Re Drose

In the Matter of:

The Rules of the Investment Industry Regulatory Organization of Canada

and

Alfred Drose

2021 IIROC 14

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

Heard: May 10, 2021 in Toronto, Ontario via videoconference
Reasons for Decision: July 6, 2021

Hearing Panel:
Marvin J. Huberman, Chair, Zahra Bhutani and Neil Murphy
Appearance:
Sylvia Samuel, Senior Enforcement Counsel and April Engelberg, Enforcement Counsel
Alfred Drose (absent)

REASONS FOR DECISION

A. Introduction

¶ 1 This is a disciplinary proceeding in which the Investment Industry Regulatory Organization of Canada ("IIROC"), in the Statement of Allegations ("SOA"), dated August 20, 2020, alleges the following contraventions against Alfred Drose, the Respondent[1]:

(i) Between February 2014 and June 2015, the Respondent engaged in excessive trading in the accounts of GA, which was not within the bounds of good business practice and was unsuitable for GA, contrary to Dealer Member Rules 1300.1(o), 1300.1(q), and 1300.1(s); and

(ii) Between February 2014 and June 2015, the Respondent failed to use due diligence to learn and remain informed of the essential facts relative to his client, GA, contrary to Dealer Member Rule 1300.1(a).

¶ 2 The Respondent, who represented himself and was not represented by counsel or by an agent: (a) filed a Response to the Notice of Hearing and SOA, in the form of a Statement of Defense, (b) was interviewed by an IIROC Investigator, on January 29, 2020, pursuant to Rule 8100 of the IIROC Consolidated Enforcement, Examination and Approval Rules ("Consolidated Rules"), and (c) attended a prehearing conference via videoconference on December 2, 2020, in this proceeding.

¶ 3 The Respondent did not attend the second prehearing conference on March 19, 2021 nor did he or anyone acting on his behalf appear at the hearing on the merits on May 10, 2021. The Panel is satisfied that Mr. Drose was aware of the misconduct allegations against him because he was served with the Notice of

[1] A third contravention alleged in the Statement of Allegations was abandoned by IIROC Staff at the start of the hearing.

Hearing, he filed a Response to the Notice of Hearing and the SOA, he was interviewed by an IIROC Investigator, he attended a prehearing conference in this proceeding, he failed to attend at the hearing on the merits scheduled with his consent on February 16, 2021, and he provided dates on which he was available to - but did not - participate in a second prehearing conference.

¶ 4 The Panel determined to proceed with the hearing on the merits, in the Respondent's absence, pursuant to Rule 8423 (12) of the IIROC Consolidated Rules, Rules of Practice and Procedure. The Panel then requested IIROC Staff to proceed to present its evidence on the merits of the misconduct allegations, and then to file written submissions on liability. Those written submissions were received by the Panel on June 14, 2021.

Standard of Proof

¶ 5 The standard of proof is on a balance of probabilities in respect of this matter. As the Supreme Court of Canada clearly stated in *F. H. v. McDougall*, "…there is only one civil standard of proof at common law and that is proof on a balance of probabilities…"[2], and that in order to satisfy this standard of proof, evidence must be "sufficiently clear, convincing and cogent".

Burden of Proof

¶ 6 The burden of proof rests with IIROC to prove its case. It is the obligation of the party who submits any particular argument to affirmatively prove that contention. As Sopinka J. states in *Snell v. Farrell*, in a civil case, the two broad principles are:

(i) That the onus is on the party who asserts a proposition, usually the plaintiff; and

(ii) That where the subject – matter of the allegation lies particularly with- in the knowledge of one party, that party may be required to prove it.[3]

¶ 7 In Robertson v. Can. Canners Ltd., Steel J. said:

> The onus of proof is to impose an onus upon any party to adduce evidence establishing, by a balance of probabilities, the correctness of any contention upon which he relies…[4].

The Evidence

¶ 8 The documentary evidence at the hearing consisted of an IIROC Staff Compendium of Documents (Tabs 1 - 407), an amended Tab 407, a transcript of an investigative interview of Mr. Drose, and an IIROC Staff Compendium of Transcript Excerpts. The Panel also heard oral testimony from Mr. Danny Triolo, an Investigator at IIROC, who conducted an investigation of this matter.

B. Findings of Fact

¶ 9 Based on the evidence before us, this Panel makes the following findings of fact.

The Respondent Was an Experienced Registered Representative

¶ 10 The Respondent became an IIROC registrant in 1983. He worked for ten different Dealer Members between 1983 and 1998, although he was not an Approved Person between 1998 and 2012.

¶ 11 In September 2013, the Respondent joined Chippingham Financial Group Limited ("Chippingham"), an IIROC Dealer Member, as a futures and options licensed Registered Representative.

¶ 12 The Respondent's employment with Chippingham ended on or about July 17, 2015.

¶ 13 Following his employment with Chippingham, the Respondent was employed at several other Dealer

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[2] *F.H. v. McDougall*, [2008] SCJ No. 54 at para. 40.
[3] *Snell v. Farrell* (1990), 72 D.L.R. (4th) 289 at pp. 294-5.
[4] *Robertson v. Can. Canners Ltd.* (1978), 4 B.L.R. 290 (Ont. H.C.), at pp. 292-3.

Members until September 2016, when he ceased to be registered with IIROC.

The Client GA

¶ 14 In February 2014, GA was 66-years old.

¶ 15 A former lawyer, GA suffered from Alzheimer's Disease. GA's cognitive decline led to intervention by the Law Society of Upper Canada (now known as the Law Society of Ontario ("LSO")), and in February 2012, an order was made appointing a trustee to manage GA's law practice.

¶ 16 By December 2012, GA was in full-time care as a result of Alzheimer's Disease.

¶ 17 In December 2012, the LSO held a capacity hearing and by decision dated January 31, 2013, the tribunal found that GA was incapacitated by reason of physical or mental illness or other infirmity which, the LSO panel held, required a surrender or revocation of his license within 30 days.

Failure to Exercise Due Diligence to Obtain Essential Facts: The GA Account Opening

¶ 18 At the beginning of February 2014, the Respondent had no prior relationship with GA, having met him only briefly at a social event more than 25 years ago.

¶ 19 In early February 2014, the Respondent arranged with GS, a.k.a. KS, to have a meeting in connection with the opening of an account ("GA Account"). Starting on or about February 4, 2014, the Respondent emailed several account opening documents to GS, including a blank NCAF, a blank Irrevocable Power of Attorney – Securities form, a blank Trading Authority Authorization form, and a blank Individual Futures Account Application. He followed up with a further email later that day in which he sent GS an email attaching a Chippingham Option Account Application Document.

¶ 20 Although the Respondent's testimony was that he did not recall the specific date of the meeting, the evidence indicates that the initial account opening meeting took place on February 11, 2014. In an email exchange on February 11, 2014, the Respondent wrote to GS to confirm the time GS's office would be closing and then wrote "I will come up." A handwritten note dated February 11, 2014 at the bottom of the copy of GA's passport is consistent with the Respondent's testimony that he verified GA's identification at the initial meeting.

¶ 21 The February 2014 meeting in connection with the GA Account opening took place at the offices of GS.

¶ 22 The February 2014 initial account opening meeting lasted approximately five minutes. The Respondent testified during his interview with IIROC Staff that "it was a brief meeting" lasting "five minutes tops."

¶ 23 Previously completed account opening documents were provided to the Respondent in connection with the opening of the GA Account.

¶ 24 The Respondent did not complete the account opening documents with GA. GA did not complete the account opening documents in the Respondent's presence.

¶ 25 GA's signature on the completed NCAF is dated February 5, 2014.

¶ 26 The Respondent did not witness GA sign the account opening documents.

a. The following is a summary of the KYC information contained on GA's NCAF:

Date of Birth	November 19, 1947
Age When NAAF Signed	66
Investment Objective	100% speculative
Risk Tolerance	100% high
Investment Knowledge	Good

Occupation	Lawyer
Annual Income	$90,000
Liquid Assets	$500,000
Fixed Assets	$5,500,000
Net Worth	$6,000,000

¶ 27 The Respondent did not speak to GA about the information on the NCAF form, including about the client's financial circumstances, investment objectives, risk tolerance, or investment knowledge prior to opening the GA Account.

¶ 28 GA's occupation was incorrectly indicated as lawyer on the NCAF notwithstanding that his license to practice law had been revoked by then.

¶ 29 The Respondent's signature on the GA Account NCAF is dated February 13, 2013 (2013 an apparent error) and approved by Chippingham's CCO on February 13, 2014.

¶ 30 KS was named as trading authority ("TA") on the GA Account at account opening.

¶ 31 The Respondent had no communication with GA between February 5 and February 13, 2014.

¶ 32 The Respondent had no communication with GA after the GA Account was opened. The Respondent's testimony was that he did not meet with GA at any time after the initial meeting at GS's office. He met him only twice, once more than twenty-five years ago and once at the meeting at GS's office.

The Respondent's Assets Under Administration ("AUA")

¶ 33 In September 2013, when the Respondent joined Chippingham, the Respondent's had AUA of zero. He had no clients.

¶ 34 In February 2014, just prior to GA becoming a client of Chippingham's, the Respondent had $23,328 in AUA, including his own account.

¶ 35 Once the GA Account was opened, the Respondent's AUA rose (from $23,328) to $597,794 on February 19, 2014.

¶ 36 In February 2014, after the GA Account was opened, it represented approximately 74.86% of the Respondent's AUA.

¶ 37 As at end of May 2015, the GA Account represented approximately 44.4% of the Respondent's AUA.

¶ 38 Between February 2014 and June 2015, the Respondent's AUA averaged $543,975.81.

Deposits into the GA Account

¶ 39 Between February 2014 and July 2015, a total of $1,330,815 was deposited into the GA Account as follows:

February 14, 2014 - $450,815

April 4, 2014 - $190,000

January 26, 2015 - $600,000

March 30, 2015 - $90,000

¶ 40 The additional $1,330,815 deposited to the GA Account was well in excess of the $500,000 in liquid assets indicated on the NCAF. Yet, there is no record of the source of the additional funds contributed to the GA Account following account opening and no KYC update or other note in client file.

¶ 41 The Respondent did not recall whether he obtained the source of the additional funds.

Trading in the GA Account

¶ 42 Trading in the GA Account was frequent and high risk, consisting of equities, ETFs, including leveraged ETFs, and options.

¶ 43 Between February 2014 and June 2015, the Respondent executed approximately 168 trades (including part fills) in the GA Account. Total purchases in the GA Account equaled approximately $14,626,172.77.

Turnover Ratio

¶ 44 The GA Account had an annualized turnover ratio of 26.52 for the period from February 2014 to April 2015 (the last month in which there were purchases in the GA Account).

Trading in Other Accounts Under the Respondent's Management

¶ 45 Between February 2014 and June 2015, the Respondent had six clients other than GA.

¶ 46 Between February 2014 and June 2015, the Respondent executed six trades for clients other than GA (not including trading by the Respondent in his own account), generating total gross commission of $850 on those trades.

Losses in GA Account

¶ 47 Between February 2014 and June 2015, the GA Account incurred losses of approximately $1,066,684 (after accounting for withdrawals of approximately $264,131).

$232,061 of Gross Commission

¶ 48 The Respondent selected a commission-based (confirmed by Chippingham Daily Commission Reports and Account Statements) structure for the GA Account at the time the account was opened.

¶ 49 Between February 2014 and June 2015, approximately $232, 061.37 of gross commission was charged as a result of trading in the GA Account.

¶ 50 The gross commissions from the GA Account between February 2014 and June 2015 represented approximately 99.6% of the total gross commission charged to the Respondent's clients 'accounts (excluding the Respondent own account).

¶ 51 The Respondent did not review the commissions charged to the GA Account to determine whether they were suitable.

Commission to Equity Ratio of 39.09

¶ 52 The commission to equity ratio of the GA Account was approximately 39.09% for the period from February 2014 to June 2015.

¶ 53 The GA Account would have had to generate returns of at least 39.09% to break even.

C. Summary of Applicable Law

The Know Your Client ("KYC") Obligation

¶ 54 The Know Your Client ("KYC") rule is paramount in the investment industry.[5]

¶ 55 IIROC Dealer Member Rule 1300.1 (a) codifies the KYC rule as follows:

> (a) Each Dealer Member shall use due diligence to learn and remain informed of the essential facts relative to every customer and to every order or account accepted.

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[5] *Conduct and Practices Handbook* (Toronto: Canadian Securities Institute, 2017) ("CPH").

¶ 56 The importance of the KYC rule was discussed in *Re Sammy*, which cited *Re Myatovic* 2012 IIROC 47, where that panel stated:

> The Know-Your-Client Rule is one of the basic tenets that defines the relationship between a registered representative and his or her client. Consequently, with the opening of an account, a registered representative has the obligation to make diligent efforts to learn of and to record the financial and personal circumstances of the client. …It also includes an informed assessment of the prospective client's knowledge and experience with investing and capital markets. …[6]

¶ 57 Among the essential facts that a Registered Representative must know about the client are the client's current financial situation, investment knowledge, investment objectives, time horizon, risk tolerance, and the account's portfolio composition and risk level.[7]

¶ 58 Closely related to the KYC rule is the obligation on registrants to assess the suitability of investments. In the Ontario Securities Commission ("OSC") decision in *Re Daubney*, the following was noted:

> The Commission has recognized that the know-your-client and suitability requirements are an essential component of the consumer protection scheme of the Act and a basic obligation of a registrant, and a course of conduct by a registrant involving a failure to comply with them is an extremely serious matter.[8]

¶ 59 The obligation to conduct suitability assessments is dealt with in the *Conduct and Practices Handbook*, which provides as follows:

> Suitability is based on the client's current financial situation, investment knowledge, investment objectives and time horizon, risk tolerance, and the account's current investment portfolio composition and risk level.
>
> It is important to note that suitability includes not only an obligation to ensure that the specific investment product is suitable for the client but also that the order type, trading strategy and method of financing the trade recommended and/or adopted are also suitable for the client. ….[9]

¶ 60 The close connection between the KYC rule and suitability is well recognized. In *Re Daubney,* the OSC referred to the seminal Alberta Securities Commission decision in *Re Lamoureux*, noting:

> The "know your client" and "suitability" obligations are conceptually distinct but, in practice, they are so closely connected and interwoven that the terms are sometimes used interchangeably.
>
>> The "know your client" obligation is the obligation to learn about the client, their personal financial situation, financial sophistication and investment experience, investment objectives and risk tolerance.
>>
>> The "suitability" obligation is the obligation of a registrant to determine whether an investment is appropriate for a particular client. Assessment of suitability requires both that the registrant understands the investment product and knows enough about the client to assess whether the product and client are a match. (*Re Marc Lamoureux (2001)*, ABSECCOM 813127 ("*Re Lamoureux*") at 10.)[10]

¶ 61 As confirmed by a number of IIROC decisions, the obligation to determine suitability rests with the registrant and cannot be transferred to the client. *Re Gareau* referred to the overview of the suitability obligation provided in *Re Lamoureux*, as follows:

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[6] *Re Sammy* 2016 IIROC 04 at para. 36.
[7] CPH at p. 1.4.
[8] *Re Daubney,* 2008 LNONOSC 338 at para. 15, citing *Re E.A. Manning Ltd. et al.* (1995), 18 O.S.C.B. 5317 at 5339.
[9] CPH at p. 1.4.
[10] *Re Daubney,* 2008 LNONOSC 338 at para. 16.

32 The Alberta Securities Commission in *Lamoureux* provided an overview of the "suitability" obligation that has evolved as a result of various decisions of Securities Commissions in Canada. The following paragraphs from the *Lamoureux* decision, found at Part IV(B)(3)(d), provides that overview:

We agree with these descriptions of the suitability obligation.

The obligation to ensure that recommendations are suitable or appropriate for the client rests solely with the registrant. This responsibility cannot be substituted, avoided or transferred to the client, even by obtaining from the client an acknowledgment that they are aware of the negative material factors or risks associated with the particular investment.

The obligation on a registrant to ensure that each investment recommended to a client is suitable is a particularly important protection for those clients whose investment experience and sophistication may be insufficient to enable them to fully recognize or assess the risks inherent in an investment. As noted below, disclosure to the client of the negative material factors of an investment, however important, is not necessarily relevant to a suitability determination and cannot replace a registrant's obligation to assess suitability. Acknowledgment on the part of an investor of awareness of the material negative factors or risk does not convert an unsuitable investment into a suitable one.

Our view is consistent with the OSC's decision in Marchment & MacKay, supra. There, the OSC considered whether the respondents, who had sent a variety of documents to their clients, could rely on this documentation to satisfy their obligation to ensure that securities sold to their customers were suitable and that they had adequately disclosed to the clients the risks associated with investing in the securities recommended. The OSC, in deciding that the obligation to determine suitability rests with the registrant and cannot be transferred to the client, stated [at p. 4735]:

> We reject this attempt to rely on these procedures as an effort to transfer to the customers the burden of determining whether the high-risk investments being recommended to them by Marchment salespersons were suitable for purchase by them. The obligation to determine suitability clearly rests with the registrant.
>
> […]

33 The salient points concerning the "suitability" obligation can perhaps be stated as follows:

(1) The obligation rests solely with the registrant and cannot be transferred to the client.

(2) The obligation is a particularly important protection for clients whose investment experience and sophistication is limited.

(3) An investor's risk profile is not simply a matter of looking at numbers on an NCAF.

(4) The "know your client" and "suitability" obligations must be measured at the time the investment is contemplated. It is not measured in light of subsequent unforeseeable events of either a positive or negative nature.[11]

[underlining added]

¶ 62 In *Re Gareau*, the panel cited with approval the following passage from *Re Lamoureux*, which discussed

[11] *Re Gareau* 2011 IIROC 53 at paras. 31-33.

the relationship between the NCAF and the obligation to provide suitable recommendations:

The Commission stated:

> Neither the "know your client" obligation or the "suitability" obligation can be fulfilled merely by completing poorly constructed forms or by following a procedure in a perfunctory fashion. Forms and procedures are merely tools that can assist in performing a task and that may provide reminders or evidence of efforts undertaken or not undertaken. (at Part IV(B)(3)(b))[12]

¶ 63 In the IIROC decision in *Re Locke* 2020 IIROC 14*,* the hearing panel held that the usefulness of the KYC document in assessing suitability is lost if the document is not completed accurately and truthfully. It stated as follows:

> If the KYC is not realistic, accurately, and truthfully completed, it cannot be used as the standard for assessing the suitability of subsequent purchases of securities.[13]

¶ 64 The hearing panel in *Re Locke* went on to note:

> … The KYC form does not provide a shield or free pass to purchase unsuitable securities notwithstanding what is written on a KYC form. More is demanded of a registrant upon whom novice investors are placing their trust and receiving the reassurances that the registrant will look after the investor's money.[14] [underlining added]

¶ 65 As noted in *Re Daubney*, completion of a KYC form is not enough. Care must be taken to make inquiries related to the client's circumstances in order to later make suitable recommendations. Referring to the KYC form, the panel in *Re Daubney* stated as follows:

> However, completion of the form is not, by itself, sufficient to ensure that suitability requirements are met. The registrant must make detailed enquiries as to the client's circumstances to ensure that suitable investments are recommended and to assess the client's likely reliance on the registrant's advice and recommendations. (*Re Lamoureux*, supra at 12-14.)[15]

¶ 66 As is well established by the cases, satisfaction of the suitability obligation is premised on the Registered Representative first satisfying the KYC obligation. In order for a Registered Representative to determine whether a particular product is suitable for a client, the Registered Representative must first know the client. As was noted in *Re Lamoreaux,* "only after the "due diligence" of the first stage is completed, can the registrant move to the second stage in which they fulfill their obligation to determine whether specific trades or investments, solicited or unsolicited, are suitable for that client".[16]

Excessive Trading and Churning

¶ 67 Trust and confidence are crucial aspects of the relationship between client and investment adviser.

¶ 68 IIROC Rule 1402 requires that Registered Representatives observe high standards of ethics and conduct in the transaction of business, act in accordance with just and equitable principles, and comply with regulatory obligations. Rule 1402 provides as follows:

> A Regulated Person:
>
> (i) in the transaction of business must observe high standards of ethics and conduct and must act openly and fairly and in accordance with just and equitable principles of trade,

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[12] *Re Gareau* 2011 IIROC 53 at para. 31.
[13] *Re Locke* 2020 IIROC 14 at para. 27.
[14] *Re Locke* 2020 IIROC 14 at paras. 22, 27 and 90.
[15] *Re Daubney*, *supra,* at para. 22.
[16] *Re Lamoreaux, supra,* as quoted in *Re Matthews* 2014 IIROC 56 at para. 10.

and

(ii) must not engage in any business conduct that is unbecoming or detrimental to the public interest.

(2) Without limiting the generality of the foregoing, any business conduct that:

(i) is negligent,

(ii) fails to comply with a legal, regulatory, contractual or other obligation, including the rules, requirements, and policies of a Regulated Person,

(iii) displays an unreasonable departure from standards that are expected to be observed by a Regulated Person, or

(iv) is likely to diminish investor confidence in the integrity of securities, futures or derivatives markets, may be conduct that contravenes one or more of the standards set forth in subsection 1402(1).

¶ 69 It is well established that excessive trading with a view to enriching the Registered Representative at the expense of the client (often referred to as "churning") is inconsistent with the high standards of ethics and conduct expected of an IIROC Registered Representative.

¶ 70 In *Ryder v. Osler, Wills, Bickle Ltd.*, where the plaintiff sued to recover damages for losses sustained as a result of the defendant's breaches of fiduciary duty, the court accepted the evidence of an accountant with the Toronto Stock Exchange that:

> Churning is a practice whereby a registered representative, exercising control of the volume and frequency of trades, trades that account excessively in view of the character of the account and the customer's objectives.[17]

¶ 71 In *Re Graydon*,[18] a decision of the Exchange Hearing Committee of the Toronto Stock Exchange, the panel considered allegations of churning against an advisor in connection with his aunt's account, and in so doing, referred with apparent approval to the definition of churning in *Ryder v. Osler*.

¶ 72 The IIROC decision in *Re Matthews* 2014 IIROC 56 adopted the summary of what constitutes excessive trading in *Re Graydon* as follows:

> 14. The panel in *Re Graydon* described the following considerations as relevant to determining "whether trading was so excessive as to constitute a breach of the principles of just and equitable trading":
>
> **a. Character of the account and the client's investment objectives**
>
> As a matter of common sense, a volume of trading that may be appropriate in an account that contains a modest part of the capital of a wealthy person and is to be used for speculation, may be totally inappropriate in an account that contains almost the entire capital of an elderly person of limited means who intends the account to supplement her present income and to provide her with a source of financial support in her retirement. …
>
> **b. Volume and frequency of trading**
>
> There are several widely used indicators of the extent of the trading activity in an account. One is the annualized rate at which an account is turned over: this is calculated by dividing the total value of the purchases in a year by the average value of the equity

[17] *Ryder v. Osler, Wills, Bickle Ltd.* (1985), 49 O.R. (2d) 609 at 620.
[18] *D.M. Graydon Osler, Wills, Bickle Ltd.,* [1987] T.S.E.D.D. No. 20.

> [turnover rate]. …
>
> Another measure is the frequency with which securities are bought and sold ("in and out trading"), especially when the same or similar investments are involved. …
>
> **c. Client loss v. broker profit**
>
> …It may be inferred from the size of the increase in the client's equity that would be needed to offset the commissions and interest paid to the broker, that the high volume of trading was excessive in the light of the nature of the account and the client's objectives, and supports a conclusion that the profit of the broker, not the interest of the client, was the dominant motivation for the transactions.

15. The panel in Re Graydon also described the mental element of churning, saying:

> This offence certainly involves more than an error of judgment, or negligence: as indicated earlier, its gist is an allegation that the broker has abused the confidence of the client by trading in the account with the intention of generating commissions, willfully disregarding the client's interests. Direct evidence of a person's state of mind is often unavailable: nonetheless, a tribunal may infer the requisite mens rea from other facts. Indeed, the rationale of many of the elements of the offence is that they point to the broker's intention to enrich himself, rather than to protect the client.[19]

De Facto **Control**

¶ 73 With respect to the element of control relevant to the charge of churning, the panel in *Re Graydon* held as follows:

> The simplest way of establishing that the registered representative controlled the client's account is to show that the client authorized the exercise of discretionary authority over the account, and that discretion was in fact exercised. Mrs. McGovern alleges precisely this.
>
> In addition, a registered representative may exercise de facto control, even if he has not been given, and is not exercising discretionary authority to trade in the account. <u>Thus, control may be inferred from the fact that the client reposed confidence in the registered representative, because, for example, of the disparity of their knowledge and experience of the market, the existence of some pre-existing family or social relationship, and the age of the client. It will also be relevant to consider to what extent the trades originated in the registered representative's recommendations, and how often the recommendations were accepted by the client.</u> It is possible, even on Mr. Graydon's version of the history of the trading in Mrs. McGovern's account, that he might be found to have exercised the degree of control necessary to find him guilty of churning.[20] [underling added]

¶ 74 The panel in *Re Graydon* found control to have existed based on the finding that the client had consented to the representative exercising discretion over the account.

¶ 75 In *Re Matthews*, the panel found that the respondent exercised *de facto* control over the client's account even though he was not given and did not exercise discretion in the client account. At paragraph 68, it held as follows:

> The panel finds that the Respondent exercised de facto control over LZ's accounts even though he was not given, and did not exercise, discretionary authority to trade in the account. The panel finds that LZ reposed trust and confidence in the Respondent by authorizing all the trades

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[19] *Re Matthews* 2014 IIROC 56 at paras. 14 - 15.
[20] *D.M. Graydon Osler, Wills, Bickle Ltd*., *supra,* at p. 9 of 16.

recommended by the Respondent, effectively yielding control over the accounts to the Respondent.[21]

Turnover Rate and Commission to Equity Ratio

¶ 76 In determining whether trading in a client account is excessive, certain quantitative factors are generally considered, including turnover rate[22] and commission to equity ratio.[23]

Turnover Rate

¶ 77 The turnover rate is calculated by dividing the total purchases over the period in question by the average equity in the account,[24] with the result then annualized.[25] Account equity is the amount the client would realize if all the securities in the account were liquidated, and, therefore, represents the amount of money available to turnover the account in order to generate commissions. By comparing total purchases to the account equity, the turnover rate represents the number of times the equity in the account is liquidated and reinvested in the given period.[26]

¶ 78 The panel in *Re Graydon* held that there is no magic turnover rate, as follows:

> We should emphasize that there is no magic turn-over rate, above which an inference of churning will be made automatically, and below which a registered representative cannot be found guilty of churning. The ultimate question is whether the trades were made to generate commissions, without regard to the client's interest: how this is answered will depend upon all the circumstance of the particular case.[27]

The Commission to Equity Ratio

¶ 79 Another way of determining whether trading in an account is excessive is by determining the cost to equity ratio, which indicates the percentage of return on the account's net equity that is needed to pay commissions and other expenses. "In other words, the cost-to-equity ratio measures the amount an investment would have to appreciate to break even."[28]

¶ 80 Eliminating other expenses from the analysis, the commission to equity ratio measures the percentage of return on the account's net equity that is needed to pay commissions. It is necessarily a more conservative measure in that it does not consider other expenses such as margin interest or fees. The cost-to-equity ratio will, therefore, be either equal to or greater than the commission to equity ratio. In comparison to the cost-to-equity, the client may still not break even if the rate of return on investment is equal to the commission to equity ratio as other expenses must also be considered.

¶ 81 The commission to equity ratio is calculated by dividing the total commissions in the account by the average equity in the account and then annualizing that number.

Decisions Considering Turnover Rates and Commission to Equity Ratios

¶ 82 Having held that there is no magic turnover rate, the panel in *Re Graydon* went on to conclude that turnover rates of 8.9, 5.2, and 3.5 were evidence that trading was so excessive as to be inconsistent with just

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[21] *Re Matthews, supra,* at para. 68.
[22] *Re Graydon* at p. 10 of 16.
[23] Cost to equity ratio, which considers other expenses (e.g., fees and margin interest) in addition to commission, is another measure.
[24] *Re Graydon, supra,* at p. 10 of 16.
[25] This is done by dividing the total number of months in the period in question and multiplying by 12 (because account statements are produced monthly). Alternatively, the ratio may be annualized using the number of days and multiplying by 365.
[26] *Pinchas (Re*), US Securities and Exchange Commission, Rel. No. 41816 / September 1, 1999 Admin. Proc. File No. 3-9639 at 5 of 15.
[27] *D.M. Graydon Osler, Wills, Bickle Ltd*., *supra,* at p. 14 of 16.
[28] *Re Pinchas*, *supra,* at p. 5 of 15.

and equitable principles of trading.[29]

¶ 83 In *Re Matthews*, commission to equity of 16.56% and turnover rate of 14.74 in one client account were considered "remarkably high."[30] Commission to equity of 17.38% and turnover rate of 14.99 in another client account were considered to be "extremely high."[31] In both instances, the panel found excessive trading.

¶ 84 In *Re Brum* 2020 IIROC 39, the agreed facts state turnover ratios from 2.7 to 5.2 to be excessive:

> The turnover ratio for SF's RRSP account for the years 2012 to 2016 was 4.13, 4.5, 2.76, 4.45 and 5.21 respectively. The turnover ratio for SF's margin account for the years 2012 to 2014 was 4.77, 3.04 and 4.06 respectively. The Respondent earned $396,542 in fees from the excessive trading and from new issues in SF's RRSP and margin accounts during this period. The short-term and frequent trading with an emphasis on new issues, which was recommended by the Respondent, was not suitable for SF given her personal and financial circumstances."
>
> …
>
> "The turnover ratio for SR and WR's account in 2014 was 3.45 which was indicative of excessive trading.[32]

¶ 85 In *Re Melkonian* 2011 IIROC 62, the turnover ratio of the portfolio during the period of reference was 6.56, and, by the parties' admission, was excessive and not in the best interests of the client.[33]

¶ 86 In the *Re Dunn* 2020 IIROC 11 decision, the parties agreed that there was excessive trading in the case of one client account with an average turnover rate ranging from 2.3 to 16.4 and another client account where the turnover rate ranged from 0 to 7.8.[34]

Mental Element May be Inferred

¶ 87 With regard to the mental element, the panel in *Re Graydon* held as follows:

> This offence certainly involves more than an error of judgment, or negligence: as indicated earlier, its gist is an allegation that the broker has abused the confidence of the client by trading in the account with the intention of generating commissions, willfully disregarding the client's interests. Direct evidence of a person's state of mind is often unavailable: nonetheless, a tribunal may infer the requisite mens rea from other facts. Indeed, the rationale of many of the elements of the offence is that they point to the broker's intention to enrich himself, rather than to protect the client.[35]

D. The Position of IIROC

¶ 88 IIROC Senior Enforcement Counsel ("Enforcement Counsel") submits that the Respondent failed in his KYC obligations in failing to exercise due diligence to obtain essential facts relevant to the client, GA, and that the Respondent then engaged in excessive trading in the seventeen months during which the GA Account was opened.

¶ 89 Enforcement Counsel further submits that:

a) After a perfunctory meeting, lasting five minutes, the Respondent opened an account for GA, with whom he had no prior relationship. He did not review KYC information or forms with the

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[29] *D.M. Graydon Osler, Wills, Bickle Ltd*., *supra,* at p. 15 of 16.
[30] *Re Matthews, supra,* at paras. 61(8), 61(10), 71.
[31] *Re Matthews, supra,* at paras. 81(8), 81(10), 98.
[32] *Re Brum* 2020 IIROC 39 at paras. 5(i) and 5(m).
[33] *Re Melkonian* 2011 IIROC 62 at para. 19, 20, 21.
[34] *Re Dunn* 2020 IIROC 11 at paras. 10, 24.
[35] *D.M. Graydon Osler, Wills, Bickle Ltd*., *supra,* at p. 11 of 16.

client either prior to, during, or after the five-minute meeting and had no further communication with the client after account opening. The Respondent's actions call into question the KYC forms and whether they were realistic or accurately and truthfully completed.

b) It is impossible to know a client whom one meets for five minutes and never speaks to again. Five minutes is not enough to review all relevant KYC information, and by the Respondent's admission, he made no attempt to do so during the five-minute meeting. Further, KYC is the starting point of the suitability obligation that rests on all Registered Representatives. The two essential obligations are interwoven, and without first complying with the KYC obligation, the Respondent was not able to determine the suitability of any investments made in the GA Account. He, therefore failed to comply with the KYC duty, a fundamental obligation of a registrant, and contravened Dealer Member Rule 1300.1(a).

c) The Respondent had *de facto* control over the GA Account based on the disparity of knowledge between the Respondent and the client and the client's lack of understanding of the market as compared to the Respondent. Given the client's lack of mental capacity due to Alzheimer's Disease, the disparity between the Respondent and the client was undeniable. In addition, the Respondent's lack of contact with the client coupled with the large number of trades marked unsolicited (less than 12% (20 of 168)) provide evidence of *de facto* control.

d) Any attempt to assess whether the trading in the GA Account was excessive based on the client's investment profile as indicated on KYC forms will produce unreliable results based on the Respondent's KYC failure. Given the Respondent's failure to know the client, there is no reasonable basis to assume the documented KYC information is realistic, accurate, or truthful.

e) However, even assuming the KYC documents accurately recorded an interest in high risk, speculative investing, the trading activity was excessive in light of the turnover rate and commission to equity ratio of the GA Account.

f) The annualized turnover ratio of 26.52 of the GA Account far exceeded the rate found to be excessive in *Re Graydon* and was well above the rate of 6 considered conclusive evidence of excessive trading in US decisions.

g) Based on the commission to equity ratio in this case, the GA Account would have had to generate returns at a rate of, at least, 39.09% to break even. As the commission to equity ratio does not take into account other expenses charged to the account, the GA Account would have had to generate returns greater than 39.09% to break even, which it did not.

h) Although the cases have established that there is "no magic turnover rate" or other calculus above or below which excessive trading will be automatically established, the turnover rate and commission to equity ratio in this case lead undeniably to a conclusion of excessive trading outside the bounds of good business practice.

i) Given the amount of losses in the GA Account, the nature of the trading that occurred, and the lack of care in collecting KYC information necessary to conduct suitability assessments as compared with the amount of commissions generated by the trading in the account, it can reasonably be inferred that the Respondent traded in the GA Account to generate commissions and enrich himself, without regard to the client's interest.

E. Analysis

¶ 90 Mr. Drose is charged with: (i) engaging in excessive trading in the accounts of GA, which was not within the bounds of good business practice and unsuitable for GA, contrary to Dealer Member Rules 1300.1(o), 1300.1(q), and 1300.1(s); and (ii) failing to use due diligence to learn and remain informed of the essential facts relative to his client, GA, contrary to Dealer Member Rule 1300.1(a).

¶ 91 In our view, the evidence in this case clearly establishes that Mr. Drose contravened Dealer Member Rules 1300.1(a), 1300.1(o), 1300.1(q), and 1300.1(s), as alleged in the Statement of Allegations. And we accept Enforcement Counsel's above submissions.

¶ 92 The Panel finds on the evidence, on a balance of probabilities, that the GA Account was opened with Mr. Drose, in February 2014, for 66-year-old GA, who had been found more than a year earlier, to lack capacity due to Alzheimer's Disease by a LSO tribunal. Although there was no prior relationship between the Respondent and the client, the initial client meeting lasted five minutes, during which the Respondent collected pre-filled account opening forms, including the NCAF. He did not discuss the content of the pre-filled forms, including essential KYC information, with the client, but following that five-minute meeting, opened the account, and had no further contact with the client. Accordingly, in our view, the Respondent failed in his KYC obligations in failing to exercise due diligence to obtain essential facts relevant to the client.

¶ 93 We further find on the evidence before us that Mr. Drose then engaged in excessive trading in the seventeen months during which the GA Account was opened. The GA Account represented more than 76% of the Respondent's AUA when the account was opened and averaged approximately 73% of the Respondent's AUA over the life of the account. The Respondent executed 168 trades over the life of the account, a number far greater than the seven trades in all of the Respondents' other clients' accounts combined. He engaged in high risk, speculative, and short-term trading. As a result, the turnover rate on the GA Account, which provides evidence of the frequency with which the securities in the account were traded for new securities, was 26.52 (annualized). This trading was not profitable and resulted in losses to the client in excess of $1.3 million. In comparison, the total gross commissions on the GA Account exceeded $232,000, resulting in a commission to equity ratio of 39.09 (annualized), which, in our view, constitutes further evidence of the excessive trading in the account.

F. Conclusion

¶ 94 The Panel therefore concludes, based on the clear, convincing, and cogent evidence in this case, that:

(i) Mr. Drose, the Respondent, by failing to know his client, diverged from the standard expected of him as an IIROC Registered Representative, and breached IIROC Dealer Member Rule 1300.1(a);

(ii) The excessive trading in the GA Account fell outside the bounds of good business practice and was unsuitable for GA, contrary to Dealer Member Rules 1300.1(o), 1300.1(q), and 1300.1(s); and

(iii) Mr. Drose is liable for these contraventions.

¶ 95 The Panel directs Enforcement Counsel to file written submissions as to the appropriate penalty and costs after consultation with the Panel and Enforcement Counsel by way of videoconference on a day and at a time to be scheduled by the National Hearing Officer.

Dated at Toronto, Ontario, this 6 day of July 2021.

Marvin J. Huberman

Zahra Bhutani

Neil Murphy