harm to 137 clients. It is not for us to examine who should have done what: no doubt, the Respondent has already made these inquiries. The fact remains, though, that clients were misled, and this in large numbers and amounts.

¶ 11 Traditionally, in addition to the Guidelines, hearing panels will also look at past cases for guidance. This is not a helpful endeavour for us. The cases which were cited are not for similar infractions, and this for the good reason that, as far as we know, this case is unique. Nevertheless, the omissions were serious and the fine must reflect this.

¶ 12 But there are mitigating circumstances as well. High on the list is the fact the Respondent moved quickly to repair whatever damage may have been caused, and while the exact amounts remain to be determined, it is fair to say that restitution payments made demonstrate a serious effort to make good the losses (or potential losses) suffered by the affected clients. Also, there was complete collaboration with IIROC, saving time and not insignificant amounts of money.

¶ 13 Finally, hearing panels will not lightly interfere with a negotiated settlement. As was said in *Re Milewski*, [1999] IDACD No. 17,

> … a District Council considering a settlement agreement will tend not to alter a penalty that it considers to be within a reasonable range, taking into account the settlement process and the fact that the parties have agreed. It will not reject a settlement unless it views the penalty as clearly falling outside a reasonable range of appropriateness.

¶ 14 Or, as put by Winkler J. (albeit in another context) in *Gilbert v. CIBC*, [2004] O.J. 4260:

> There is a presumption of fairness when a proposed class settlement negotiated at arms length … is presented to the court for approval. A court will only reject a proposed settlement when it finds that the settlement does not fall within a range of reasonableness.
>
> The test to be applied is whether the settlement is fair and reasonable … This allows for a range of possible results and there is no perfect settlement. Settlement is a product of compromise, which by definition, necessitates give and take.

¶ 15 In our viewp, the settlement, negotiated as it was by the parties assisted by capable counsel, does not clearly fall "outside a range of appropriateness" and it should therefore be, and was, accepted by the panel.

Given in Toronto, Ontario, this 17th day of June, 2011.

Hon. Fred Kaufman, Chair

Selwyn Kossuth, Member

Ron Smith, Member