

Re Penson Financial Services Canada

IN THE MATTER OF:

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

and

The By-Laws of the Investment Dealers Association of Canada (IDA)

and

Penson Financial Services Canada Inc.

2011 IIROC 56

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

Heard: September 8, 2011
Decision: October 12, 2011
(8 paras.)

Hearing Panel:

Claire Richer, chair, Lise Casgrain, Jean-André Élie

Appearances:

Lorne Herlin for IIROC

Me Philippe Leroux for Respondent (and Andrew Koslow, U.S. counsel for Respondent)

REASONS FOR APPROVAL OF SETTLEMENT AGREEMENT

¶ 1 Pursuant to IIROC Rules and IDA By-laws, a hearing was called to consider the Settlement Agreement between IIROC staff and the Respondent in early July 2011, a copy of which agreement is attached hereto to form part of this decision.

¶ 2 The Panel heard the submissions made by counsel for both parties, including a review of the authorities. The parties also answered the Panel's questions.

¶ 3 After consideration, the Panel advised the Parties that it accepted the Settlement Agreement. The reasons for acceptance are set out hereafter.

¶ 4 The Panel accepted that the monetary sanction of \$225,000 plus costs of \$20,000 was fair and should constitute a deterrent to ensure compliance with the due process and proper procedures by members in the future, although the Panel found that the sanction was somewhat low in view of the seriousness and financial impact of the contraventions admitted to by the Respondent.

¶ 5 The Panel noted Respondent's admittance to having failed to identify and react to a number of red flags during the period in question.

¶ 6 The Panel underlined not only the importance by a member of establishing and maintaining adequate

internal controls over a member's business but also the necessity of supervising its day-to-day activities, including its staff. In addition, such controls should be the object of amendment or clarification in a timely fashion as required by circumstances and occurrences.

¶ 7 The Panel also underlined the timely role of IIROC in ensuring compliance by its members of the various requirements found in its Rules, Regulations etc.

¶ 8 The Panel recognized that there were mitigating factors:

- a) Penson had no prior disciplinary history.
- b) The conduct of the head trader at Evergreen was tantamount to fraud.
- c) The Respondent's cooperation with IIROC staff, including the diligent implementation of enhancements to its internal controls and supervisory procedures.

Signed this 12th day of October , 2011.

Claire Richer, chair

Lise Casgrain, member

Jean-André Élie, member

SETTLEMENT AGREEMENT

I. INTRODUCTION

1. IIROC Enforcement Staff and the Respondent, Penson Financial Services Canada Inc. ("Penson" or the "Respondent"), 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 Penson.
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 to the following contraventions of IIROC Rules, Guidelines, IDA By-Laws, Regulations or Policies:
 - a) From March to October 2008, Penson contravened IDA By-law 17.2A and Dealer Member Rule 17.2A, by:
 - (i) failing to establish and/or maintain adequate internal controls related to certain Evergreen's Capital Partners Inc.' ("Evergreen") accounts; and
 - (ii) failing to establish appropriate controls and procedures to ensure the proper reporting of margin required on Introducing Broker's accounts.
 - b) From March to October 2008, Penson contravened IDA By-law 29.27 and Dealer Member Rule 29.27, by failing to ensure that each partner, director, officer, registered representative, employee

and agent of Penson understood his responsibilities relating to the review of all Introducing Broker's inventory accounts and accumulation accounts.

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

a) a fine in the amount of \$225,000.

9. The Respondent agrees to pay costs to IIROC in the amount of \$20,000.

III. STATEMENT OF FACTS

(i) Acknowledgment

10. 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.

(i) Factual Background

11. On or about October 28, 2008, "AA", the Chief Financial Officer at Penson advised IIROC about a serious potential negative impact on Penson's Risk Adjusted Capital ("RAC").

12. The potential impact related to significant securities positions that had been accumulated in Evergreen's accounts.

13. From May 2008 to October 2008, certain Evergreen accounts held increasingly large positions.

14. By late October 2008 the cost of these positions was \$69,600,000.

15. As a result of declining markets, the value of the positions in late October 2008 was only \$36,415,000, resulting in an exposure of approximately \$33,200,000. Penson booked out most of the position to Evergreen clients, however the trades failed to settle. This caused Evergreen to cease operations and file for bankruptcy. On November 4, 2008, Evergreen's IIROC membership was suspended indefinitely.

16. Penson did not put any margin on these positions and ultimately, incurred an unsecured liability as a result of the exposure.

17. Due in part to the state of Penson's internal controls, Penson did not discover that the inventory account should be considered client accumulation accounts rather than firm inventory accounts;

18. Penson failed to realize the magnitude of the risk exposure until late October.

19. On October 31, 2008, an investigation was opened by IIROC against Penson.

20. The investigation was opened after IIROC placed Penson into Early Warning Level Two in October 2008.

PENSON

21. At all material times, Penson was a regulated Member of IIROC (or its predecessor IDA) with its head office located in Montréal, Québec.

22. Penson is an independent provider of correspondent clearing services including trade execution, clearing, settlement, custody, bookkeeping and administration, and direct market access services.

23. Penson is a Type 2 Carrying Broker for other IIROC dealer member firms, including Evergreen.

24. "BB" was Penson's Vice-President Credit, who reported directly to "CC" Vice-President Integrated Risk Management.

25. "AA" was Penson's Chief Financial Officer.

26. "DD" was a Penson Client Relations Representative.

EVERGREEN

27. At all material times, Evergreen was a regulated Member of IIROC (or its predecessor IDA).

28. “EE” was Chief Operating Officer and Chief Compliance Officer of Evergreen.

29. David Connacher (“Connacher”) was Head Trader at Evergreen.

THE INTRODUCING/CARRYING BROKER ARRANGEMENT BETWEEN EVERGREEN AND PENSON

30. On August 29, 2006, Evergreen and Penson entered into a Uniform Type 2 Introducer/Carrier Broker Agreement (the “Agreement”).

31. By virtue of the Agreement, Penson was Evergreen’s Type 2 carrying broker and agreed to perform certain services including trade execution, trade clearing and settlement, and record-keeping activities for Evergreen, the Type 2 introducing broker.

PENSON’S TREATMENT OF AVERAGE PRICE INVENTORY/ACCUMULATION ACCOUNTS

32. Average Price Inventory (“API”) accounts (also known as accumulation accounts) are non-proprietary client accounts used to accumulate securities for large non-contingent client orders.

33. Penson did not realize that certain Evergreen inventory accounts were considered by Evergreen to be client accumulation accounts and consequently Penson did not maintain any margin relative to these Evergreen accounts.

34. Only in November 2008, did Penson undertake detailed steps to assist its Introducing Brokers to mitigate the risk with respect to inventory account monitoring and clarification as to capital reporting on inventory accounts with its correspondent customers.

35. On November 13, 2008, Penson sent an email to all correspondents stating the following:

Summary

We would like to remind our valued customers of their responsibility with respect to double alpha inventory accounts assigned to you by Penson. The responsibility for the inventory accounts from a regulatory capital perspective rests with the introducer for all trading activities. This applies to all inventory accounts regardless of how they are used; e.g. proprietary trading, accumulation, average price, allocation, etc...

Additional Information

In addition, if your firm is a Type 2 Introducing Broker and elects to use cash or margin accounts as an Allocation Account, Average Price or Accumulation Account for customers trades; an email must be sent to both “CC”, VP Risk, and “AA”, CFO, prior to being established. The information required includes the purposes of the account, the account number, and any relevant information. This will allow us to calculate the trades correctly but we will then confirm with your firm’s CFO the responsibility for regulatory capital.

CONNACHER’S MISLEADING AND DECEPTIVE TRADING ACTIVITIES

36. The majority of the unsecured liability was directly traced back to the trading conducted by Connacher in the client accumulation account. On May 10, 2011, the hearing Panel found that Connacher violated IIROC rules by engaging in misleading and deceptive trading activity, and also engaging in personal financial dealings with clients without the knowledge or consent of his employer.

37. The Hearing Panel concluded notably that the conduct of Connacher was contemptible and was tantamount to fraud.

38. The Panel imposed a lifetime prohibition, payment of a fine in the sum of \$500,000 and payment of costs in the sum of \$71,315.50.

PENSON’S INTERNAL CONTROL FAILURES

39. During the period from March to October 2008, Penson ought to have identified a number of red flags to indicate that Evergreen’s inventory accounts were being considered by Evergreen as API accounts (and not

firm inventory accounts) and that the margin required should have been included by Penson at month-end.

40. However, Penson did not identify certain red flags (as discussed in detail below) in a timely manner and failed to identify Evergreen's treatment of the API accounts.

RED FLAGS

1. REVERSALS OF THE WRITE-OFFS

41. In May 2008, at Evergreen's request, Penson provided to Evergreen's trading desk staff double alpha coded inventory accounts.
42. Evergreen's position is that it considered the API or double alpha inventory accounts as non-proprietary client accumulation accounts.
43. In or around May 2008, Evergreen noticed that Penson was treating the API accounts as proprietary accounts.
44. As a result, Penson was valuing these accounts mark to market which automatically generated month-end write-offs.
45. Due to the write-offs, Evergreen incurred problems relative to the pricing of securities positions in the inventory account.
46. "EE" requested that Penson, through "DD", reverse the profits and losses generated by the mark to market valuations; "DD" in turn redirected the issue to "BB".
47. "BB" manually reversed the write-offs for the following months, from July to September 2008, for a total of approximately \$25 million.
48. "BB" failed to question the reasons for the reversal of write-offs and/or the financial impact of these reversals on Penson and/or Evergreen.
49. During this same time, Evergreen and Penson personnel tried to resolve valuation problems associated with the inventory accounts.
50. Evergreen's continued requests to reverse the write-offs should have been an indication to Penson that Evergreen considered the inventory accounts as API accounts, instead of firm inventory accounts.
51. Penson had inappropriate controls to monitor reversals of write-offs.
52. Evergreen treated its inventory positions as client positions and was not putting up any margin on a regulatory capital perspective.
53. At that time, there was no internal written procedure relating specifically to the monitoring of the reversals of the write-offs by Penson staff.
54. At that time, the application of Penson's Credit & Risk Policies and Procedures was unclear relative to the supervision of Introducing Broker's accumulation accounts for clients.

2. DAILY INVENTORY REPORTS

55. Penson did not diligently review Daily Inventory Reports it prepared and forwarded to Evergreen.
56. A more careful review of these reports would have shown:
- The market value and the cost price of securities positions.
 - The write-offs.
 - The approximate exposure to Penson.
57. Ultimately, the Daily Inventory Reports presented a red flag for Penson.
58. During the relevant period, neither the CFO, the VP Credit nor the VP Integrated Management Risk at

Penson reviewed the Daily Inventory Reports.

3. FAILED TRADES REPORTS

59. Penson prepared Failed Trade Reports for Evergreen.
60. The Failed Trades Reports are generated when the positions in inventory accounts are booked to clients and are not settled in the delay T+3.
61. According to Penson's own internal Credit and Risk Policies and Procedures, Introducing Broker's clients' accounts were subject to being restricted from trading unless the trades are properly settled.
62. As early as of May 2008, the transactions contained in Evergreen's Failed Trades Report far exceeded Evergreen's financial capacity to withstand its clients potential failure to settle booked trades.
63. Penson's Failed Trades Reports showed that restrictions on Evergreen accounts were not applied by Penson on unsettled booked trades.
64. The review and/or control of these reports by Penson was inadequate in regard to the high value of recurrent unsettled trades.
65. Penson did not proactively address with Evergreen the issue of the potential risk exposure relative to the importance of the amount of unsettled trades in the Failed Trades Reports.

PENSON'S CREDIT & RISK POLICIES AND PROCEDURES

66. Penson's Credit & Risk Policies and Procedures ("Policies and Procedures") were unclear and failed to clearly outline a procedure relating to the supervision of Introducing Broker's API accounts.
67. Penson's Policies and Procedures indicated that Penson would assist in the review of inventory accounts.
68. According to "BB", he did not have the responsibility to review specific inventory accounts of Evergreen.
69. However, according to "CC" and "AA", "BB" was responsible for reviewing all inventory accounts and was responsible for the application of Penson's policies and procedures.
70. In fact, there was insufficient supervision by Penson of Evergreen's API accounts.

FACTORS TAKEN INTO CONSIDERATION BY IIROC STAFF

71. In reaching an agreement with Penson as the joint settlement recommendations set forth above, IIROC staff has given due consideration to a number of factors such as:
 - the absence of prior enforcement proceedings against Penson;
 - Penson's immediate self-reporting of the unsecured liability to IIROC;
 - Penson's internal investigation of the circumstances leading to the unsecured liability;
 - the diligent implementation of enhancement to its Policies and Procedures, internal controls and supervisory procedures;
 - Penson's cooperation with IIROC staff in the course of the investigation and the enforcement proceedings.

V. TERMS OF SETTLEMENT

72. 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.
73. The Settlement Agreement is subject to acceptance by the Hearing Panel.
74. The Settlement Agreement shall become effective and binding upon the Respondent and Staff as of the date of its acceptance by the Hearing Panel.
75. 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.

76. 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.
77. 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.
78. The Settlement Agreement will become available to the public upon its acceptance by the Hearing Panel.
79. 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.
80. Unless otherwise stated, any monetary penalties and costs imposed upon the Respondent are payable immediately upon the effective date of the Settlement Agreement.
81. 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.

AGREED TO by the Respondent at the City of Toronto in the Province of Ontario, this 10th day of July, 2011.

“Witness signature”

Witness

“Respondent’s signature”

Respondent

AGREED TO by Staff at the City of Montréal in the Province of Québec, this 8th day of July, 2011.

“Witness signature”

Witness

“Carmen Crepin”

Carmen Crépin

Vice President Québec Investment Industry
Regulatory Organization of Canada

ACCEPTED at the City of Montréal in the Province of Québec, this 12th day of October, 2011, by the following Hearing Panel:

Per: “Me Claire Richer”

Panel Chair

Per: “M. Jean Elie”

Panel Member

Per: “Mme Lise Casgrain”

Panel Member

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