Mutual Fund Dealers Association of Canada
Association canadienne des courtiers de fonds mutuels

IN THE MATTER OF A SETTLEMENT HEARING
PURSUANT TO SECTION 24.4 OF BY-LAW NO. 1 OF
THE MUTUAL FUND DEALERS ASSOCIATION OF CANADA

Re: Patrick Hugh Lumbers

Heard: March 26, 2019 in Toronto, Ontario
Decision: March 26, 2019
Reasons for Decision: May 6, 2019

REASONS FOR DECISION

Hearing Panel of the Central Regional Council:

The Hon. Peter B. Hambly	Chair
Susan Dicks	Industry Representative
Kenneth P. Mann	Industry Representative

Appearances:

Francis Roy	)	Enforcement Counsel for the Mutual Fund Dealers Association of Canada
A. Benson Forrest	)	Counsel for the Respondent
Patrick Hugh Lumbers	)	Respondent, in person

Introduction

1. This is a settlement hearing under Section 24.4 of By-law No. 1 of the Mutual Fund Dealers Association of Canada (the "MFDA") regarding allegations made by the MFDA against Patrick Hugh Lumbers (the "Respondent"). The hearing is to determine whether the hearing panel approves a settlement agreement dated March 25, 2019 ("Settlement Agreement") entered into between the parties.

Background

2. The Respondent has been a mutual fund salesperson, now known as a dealing representative, with Investors Group Financial Services Inc. ("Investors Group") since May, 1988. MC was an elderly lady with fair investment knowledge. The Respondent serviced her investment accounts.

3. In April, 2013 MC sold her condominium where she had been living and moved into a retirement residence. She sold the condominium for $410,402. At that time her other assets totaled $47,700. They consisted of mutual funds of $12,000 in a RRIF account, $21,400 in a TFSA account, and $14,300 in a Non-Registered account. By the end of 2012, her annual income was approximately $37,000 from CPP, the Old Age Pension, her deceased husband's pension and $2,400 from her RRIF.

4. After the sale of her condominium, acting on the Respondent's advice, she made investments as follows on May 1, 2013:

a) $200,000 in the Investors Dividend A Fund (DSC);
b) $140,000 in the Investors Premium Money Market Fund (DSC)[1];
c) $25,000 in the Investors U.S. Large Cap Value B Fund (no load); and
d) $15,000 in the Investors International Small Cap B Fund (no load).

5. The first 2 of these (Series A) funds were deferred service charges funds which were subject to a 7year redemption schedule. In early 2014 MC's mental health deteriorated. She moved

[1] On May 15, 2013, the Respondent switched the $140,000 investment in the Investors Premium Money Market Fund (DSC) to the Investors Real Property Fund A (DSC).

into an assisted living facility. The monthly fees were $5,115. She needed the money from the sale of her condominium and other savings to pay these fees. In August, 2014 she moved into a long-term care facility. On December, 31, 2014 she died at the age of 93.

6. The Respondent prepared a Know-Your Client ("KYC") update form for MC stating, among other things, that she was 92 years old, had a time horizon 10+ years, had a medium risk tolerance, and had an investment objective to “leave an estate”. Investors Group did not receive this KYC update form. The only change from prior KYC information on file with Investors Group was a change of MC’s risk tolerance on her non-registered account from high to medium.

7. The investments which the Respondent recommended to MC that she purchase were not suitable for her given her age, health condition, investment time horizon and investment objectives.

8. RC, who was MC’s son, and MC’s niece held joint power of attorney and personal care for her. On March 4, 2014, the Respondent sent an email to MC's son, RC, which stated:

> (MC’s) portfolio has increased over the year $427,725.00 to $448,958.00 to Dec 2013 and now is currently at $447,584.32 with a risk tolerance as before allowing equity being High on the grid but her true profile is moderate /conservative and her risk is medium even if her time horizon is 3-6 years. I have always used 10 years for (MC).

9. The Respondent was aware of MC's health condition, change in living arrangements, and investment time horizon. The Respondent stated that he nonetheless saw no need to update client MC's KYC information or reassess the suitability of her investments.

10. In August, 2015 after MC’s death RC who was an executor of her estate submitted a complaint to Investors Group regarding the DSC investments that the Respondent had recommended to her. When the estate redeemed these investments Investors Group refunded to the estate the DSC fees totaling $10,180.96.

11. The Respondent has admitted MFDA’s allegations against him as follows:

a) between May 2013 and March 2014, he failed to learn, or update material changes to, the essential Know-Your-Client information for a 92 year old client's accounts, contrary to MFDA Rules 2.2.1, 2.2.4, and 2.1.1; and

b) in May 2013, he recommended for the account of a 92 year old client the purchase of approximately $340,000 of mutual funds which were subject to a 7 year deferred sales charge schedule, without ensuring that the recommendation was suitable having regard to the essential Know-Your-Client factors relevant to the client, including the client's age, health condition, investment time horizon, and investment objectives, contrary to MFDA Rules 2.2.1 and 2.1.1.

12. He had agreed to the penalty proposed by MFDA, namely, a fine of $20,000, costs in the amount of $2,500 and a schedule of repayment.

Discussion

The Law

13. Relevant Rules of MFDA procedure and legislation are as follows:

1. **2.1.1 Standard of Conduct**

Each Member and each Approved Person of a Member shall:

a) deal fairly, honestly and in good faith with its clients;
b) observe high standards of ethics and conduct in the transaction of business;
c) not engage in any business conduct or practice which is unbecoming or detrimental to the public interest; and
d) be of such character and business repute and have such experience and training as is consistent with the standards described in this Rule 2.1.1, or as may be prescribed by the Corporation.

2. **2.2.1 "Know-Your-Client"**

Each Member and Approved Person shall use due diligence:

a) to learn the essential facts relative to each client and to each order or account accepted;

b) to ensure that the acceptance of any order for any account is within the bounds of good business practice;

c) to ensure that each order accepted or recommendation made, including recommendations to borrow to invest, for any account of a client is suitable for the client based on the essential facts relative to the client and any investments within the account;

d) to ensure that, notwithstanding the provisions of paragraph (c), where a transaction, including a transaction involving the use of borrowed funds, proposed by a client is not suitable for the client based on the essential facts relative to the client and the investments in the account, the Member or Approved Person has so advised the client before execution thereof and the Member or Approved Person has maintained evidence of such advice;

e) to ensure that the suitability of the investments within each client's account is assessed:

   i. whenever the client transfers assets into an account at the Member;

   ii. whenever the Member or Approved Person becomes aware of a material change in client information, as defined in Rule 2.2.4; or

   iii. by the Approved Person where there has been a change in the Approved Person responsible for the client's account at the Member;

   and, where investments in a client's account are determined to be unsuitable, the Member or Approved Person so advises the client and makes recommendations to address any inconsistencies between investments in the account and the essential facts relative to the client and the Member or Approved Person maintains evidence of such advice and recommendations;

f) to ensure that the suitability of the use of borrowing to invest is assessed:

   i. whenever the client transfers assets purchased using borrowed funds into an account at the Member;

ii. whenever the Member or Approved Person becomes aware of a material change in client information, as defined in Rule 2.2.4; or

iii. by the Approved Person where there has been a change in the Approved Person responsible for the client's account at the Member;

and, where the use of borrowing to invest by the client is determined to be unsuitable, the Member or Approved Person so advises the client and makes recommendations to address the inconsistency between the use of borrowed funds and the essential facts relative to the client and the Member or Approved Person maintains evidence of such advice and recommendations.

3. **2.2.4 Updating Client Information**

a) Definition. In this Rule, **"**material change in client information**"** means any information that results in changes to the stated risk tolerance, time horizon or investment objectives of the client or would have a significant impact on the net worth or income of the client.

b) The form documenting know-your-client information must be updated to include any material change in client information whenever a Member or Approved Person becomes aware of such change including pursuant to Rule 2.2.4(e).

c) Subject to paragraph (d), the Member must maintain evidence of client instructions regarding any material changes in client information and all such changes must be approved by the individual designated in accordance with Rule 2.2.3 as responsible for the approval of the opening of new accounts.

d) A client signature or other internal controls sufficient to authenticate the client's identity and verify the client's authorization must be used to evidence any change in client name, client address or client banking information.

e) Without reducing the responsibility of Members in Rule 2.2.1, all Members must at least annually, in writing, request each client to notify the Member if there has been any material change in client information previously provided to

the Member or the client's circumstances have materially changed. The date of such request and the date upon which any such client information is received and recorded or amended must be retained.

4. **Penalty**

MFDA By-Law No. 1

Power of Hearing Panels to Discipline

24.1.1 *Approved Persons*

A Hearing Panel of the applicable Regional Council shall have power to impose upon an Approved Person or any other person under the jurisdiction of the Corporation any 1 or more of the following penalties:

b) a fine not exceeding the greater of:

(i) $5,000,000.00 per offence; and

24.2 Costs

Applications in Exceptional Circumstances A Hearing Panel may in any case in its discretion require that the Member or Approved Person pay the whole or part of the costs of the proceedings before the Hearing Panel pursuant to Section 20 and Section 24.1 or Section 24.3 and any investigations relating thereto.

Analysis

Respondent's Liability

14. In *Arseneau (Re),* 2012 LNCMFDA 93 the Respondent was a mutual fund salesperson. He advised his clients to purchase leveraged investments i.e. to borrow money to purchase investments. The investments that the Respondent advised his clients to purchase were return of capital investments. If the cost of borrowing the money is less than the revenue produced by the investments everything is fine. However, if the economy declines and the revenue produced by the investments is less than the cost of borrowing the client would need other cash resources to pay the loans or face insolvency. This is what happened here. There were 20 complainants. The Respondent received commissions from leveraged investments of $629.000. The hearing panel

found that the Respondent was in breach of MFDA Rules 2.1.1 and 2.2.1. It held the following:

> 42. First, Rule 2.2.1(a) of MFDA Rules, under a heading "Know-Your-Client" requires an Approved Person (the Respondent) to "use due diligence" to learn the essential facts relative to each client and to each order or account accepted.
>
> 43. In this case "due diligence" includes at least the obligation to know the client's financial situation, current and continuing financial obligations, net worth, income, liquid assets, understanding of the market, age relative to retirement, financial situation after retirement if retirement would occur during the term of the investment, purpose of the investment, together with knowledge and understanding of borrowing to invest and of Return of Capital ("ROC") mutual funds and the ability to repay the borrowed amount in the event of market changes to the value of the mutual fund and/or its distributions.
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> 44. While the Respondent did acquire knowledge of some of the foregoing, basically the necessary things required for the loan application, he failed to meet the "due diligence" requirement of assuring that the client knew the investment, (a ROC mutual fund), understood how such a fund works, understood the risks involved and could afford to make regular monthly payments on the loan if the distributions reduced which they did in the fall of 2008 and in the spring of 2009. Twelve of the complainants, including the three affiants who testified at the Hearing, FS, SA and JK indicated they could not afford to pay the costs of the loans if the distributions were not sufficient and would not have invested in the strategy had they been told of the risk.
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> 45. In fact, the Respondent relied solely on the approval of the loan by the lender as his assessment of the suitability of the client to engage in the borrow-to-invest leverage strategy. The obligation of due diligence in Rule 2.2.1 rests on the Respondent solely and is not transferable and by acting as he did the Respondent utterly failed his "Know-Your-Client" obligations.
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> 46. His failure to use due diligence also arises in relation to Rule 2.2.1(c) which places the onus on the Respondent to ensure that his recommendations for these leveraged accounts and the orders accepted for them were suitable for the client (complainants) based upon the essential facts relative to the client and any investments within the account.
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> 47. In the present matter, clearly the borrow to invest strategy was not suitable to the complainants who would not have bought into the leveraged strategy if they were made aware of any risks, particularly if they were alerted that the value of the investment could fluctuate downward and the distributions could similarly fluctuate downward so as to fall below, in even a minor way, the amounts required to apply on the investment loan.
>
> …

52. The two key principles in Rule 2.2.1 are Know-Your-Client and suitability. As was said in *Re Daubney*, a 2008 decision of the Ontario Securities Commission, para. 15, 16 and 17:

> 15. 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." (Re E. A. Manning Ltd. et al. (1995), 18 O.S.C.B. 5317 at 5339)
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> 16. The Alberta Securities Commission (the "ASC") described these two obligations as follows:
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> > 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.)
>
> 17. Canadian securities authorities have adopted a three-stage analysis of suitability, according to which a registrant is obliged to:
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> a) use due diligence to know the product and know the client;
> b) apply sound professional judgement in establishing the suitability of the product for the client; and
> c) disclose the negative as well as the positive aspects of the proposed investment.

53. In the present matter the Respondent did little to learn about these clients. His main focus was to convince the client to borrow $50,000.00 and invest it in a ROC mutual fund. He did not consider the client's financial sophistication, investment experience or risk tolerance. Risk was not a concern as he advised each of the complainants there was no risk. His "no-brainer" concept blinded him to his obligations under know-your-client.

> 54. The Respondent failed completely in the suitability obligations he was bound by. He admitted in his interview with Mike Ford, Tab 7 of the Ford Affidavit, that he made no inquiries as to suitability and relied solely on the lender. If the lender approved the loan, then he was satisfied as to the suitability of the leveraged investment.

The panel imposed a fine of $500,000, assessed costs in the amount of $20,000 and a permanent prohibition on the Respondent from conducting securities related business with a MFDA member.

> (see also *DeVuono (Re),* [2012] MFDA Pacific Regional Council, File No. 201102 on similar facts at para. 52)

15. MC at age 93 did not have a time horizon of 10 years as stated on the Know Your Client form. Although the Respondent changed her risk tolerance from high to medium on the form, he did not file it with Investors Group. Clearly the Respondent is in violation of MFDA Rules 2.1.1. and 2.2.4.

16. The DSC charge investments were not at all suitable for the needs of MC. She needed the money from the sale of her condominium to meet her immediate needs of paying the fees at the assisted living residence where she moved. By recommending these investments for her the Respondent is in violation of MFDA Rules 2.1.1 and 2.2.1.

The Role of the Hearing Panel and the Proposed Penalty

17. MFDA By-Law No. 1 states the following:

> 24.4.3 *Review and Determination by Hearing Panel*
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> Such settlement agreement shall, on the recommendation of: the Corporation, be referred to a Hearing Panel of the applicable Regional Council which shall:
>
> a) accept the settlement agreement; or
> b) reject it.

18. A hearing panel should not interfere with a settlement agreement without a good reason. In *Sterling Mutuals Inc. (Re),* MFDA File No. 201619, a Hearing Panel of the Central Regional Council explained the role of a hearing panel in considering a settlement agreement as follows:

11. The duty of a Hearing Panel sitting on a Settlement Hearing differs from that of a Hearing Panel at a contested hearing. As was stated in Re Clark (Re), [1999]:

> "In a contested Hearing, the Hearing Panel attempts to determine the correct penalty. In a Settlement Hearing, the Hearing Panel takes into account the settlement process itself and the fact that the parties have agreed to the penalties set out in the Settlement Agreement. In our view, a Hearing Panel should not interfere lightly in a negotiated settlement and should not reject a Settlement Agreement unless it views the penalty as clearly falling outside a reasonable range of appropriateness. As has been said: "The settlement process is one of negotiation and compromise and the penalty imposed following a settlement will often be less onerous than one imposed following a Hearing where similar findings are made."

19. The breach of the Rules as set out above by the Respondent are serious. If MC had lived longer and her money had not been available to her to pay the fees for her assisted living accommodation she could have been in serious financial difficulty. Both specific and general deterrence must be reflected in the penalty. In mitigation by admitting the allegations the Respondent has saved MFDA the time and cost of conducting a contested hearing. The results are publicized. This will be an embarrassment to the Respondent. Investors Group has prohibited its sales persons from selling mutual funds subject to DSC fees. The Respondent has been a mutual fund sales person (now a dealing representative) with Investors Group for over 20 years. He has no previous record of violating the Rules. The panel has considered the factors set out in *Headley (Re),* 2006 LNCMFDA 3 at p. 25. It has also considered the similar MFDA sanctions guidelines. The penalty proposed is similar to penalties imposed in the cases listed at para. 31 of the Submissions of Staff.

Result

20. We approve the Settlement Agreement and impose the penalties proposed as follows:

a) the Respondent shall pay a fine in the amount of $20,000 (the "Fine"), pursuant to section 24.1.1(b) of MFDA By-law No. 1;

b) the Respondent shall pay the costs (the "Costs") of this proceeding and investigation in the amount of $2,500, pursuant to section 24.2 of By-law No. 1;

c) The Fine and Costs are to be paid by the Respondent as follows:

i. an initial payment to the MFDA in the amount of $7,500 upon acceptance of this Settlement Agreement; and

ii. commencing 30 days following acceptance of this Settlement Agreement, six additional, and consecutive, monthly installment payments in the amount of $2,500 until the Fine and Costs are paid in full.

21. We confirm the order that we signed at the close of the oral hearing.

22. We thank counsel for their very helpful oral and written submissions.

DATED this 6th day of May, 2019.

"Peter B. Hambly"
The Hon. Peter B. Hambly
Chair

"Susan Dicks"
Susan Dicks
Industry Representative

"Kenneth P. Mann"
Kenneth P. Mann
Industry Representative

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