

# Re Husebye

IN THE MATTER OF:

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

**and**

**Kim Husebye**

2016 IIROC 05

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

Heard: January 11-13, and 15, 2016

Decision: February 2, 2016

**Hearing Panel:**

Martin L. Friedland, C.C., Q.C. (Chair), Charles Macfarlane, T. Hugh McNabney

**Appearances:**

Rob DelFrate, Senior Enforcement Counsel for IIROC

Michael Byers, for the Respondent

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## DECISION AND REASONS

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### Alleged Contravention

¶ 1 The Investment Industry Regulatory Organization of Canada (“IIROC”) issued a Notice of Hearing on June 10, 2015, alleging that Kim Husebye (the “Respondent”) committed the following contravention:

“Between November 2009 and December 2010, the Respondent failed to use due diligence to ensure that investment recommendations were suitable for his clients, contrary to IIROC Dealer Member Rule 1300.1(q).”

¶ 2 Rule 1300.1(q) reads as follows:

“Each Dealer Member, when recommending to a client the purchase, sale, exchange or holding of any security, shall use due diligence to ensure that the recommendation is suitable for such client based on factors including the client’s current financial situation, investment knowledge, investment objectives and time horizon, risk tolerance and the account or accounts’ current investment portfolio composition and risk level.”

¶ 3 Rule 1300.1(q) applies to the Respondent because of Dealer Member Rule 29.1, which states:

“For the purposes of disciplinary proceedings pursuant to the Rules, each Dealer Member shall be responsible for all acts and omissions of each partner, Director, Officer, Supervisor, Registered Representative, Investment Representative and employee of a Dealer Member; and each of the foregoing individuals shall comply with all Rules required to be complied with by the Dealer Member.”

¶ 4 IIROC submitted in its closing statement that the “Respondent recommended high risk, leveraged exchange traded funds (‘ETFs’) to several of his clients. He failed to use due diligence to assess the risks associated with these ETFs. The Respondent overlooked or disregarded clear, unambiguous disclosure of the significant risks associated with an investment in the ETFs, and concentrated a significant amount of his

clients' accounts in these securities.”

¶ 5 Three of the Respondent's clients later complained to IIROC about these transactions: Mr. TC and Mrs. LC (collectively, “Mr. And Mrs. C”), a married couple, who became clients of the Respondent in August 2006 and Ms. LP, who became a client of the Respondent in September 2008. There is no evidence that the Respondent's other clients made formal complaints.

¶ 6 Mr. Husebye's counsel admits the transactions, but argues in his closing statement that Staff “has failed to meet its onus of establishing that [the Respondent] recommended unsuitable investments for the clients.” The Respondent argues that the holdings were suitable for the clients.

¶ 7 The onus of proof is on Staff to establish that Mr. Husebye failed to use due diligence to ensure that investment recommendations were suitable. The Supreme Court of Canada unanimously held in *F.H. v. McDougall* ( [2008] 3 S.C.R. 41 at paragraph 40) that “there is only one civil standard of proof at common law and that is proof on a balance of probabilities.” The Court went on to say at paragraph 46 that “[I]f a responsible judge finds for the plaintiff, it must be accepted that the evidence was sufficiently clear, convincing and cogent to that judge that the plaintiff satisfied the balance of probabilities test.”

¶ 8 For the reasons that follow, the Panel finds that the evidence that the Respondent failed to use due diligence to ensure that investment recommendations were suitable for his clients is clear, convincing and cogent.

### **The Respondent**

¶ 9 After completing his studies in commerce, applied mathematics, and computer science at the University of Toronto in 1987, Mr. Husebye worked for 26 years as an investment advisor and portfolio manager. He earned a number of designations, including Chartered Financial Analyst (CFA) and Chartered Market Technician (CMT). The panel accepts counsel for the Respondent's statement that “Mr. Husebye has an extensive background in technical and fundamental financial analysis and possesses extensive knowledge of a wide range of financial products and concepts.”

¶ 10 Mr. Husebye was employed at the Oakville branch of Lakeshore Securities Inc. (“Lakeshore”) at the time of the alleged transactions. He joined the firm, then known as Centurion Investment Advisors, in 2006. In late 2010 he left Lakeshore and joined Raymond James, which he left in March 2013, and is not currently working in the securities industry.

¶ 11 In 2007, Mr. Husebye's analysis of the markets convinced him that the markets were going down. He recommended to all his clients, including the three complainants, that they sell their equities and remain in cash. When the market started to recover from the 2008 downturn, the Respondent believed, through his “wave theory analysis,” that the rise was temporary and that the market would continue to decrease in value.

¶ 12 In a report to his clients, dated September 13, 2009, entitled “The Big Bear Trap” (accompanied by several charts), he stated, in part:

“The overall weakness demonstrated in this rally therefore implies that we might be in a larger fractal pattern which has not yet been completed. If true, then the entire 17-month stock market decline, which played out in five waves, is itself just the first wave down of a much larger five wave pattern. The recent recovery then, probably is Wave 2 in the opposite direction to the larger trend, which continues to be down. (Chart 1)

On this basis, expect the next major move to be Wave 3 down, followed by another countertrend move up in Wave 4, and ultimately Wave 5 down to a multi-decade low. At this higher degree of trend we should expect that final bottom in two to three years.”

### **Respondent's Strategy**

¶ 13 Mr. Husebye's Strategy – Strategy is the description he used – was to use Leveraged Inverse Exchange Traded Funds. As is well-known, exchange-traded funds (“ETFs”) are securities that trade on an exchange that track the performance of an underlying benchmark or index. “Inverse” or “short” ETFs, in contrast, seek to

deliver the inverse or opposite of the performance of the index or benchmark they track. If the market goes *down*, the inverse ETFs go *up*.

¶ 14 The securities that Mr. Husebye employed for all his clients who participated in his Strategy were not simply inverse or short ETFs, but were *leveraged* inverse funds which provided double the impact of a simple inverse fund. If the market went down by 5%, for example, the security was designed to increase in value by 10%. Conversely, if the market went up, it would *decrease* by double that amount. A more detailed description of these securities can be found in a later section of these reasons.

¶ 15 Mr. Husebye told us that perhaps 50 families participated in the Strategy through managed accounts, which gave Mr. Husebye the authority to purchase and sell securities without a client's specific approval. Some of his other clients did not participate in the Strategy and kept their funds in safe investments, such as cash and government bonds. Some used the Strategy for part of their holdings, and had other accounts for other investments.

¶ 16 The three clients who complained had all of their investments with Mr. Husebye (not including cash in their accounts) in Leveraged Inverse ETFs that had double the impact on increases and decreases in value than did simple inverse ETFs.

¶ 17 There were three funds used by the Respondent. Two of them were from ProShares Trust ("ProShares"): the ProShares UltraShort QQQ (trading designation QID) fund, which inversely tracks the NASDAQ 100, and the ProShares UltraShort S&P500 (SDS), which tracks the S&P500. The word Ultra in each fund's name indicates that these are leveraged funds, where increases or decreases in the value of the funds are 200% of what the increase or decrease of a simple short fund would be. In each case, simple short funds were available through ProShares. The third fund was the Horizon BetaPro U.S. Dollar Bull+ (HDU), which inversely tracks at 200% the value of the Canadian dollar with respect to the American dollar. The Respondent not only believed that the market was going down, but also that the Canadian dollar would decrease in comparison with the American dollar. Not all the clients were eligible for the last fund because, we were informed, only registered accounts were eligible to purchase that fund.

¶ 18 These specific funds were traded on exchanges and had high liquidity. The Respondent would place orders for a block of shares that were then automatically allocated amongst the various managed accounts of the clients of the Respondent who participated in the Strategy, according to the size of their accounts and their risk profile. Everyone who participated in the Strategy received a certain proportion of the purchased shares. Mr. Husebye stated at the hearing, with respect to the managed accounts:

"The practice was to have a uniform sort of mix across the board, so all the portfolios were quite similar as long as the risk profile was similar, because there were other clients who had lower risk tolerances that would have had a smaller allocation to the LETFs. But to the question of cash, the uninvested portion of their portfolio was still in cash, so rather than 20 to 40% cash, they might have had 50 or 60% cash."

### **Clients Mr. TC and Mrs. LC**

¶ 19 Mr. TC and Mrs. LC ("Mr. and Mrs. C"), a married couple, became clients of the Respondent in August 2006. They had been referred to the Respondent by a friend who had also been a client of the Respondent.

¶ 20 In August 2006, the couple each completed a New Account Application Form ("NAAF") with the Respondent. These NAAFs included the relevant Know Your Client ("KYC") information. At the time, they were in their 50s, had a combined net worth of about \$1.2 million that included \$200,000 in liquid assets and a house in Mrs. LC's name, and had incomes of \$80,000 each. Mr. TC's investment knowledge was listed as "Good" and Mrs. LC's was listed as "Limited." Mr. TC was primarily responsible for dealing with the Respondent in relation to the investments. He was employed as a building inspector, having received an MBA from the University of Western Ontario (now called Western University). Mrs. LC was a school teacher.

¶ 21 Mr. TC opened an RRSP account with the Respondent in 2006. His risk tolerance was listed as 20% "lower-risk, income-producing securities;" 30% "moderate- to higher-risk, income-producing securities;" 30%

“moderate-risk, growth-oriented securities;” and 20% “higher-risk, speculative securities and trading strategies.”

¶ 22 About the same time, Mrs. LC opened both an RRSP account and a margin account with the Respondent. For both accounts, LC’s risk tolerance was listed as 20% “lower-risk, income-producing securities;” 20% “moderate- to higher-risk, income-producing securities;” 50% “moderate-risk, growth-oriented securities;” and 10% “higher-risk, speculative securities and trading strategies”. Her risk profile was therefore somewhat lower than her husband’s profile.

¶ 23 As stated earlier, Mr. Husebye believed that the market was heading downwards. The accounts of both Mr. TC and Mrs. LC, which had been in equities, were converted to cash.

¶ 24 The market then started to recover from the lows of 2008. During this period, Mr. TC inherited about \$200,000 from his parents. In 2009, the couple opened a joint account with the Respondent and converted all of their accounts to managed accounts. The fee was 1% of the value of the accounts and a \$40 fee for each trade. Their joint net worth was now about \$1,500,000, including their home. They completed a managed account application for all four of their accounts, each of which now had the same objectives and risk tolerance of:

25% income (low risk)

50% long-term capital appreciation (medium risk)

25% short-term capital appreciation/speculative trading (high risk)

The risk tolerance was therefore higher in 2009 than it had been in 2006.

¶ 25 As mentioned above, the Respondent then started to purchase leveraged inverse funds for his clients. Because the markets rose in value, Mr. and Mrs. C’s accounts fell in value. Between the end of November 2009 and the end of December 2010, their accounts declined in value by about \$130,000, representing a loss of about 28% of their value. These figures come from charts prepared by IIROC investigator Frank Scali. They do not distinguish between US and Canadian currencies, but because the two currencies were at about par at the time, the figures would not vary to a significant extent if they were all converted to one currency or the other.

¶ 26 On June 28, 2011, Mr. and Mrs. C complained to the president of Lakeshore, Mr. William Podolsky. The three-page letter states in part:

“We are low risk investors who have lost \$158,000 of our savings because our instructions were ignored. We consider your firm responsible for this unnecessary loss of one third of our combined portfolio, during a period of market growth. Our accounts were supposed to be conservatively managed to help fund post graduate studies for our children and our retirement....

With the exception of two normal looking equity trades in the spring of 2009, all subsequent trades were what we later learned were highly speculative inverse leverage Proshare Ultrashort QQQ, Proshare Ultrashort S&P500, or Horizon BetaPro Exchange Traded Funds-US Dollar Bull. In addition, similar trades of these same funds were made in our unmanaged accounts. At no time were we advised of the risk, nor did we consent to trades in either the managed or unmanaged accounts of these leveraged inverse instruments. We had never traded in options or leveraged instruments and believed we were holding equities consistent with our stated low risk tolerance....

We are accordingly demanding that your firm cover our losses of the past two years. We are prepared to commit the time and resources to vigorously pursue this matter.”

¶ 27 On July 28, 2011, Mr. Husebye sent what he called a “rebuttal to letter of Complaint” to Mr. Podolsky. The five-page letter states in part:

“[Mr. and Mrs. C’s] assertion that they are low risk investors is false, as is their claim that their instructions were ignored. All of their accounts, with the exception of a small RESP, were Managed Accounts which were directed in accordance with their stated objectives which emphasized growth and speculation....Accordingly, there were no unauthorized trades....

As 2009 progressed, market patterns were strongly hinting that the rally was most likely a counter-trend move within a larger bear market which had begun in 2007. In other words, the signals were becoming clearer that the market would eventually turn down again in a subsequent phase of the bear market.

In order to position for a renewed downturn, I prepared to initiate positions in three leveraged exchange-traded funds...At that time, I considered these instruments to fit well within the definition of growth-oriented securities.

Contrary to the clients' allegations, I communicated the strategy in great detail to them and was satisfied that they fully understood the plan...This approach was fully explained to the clients through regular phone conversations and meetings at their home.

In my professional opinion, these investments were completely suitable for their portfolios...A significant cash buffer of between 25% and 50% was continuously maintained across all accounts....

Therefore, in the context of the investment objectives of 50% growth and 25% speculative, the accounts were properly onside according to my understanding of those definitions....

My original assessment that LETFs reasonably fit with the profile of 'growth' securities came under scrutiny upon the implementation of IIROC's new and stricter policy regarding these securities. I discussed the matter with compliance throughout the summer and fall of 2010 and pleaded my case to allow old positions to be grandfathered for the benefit of the clients."

¶ 28 In a five-page letter to Mr. and Mrs. C, dated October 4, 2011, Mr. Podolsky ended by stating: "At this stage I respectfully suggest that we arrange an in person meeting to discuss the possibility of resolving this matter on our own terms. Please do not hesitate to contact me directly by email or by telephone at any time."

¶ 29 They met with Mr. Podolsky on several occasions. The matter could not be satisfactorily resolved and on October 19, 2012, a writ was issued by Mr. and Mrs. C against Lakeshore Securities Inc. and Kim Husebye for \$250,000 for special damages and over a million dollars for punitive, exemplary and aggravated damages. Discoveries have not yet taken place in the action.

¶ 30 Mr. And Mrs. C each testified that they did not know how risky the funds were. If she had known they were high risk, Mrs. LC said, she would have been "flabbergasted." Mr. TC said he would have said 'get rid of them.' We are aware that there is a pending law suit which may consciously or unconsciously influence their testimony. It is hard for us to determine what they actually knew. Mr. Husebye came to their house on a number of occasions, but there is no record of how forthright he was about the risks. No string of emails was put into evidence, as is the case with Ms. LP, discussed below. The Panel has concluded that the couple probably would have known that they were meant to profit by a decline in the market, but probably were not aware of the details or the risks of the funds that were purchased.

¶ 31 In the end, however, the Panel's task is to determine whether the funds were suitable, within the clients' risk tolerance, not whether the three complainants knew the details of how the funds operated or the risk involved. As an IIROC panel stated in *Re Phillips* (2013 IIROC 52 at para. 56): "the responsibility to use due diligence, in recommending a security to a client, rests solely with the registrant. It cannot be transferred to the client even if the client acknowledges that he is aware of the risks associated with the investment."

#### **Ms. LP**

¶ 32 Ms. LP became a client of the Respondent in September 2008. Mr. Husebye inherited her account when her previous advisor left Lakeshore. Shortly thereafter, she transferred approximately \$50,000 from an RRSP account held at another Dealer Member to her account at Lakeshore. Her earlier NAAF of March 2007 with her previous advisor showed her risk tolerance as 20% "lower-risk, income-producing securities;" 40% "moderate-to higher-risk, income-producing securities;" and 40% "moderate-risk, growth-oriented securities." There was nothing in the category "higher risk, speculative securities and trading strategies."

¶ 33 In September 2008 Ms. LP completed a managed account agreement with the Respondent, which included her KYC information. The fee was 2% of the value of her account. At the time, she was 52 years old,

single, and was employed as a legal assistant. Her annual income was about \$50,000 and her net worth was about \$100,000, including \$40,000 in liquid assets. (Included in this were some registered funds with her employer.) Her investment knowledge was listed as “Limited.” Her general investment objectives and risk tolerance (there were now three categories rather than four in the earlier KYC forms) were listed as:

10% income/low risk

70% long-term capital appreciation/medium risk

20% short-term capital appreciation/speculative trading/high risk..

¶ 34 Between the end of November 2009 and the end of December 2010, Ms. LP’s account declined in value by over \$20,000, representing a loss of about 33%.

¶ 35 As in the case of Mr. And Mrs. C, Ms. LP complained to Mr. Podolsky, the president of Lakeshore. In a three-page letter dated March 4, 2012 she outlined what had occurred from her perspective, and sought reimbursement for the losses incurred while Mr. Husebye was at Lakeshore – about \$25,000. Mr. Husebye wrote to Mr. Podolsky on April 12, 2012 saying, in part, that “Ms. [LP]’s claim that her tolerance for risk was low is false. On the contrary, Ms. [LP] emphasized a desire for a relatively high level of growth based on the fact that she had a limited number of years until retirement.”

¶ 36 Mr. Podolsky told Ms. LP that she would get a response within 90 days. On May 17, 2012, Ms. LP contacted IIROC, enclosing her earlier letter to Mr. Husebye and stating that she had also incurred losses through Mr. Husebye at Raymond James, but felt that she could not do anything about that because she had signed a form indicating a 70% high risk tolerance, which Raymond James had required and which Mr. Husebye had strongly recommended she enter on the form. Mr. Podolsky wrote a letter, dated June 5, 2012, outlining various dispute formats available to her. Later, on December 13, 2012, he offered to give Ms. LP \$8,000, which she considered not sufficient compensation. In a letter to Mr. Podolsky dated January 7, 2013, she said that her loss was about \$25,000.

¶ 37 Ms. LP complained to the Ombudsman for Banking Services and Investments (OBSI), who ruled in her favour. She was subsequently reimbursed by Lakeshore for some or all her losses.

¶ 38 Ms. LP was interviewed by IIROC staff under affirmation on April 5, 2013, but refused to show up to testify at the hearing. Counsel for the Respondent objected to the admission of the evidence as hearsay and not subject to cross-examination.

¶ 39 After argument by counsel, the Panel ruled that the transcript of Ms. LP’s interview, as well as emails, should be admitted into evidence. Section 1.5(b) of the IIROC Rules of Practice and Procedure states: “A Panel may...admit as evidence in a hearing, whether or not given or proven under oath or affirmation, anything that is relevant to the proceedings.” This evidence is relevant and cannot otherwise be obtained. The testimony was under affirmation. Neither IIROC or the Panel has the power to compel a witness to give evidence. In our ruling, we noted that the Respondent could contradict the evidence in his testimony. Mr. Husebye’s emails are clearly necessary because he is the Respondent in the proceedings and we consider it important to have Ms. LP’s emails to get the full picture of the exchanges between Mr. Husebye and Ms. LP. We were, of course, mindful of the fact that the evidence could not be tested by cross-examination and took this into account in the weight we gave to the evidence and the desirability of having other corroborating evidence.

#### **Extent of Mr. and Mrs. C and Ms. LP’s Holdings of these Leveraged Inverse Funds**

¶ 40 The extent of the holdings of these leveraged inverse funds increased over time. Remaining funds were held in cash. Mr. TC’s RRSP account of about \$150,000, for example, was initially in cash. The Respondent started purchasing the leveraged inverse funds in August 2009. As a result, at the end of November 2009, this account consisted of about 25% in these products and the rest in cash. By the end of June, 2010, it had risen to about 80% in leveraged inverse funds; and by the end of December 2010 was a little under 75%. The cash position was about the same for both the June and December 2010 statements, but was a higher percentage of the total because the fund had decreased in value: the market had gone up and thus the value of the funds had

gone down. The other accounts held by Mr. and Mrs. C were similar to this account, with respect to the extent they contained leveraged inverse funds.

¶ 41 Ms. LP's RRSP account – her only account with the Respondent – was also similar. Mr. Husebye started purchasing the leveraged inverse products in August 2009, using cash that was in the account from the previous sale of relatively safe securities a year earlier. At the end of November, she had about 30% of her account in leveraged inverse products, with about 70% in cash. Additional purchases of these products took place over the next year and by the end of June 2010 the percentage in these products was 83%. By the end of December 2010 she had about 77% of her account in these products and about 23% in cash.

### **The Products Purchased**

¶ 42 The three investments, as stated earlier, were designed to produce daily investment results, before fees and expenses, that corresponded to twice (200%) the inverse (opposite) of the daily performance of the fund. How risky were the products? An important indication of how risky they were can be found by consulting the prospectuses for each product.

¶ 43 Each prospectus warns of the risks of the investment in this type of fund and in the three specific funds used by Mr. Husebye. He stated that he was very familiar with the prospectuses. He also told us that the prospectuses would have been sent to all the clients that purchased the funds, but whether they examined them is not known. One of the prospectuses is 485 pages long.

¶ 44 Not all of the funds described in the prospectuses present the same degree of risk. Some, for example, have greater liquidity than others. Some have greater volatility than others. Volatility plays an important role in determining the value of a fund held for more than one day because the funds are valued each day and the effect of compounding affects the value of funds held for longer periods. We should therefore look particularly at the prospectuses for the specific funds used by Mr. Husebye.

¶ 45 The QQQ leveraged fund, which inversely tracks the NASDAQ 100, states in the opening paragraph about this specific fund (at page 151 of the prospectus filed September 2009; the bolding is in the original):

#### “Important Information about the Fund

ProShares UltraShort QQQ (the “fund”) seeks investment results **for a single day only**, not for longer periods. This means that the return of the Fund for a period longer than a single trading day will be the result of each day's returns compounded over the period, which will very likely differ from twice the inverse of the return of the NASDAQ -100 Index (the “Index”) for that period. In periods of higher market volatility, the volatility of the benchmark may be at least as important to the Fund's return for the period as the return of the benchmark. **The Fund is different from most exchange-traded funds in that it seeks inverse leveraged returns and only on a daily basis. The Fund also is riskier than similarly benchmarked exchange-traded funds that do not use leverage. Accordingly, the Fund may not be suitable for all investors and should be used only by knowledgeable investors who understand the potential consequences of seeking daily inverse leveraged investment results. Shareholders should actively monitor their investments.”**

¶ 46 The same note, with appropriate changes, is contained in the opening paragraph for the SDS fund that inversely tracks the S&P500 (page 159 of the prospectus).

¶ 47 Similarly, the Horizon BetaPro US Dollar Bull+ (HDU) contains on the second page of its prospectus in a separate distinctive box in bold letters:

**“Double ETFs are very different from most other exchange-traded funds. Each Double ETF uses leverage, and is riskier than funds that do not. Each Double ETF does not and should not be expected to return twice (i.e., +200% or -200%, as applicable) the return of its underlying index over any period of time other than daily. Investors should monitor their investment in a Double ETF daily.**

**A Double ETF's returns over periods longer than one day will likely differ in amount and possibly**

**direction from the performance of its underlying index for the same period. This effect becomes more pronounced as the volatility of the underlying index increases.”**

¶ 48 On the next page, the Horizon prospectus states:

“Each investor should carefully consider whether their financial condition and/or retirement savings objectives permit them to buy Units of [these funds]. Units of [these funds] are highly speculative and involve a high degree of risk, some not traditionally associated with mutual funds. No ETF by itself constitutes a balanced investment plan. An investor may lose a portion or even all of the money that they place in an ETF.

The risk of loss in trading derivatives can be substantial. In considering whether to buy Units of an ETF, the investor should be aware that trading derivatives can quickly lead to large losses as well as large gains. Such trading losses can sharply reduce the net asset value of an ETF and consequently the value of an investor’s Units in the ETF.”

¶ 49 In a later section, under the heading “Risk Factors” there are over five pages that describe in detail the various risks involved. The introductory paragraph is as follows:

“Investing in Units of [their funds] can be speculative, can involve a high degree of risk and may only be suitable for persons who are able to assume the risk of losing their entire investment. Prospective investors should therefore consider the following risks, among others, before subscribing for units of [their funds].”

¶ 50 Two of the many risks discussed in the Horizon prospectus are “Leverage Risk” and “Aggressive Investment Technique Risk.” The former is, in part, described as follows:

“Leverage offers a means of magnifying market movements into larger changes in an investment’s value and provides greater investment exposure than an unleveraged investment. Leverage should cause a Double ETF to lose more money in market environments adverse to its daily investment objective than an ETF that does not employ leverage.”

¶ 51 To achieve leverage, the funds use aggressive investment techniques, described as follows in the Horizon prospectus:

“The ETFs use investment techniques and financial instruments that may be considered aggressive, including the use of futures contracts, options on futures contracts, securities and indices, forward contracts, swap agreements and similar instruments. Such techniques, particularly when used to create leverage, may expose an ETF to potentially dramatic changes or losses in the value of the instruments and imperfect correlation between the value of the instruments and the index, security, currency or commodity.”

¶ 52 From the prospectuses alone, it is difficult to argue that these securities are merely medium risk securities. The prospectuses are clearly alerting investors to the fact that these securities are relatively high risk. It is up to the Panel to determine the degree of risk and whether they were suitable for the investors involved in this hearing.

### **IIROC, FINRA and SEC Notices**

¶ 53 In addition to the prospectuses, there are guidance notices by IIROC and by the comparable American organization, FINRA, as well as from the SEC, that show the speculative nature of these products.

¶ 54 An IIROC Guidance Note under the heading “Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds”, was issued on June 11, 2009 (Note 09-0172) – before Mr. Husebye purchased any of these securities. The first paragraph of the four-page document states:

“Exchange-traded funds (ETFs) that offer leverage or that are designed to perform inversely to the index or benchmark they track, or both, are growing in number and popularity. While such products may be useful in some sophisticated trading strategies, they are highly complex financial instruments that are

typically designed to achieve their stated objectives on a daily basis. Due to the effects of compounding, their performance over longer periods of time can differ significantly from their stated daily objective. Therefore, leveraged and inverse ETFs that are reset daily typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets.”

¶ 55 The note requires that a determination first be made by the Member that the product is suitable for *any* customer. It then goes on to say:

“Once a determination is made that a product is generally suitable for at least some investors, a firm must also determine that the product is suitable for specific customers. This analysis includes making reasonable efforts to obtain information concerning the customer’s financial situation, investment knowledge, investment objectives, risk tolerance and any other relevant customer specific information. While the customer-specific suitability analysis depends on the investor’s particular circumstances, leveraged and inverse ETFs typically are not suitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets.”

¶ 56 A similar note was issued in June 2009, by the U.S. Financial Industry Regulatory Authority (FINRA) under the heading “FINRA Reminds Firms of Sales Practice Obligations Relating to Leverage and Inverse Exchange-Traded Funds,” with a further notice in August 2009 in conjunction with the SEC under the heading “Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy and Hold Investors.”

¶ 57 Mr. Husebye testified that he was not aware of the IIROC notice or those by FINRA or the SEC until 2010, after the various trades had been concluded. When asked at the hearing why he did not know about the notice, he replied: “Well, it must have been some kind of oversight, either that or I received it and don’t remember receiving it, but I remember the first time I saw it or read it was 2010, because I was – my attention was drawn to it by my compliance department.” It is not clear when his firm became concerned. The documents that were put into evidence indicate that his firm did not seem to comment about using the products until the routine quarterly review of his transactions on April 22, 2010, where the first quarter of 2010 was reviewed. At that review, it was noted with respect to the various accounts of Mr. and Mrs. C: “Too much exposure to inverse index ETFs.” The previous review of the fourth quarter of 2009 on February 5, 2010, however, noted that the accounts were “consistent with the investment objectives” and “with the risk tolerant levels.” The Lakeshore compliance reviews for the second and third quarters of 2010 also showed that the exposure to the ETFs was beyond each client’s risk tolerance.

¶ 58 It is difficult for us to believe that nobody brought any of these notices to Mr. Husebye’s attention. These particular securities were his principal stock-in-trade. Surely someone would have brought his attention to the notice. It is likely, in our view, that he knew or was wilfully blind about these notices, but dismissed the warnings because of his strong belief that these were suitable investments for many of his clients.

¶ 59 In deciding whether to use these funds, Mr. Husebye had spoken to persons in the United States involved in the production of these products about some of the characteristics of the funds. Again, it is not easy to believe that the subject of the FINRA and SEC notices did not come up in these conversations. Again, these notices were issued many months before Mr. Husebye purchased any of these securities.

### **Case Law and other Documents relating to Inverse Exchange Traded Funds**

¶ 60 We were referred by counsel to a number of IIROC cases involving Inverse Exchange Traded Funds. These cases, however, do not shed very much light on the present case because in two of them there were Settlement Agreements (see *Re Carinci* 2013 IIROC 49; *Re Axford* 2013 IIROC 36 – a single inverse ProShare short) and in a third case, although not a Settlement Agreement, the Respondent was represented at the hearing by counsel “who raised no objection as to anything,” including the proposed penalty (*Re Dyck* 2012 IIROC 31.) There are many reasons why a Respondent would not contest an allegation. The present case appears to be the first contested IIROC hearing relating to the suitability of inverse or leveraged Exchange Traded Funds.

¶ 61 The widely used *CSI Conduct and Practices Handbook* of 2009 is also relevant. It states on the back of the cover page that the “Handbook reflects regulatory developments up to and including September 2009” and

then adds: “Registrants are expected to keep their knowledge current by checking the IIROC website [www.iiroc.ca](http://www.iiroc.ca) on a regular basis.” The funds in question in the present hearing are discussed briefly in the section on “Know your Client and Suitability.” After discussing new and non-traditional products, the Handbook states:

“For example, during the period 2007-2009 Exchange Traded Funds (ETFs) gained in popularity, particularly with retail investors. With their proliferation, funds that offer leverage or that are designed to perform inversely to the index, or both, are growing in number and popularity. These funds are generally designed to achieve their stated objectives on a short term (i.e., daily) basis. Although many investors assume that such funds will perform over time in their stated relationship to their index, the effect of compounding can result in significant variations. Consequently dealer members are advised to exercise caution when recommending purchases of these funds. The terms and features of the funds must be understood, sales materials must be fair and accurate and appropriate supervision must be in place.”

### Reasons for Our Conclusion

¶ 62 There is no bright line test to determine when a security is high risk. Based on the number of risk factors outlined in the relevant prospectuses, the alerts to Members and Registered Representatives through the IIROC and FINRA notices regarding suitability of the products, and Lakeshore’s own determination that the accounts were not consistent with the client’s risk tolerances, we find that the leveraged inverse products in question here were relatively high risk securities.

¶ 63 Although the products might have been suitable – even if held for lengthy periods – for very sophisticated clients, who understood the risks and had the resources to withstand heavy losses, they were not suitable for these clients, whose net worth was not high, who were approaching retirement, did not fully understand the product, and could not afford to gamble with their assets.

¶ 64 “Suitability determinations,” as an Alberta Securities Commission Panel has stated, “will always be fact specific.” (*Re Lamoureux* 2001 A.S.C.D. No. 613 at page 21.)

¶ 65 The *CSI Conduct and Practices Handbook* refers to “Know Your Client” rule as “The Cardinal Rule,” stating (at 4.4):

“[I]t is the cornerstone of all dealings with clients. The KYC rule requires that every dealer member use due diligence:

- \*to learn the essential facts relative to every client and to every order or account accepted;
- \*to ensure that the acceptance of any order for any account is within the bounds of good business practice; and
- \*to ensure that recommendations made for any account are appropriate for the client and in keeping with their investment objectives.”

(See *Re Hauchecorne* 2000 LNBCSC 74; *Transpacific Sales (Trustee for) v. Sprott Securities Ltd.*, [2001] OJ No 597; *Blackburn v. Midland Walwyn Capital Inc.*, [2003] OJ No 621.)

¶ 66 The *Handbook* lists a large number of considerations in determining suitability, stating (at 5.5):

“The following variables relating to a client should first be considered in determining whether a proposed trade is suitable:

- \*net worth;
- \*earnings;
- \*age;
- \*dependents;

- \*degree of risk in proposed transaction;
- \*knowledge of securities (or options or futures) markets;
- \*investment objectives;
- \*temperament;
- \*accessibility;
- \*existing portfolio;
- \*existing non-securities investments (i.e., pension, real estate, etc.) and
- \*time horizon of the investment (when is the money needed?).”

Obviously, investments which may be suitable for some clients are not necessarily suitable for all clients.

¶ 67 It is true that Mr. LC had an MBA, but he was never in the financial or securities business. He inspected homes. His spouse had limited knowledge of the markets. We do not believe that they really understood the products that were being bought for them by the Respondent. Mr. TC testified that he left it to Mr. Husebye. These are complicated products and not easy to understand. It is difficult to grasp the intricacies of these products, particularly how the various techniques, such as futures contracts, options on futures contracts, securities and indices, forward contracts, swap agreements and similar instruments, operate to achieve the desired leveraged results. Although the clients may not be directly involved in these techniques, the success of the investment depends to some extent on the success of the techniques employed.

¶ 68 As we stated above, the Panel has concluded that Mr. and Mrs. C probably would have known that they were meant to profit by a decline in the market, but would not have been aware of the details of the funds that were purchased and the risk they were taking.

¶ 69 Ms. LP’s emails show that she clearly did not understand the products, whatever the Respondent might have said to her, and Mr Husebye did say in a number of emails that her shares would go up if the market went down. The first purchase of leveraged inverse funds was purchased for Ms. LP in August 2009. After she received her statement in September 2009, showing a loss, she emailed Mr Husebye, stating, in part: “I hope to recoup some of the losses before year end with the seemingly turn around of the economy.” And in an email to Mr. Husebye on April 15, 2010, she wrote: “I am writing because I received my March 31<sup>st</sup> statement and I see that my account has gone from \$65,000 + to (if I understand correctly) a market value of \$50,778.25...I thought this year things were getting better in the markets but I am getting concerned as I don’t want to keep on losing as I am close to retirement.” Mr. Husebye replied: “I believe that the rise from March 2009 was a rally within a larger bear market which is far from over – the next phase should be a decline which takes us to lower lows, and consequently should take your account to new highs.” She replies immediately: “I am not understanding ‘a decline which takes us to lower lows and consequently should take your account to new highs’. I was under the impression that my money goes down when the markets are down.”

¶ 70 The transcript of her evidence is consistent with these emails. She stated: “And – like, I never understood what was going on. Because all I know is if market is going up, I’m going to make money. Because I didn’t know what the ETFs were.” The Panel believes that she never really grasped the nature of these products in those years. The products were clearly not suitable for her.

¶ 71 Later, her emails show that she did gain an understanding about how the products worked. On March 16, 2011 she wrote to Mr. Husebye: “I got some information on ETF’s and read a little – my blood pressure has gone up (seriously on medication) and I am unable to function properly at work nor sleep. I only wished that you did not put almost all my investments into this – and that some of my money was invested in something else (don’t mean stocks) that would at least increase in value/even interest, however minimal – at least I wouldn’t be risking so much. But I did put my trust in you now I can only hope.”

¶ 72 It may be that if a smaller proportion of the assets of the clients had been invested in the Strategy, there would be less concern. After all, the clients did say that about a quarter of their assets could be invested in

speculative products. But in the present cases **all** their liquid assets, except cash, were invested in these funds. It is not for us to say what a proper mix of assets would be for these clients, but concentration of **all** their assets, except cash, in relatively high risk securities is inappropriate and unsuitable, considering the risk tolerance set out in the clients' NAAFs.

¶ 73 Concentration of securities is important. As an IIROC Panel stated in a 2012 case (*Re Myatovic* 2012 IIROC 47 at paragraph 111):

“Once the account has been opened, the Know-Your-Client Rule then extends to the trading in the account. The registered representative has an ongoing obligation to ensure that the trading in the account reflects the investment objectives and risk tolerances of the client as outlined in the NCAF. This obligation includes monitoring the concentration and the suitability of the securities traded in the account. Monitoring concentration imposes upon the registered representative the requirement to ensure that the holding of securities in the account are not so weighted in favour of one or more securities so that the concentration of the holdings in these securities increases the risk in the account to an extent which exceeds the risk tolerances defined for the account.”

¶ 74 Moreover, it was not necessary for the Respondent to purchase products that produced double the effect of simple inverse funds. Unleveraged funds were available at the time. They may have posed some risk, but they were clearly not as risky as double leveraged funds. If the products had not been leveraged, the Panel may possibly have hesitated before concluding that the funds used were unsuitable. There is no evidence that non-leveraged inverse products were even offered to Mr. and Mrs. C or to Ms. LP.

¶ 75 When asked at the hearing why he used the double inverse products rather than simple inverse funds, Mr. Husebye replied: “it just seemed to me to be more efficient and, again, it was for the advantage of getting leverage that we could use a relatively smaller amount of funds, half the amount of funds that we would have required to do an unleveraged ETF....[U]sing a smaller portion of funds you could have two times the potential for reward, two times the potential risk, but it allowed you to achieve your possible goal with half the amount of capital. So it was just a question of getting a little bit of power, which is essentially what the leverage was.” Mr. Husebye understood that leveraged funds were riskier than non-leveraged funds.

¶ 76 He also understood that leveraged funds were not for everyone. Even non-leveraged inverse funds, he wrote, were for “aggressive investors”. In webmail message in January 2010 under the heading “Bear Market Strategy” sent to to his clients, including Mr. and Mrs. C and Ms. LP, Mr. Husebye wrote:

“When the stock market is in a down-trend or bear market, we usually will be in cash or government bonds in order to protect our capital.

However, aggressive investors may consider short-selling or trading inverse Exchange Traded Funds (ETFs), which are designed to produce positive returns during falling markets....

Inverse Exchange Traded Funds (ETFs) can be bought or sold on major stock exchanges just like common shares. They are designed to exactly replicate the inverse performance of various underlying indexes, commodities or currencies. For example, an ETF which corresponds to the inverse of the Dow Jones would be expected to rise in value as the Dow falls, and vice versa.”

Mr. Husebye is referring here to *single* inverse ETFs for “aggressive investors.” He then goes on to say:

“When appropriate, we can also employ leveraged ETFs which are designed to provide a negative multiple (e.g., -200%, -300%) of an index’s performance on a daily basis. For example, a double-short ETF will nominally return twice the inverse return of the underlying index – if the index falls 5% the double-short ETF will rise 10%, and vice versa.”

So he appears to be suggesting that the double leveraged products would only be appropriate for *some* of his “aggressive” clients. If Mr. and Mrs. C and Ms. LP understood that Mr. Husebye was using inverse ETFs for their investments, it is likely that they did not appreciate that he was using “double-short ETFs”.

¶ 77 This webmail message was the only reference in the various communications sent to his client in the

material we were given by the Respondent that referred to double short ETFs. In a note sent to his clients on April 8, 2010, he refers to inverse ETFs, but does not mention leveraged ETFs, stating: “Beyond cash, there are potentially excellent opportunities to profit from falling stock indexes through inverse ETFs...Many such derivatives tripled or quadrupled in the 2008 rout – which is not to guarantee a similar outcome in the future. But in our view they are a much safer place to be than in the stock market along with everyone else.”

¶ 78 In a *Globe and Mail* article on January 31, 2010, the business writer Brian Milner interviewed Mr. Husebye for an article entitled: “Brace yourselves for the next wave of the bear market.” No mention is made of inverse ETFs or leveraged ETFs. He is quoted as stating to Mr. Milner in relation to the 2009 rally: “I’ve been overly conservative in the sense that I’ve protected their capital.” Mr. Milner then states: “His safe play: U.S. dollars and government bonds.” If Mr. and Mrs. C or Ms. LP read and understood this article, they would be excused for thinking that his “safe play” approach applied to them.

¶ 79 The fact that the Respondent was betting against a rise in the market is not the issue. It was the manner in which it was done in this case, with this concentration of products, in these leveraged products, for these particular clients, that we find unsuitable and inappropriate.

¶ 80 The fact that other inverse products may have been even riskier, such as triple-short ETFs or products involving commodities that produced greater market volatility, or were not as broad-based as the index funds he employed, does not mean that the products he did use were suitable for these clients. Nor does the fact that a standard short sale of a security might be even more unsuitable because a client can lose even more than the sum invested.

¶ 81 And the fact that Mr. Husebye had not previously been the subject of complaints to IIROC, and sincerely believed that his Strategy was suitable for his clients, are factors to be taken into account in assessing the penalty, not a defence to the allegations.

¶ 82 To conclude: we find that between November 2009 and December 2010, the Respondent failed to use due diligence to ensure that investment recommendations were suitable for his clients, contrary to IIROC Dealer Member Rule 1300.1(q).

Dated at Toronto this 2<sup>nd</sup> day of February, 2016

Martin L. Friedland, C.C., Q.C., Chair

Charles Macfarlane

T. Hugh McNabney

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