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

IN THE MATTER OF A DISCIPLINARY HEARING
PURSUANT TO SECTIONS 20 AND 24 OF BY-LAW NO. 1
OF THE MUTUAL FUND DEALERS ASSOCIATION OF CANADA

Re: Leo Alexander O'Brien and David Baxter Snow

Heard: September 24, 2008
Panel Decision: November 25, 2008

DECISION and REASONS

Hearing Panel of the Atlantic Regional Council

The Honourable Hilroy S. Nathanson, Q.C. .....Chair
Ann C. Etter..... Panel Member
David Losier ..... Panel Member

Appearances

H.C. Clement Wai, Esq. ....Counsel for Mutual Fund Dealers Association of Canada
Leo Alexander O'Brien..... In Person
David Baxter Snow ..... In Person

I THE ALLEGATIONS

1. In a Notice of Hearing dated May 15, 2008, the Mutual Fund Dealers Association of Canada (the "MFDA") made two allegations against the Respondents – one allegation against each of the Respondents – as follows:

Allegation # 1:

> Between April 20, 2005 and June 16, 2006, O'Brien engaged in excessive trading by processing 166 switches in 22 client accounts using limited trading authorizations without obtaining instructions, approval or authorization from the clients, contrary to MFDA Rules 2.3.4, 2.1.1 and outside the scope of his registration as a mutual fund salesperson as stipulated under section 86 of the Consolidated Newfoundland and Labrador Regulation 805/96, *Securities Regulations under the Securities Act*, O.C. 96-286;

Allegation # 2:

> Between April 20, 2005 and June 16, 2006, Snow, at all material times the Branch Manager responsible for supervising O'Brien, failed to adequately supervise O'Brien's trading activity, contrary to MFDA Rule 2.5.3(b) and MFDA Policy No. 2.

II FIRST APPEARANCE

2. The Notice of Hearing gave notice of a first appearance by teleconference before a Hearing Panel of the Regional Council of the Atlantic Region of the MFDA. As is indicated in an Affidavit of Service on file, the Respondents were served with the Notice of Hearing in accordance with Rule 4.2(1)(b) of the MFDA Rules of Procedure.

3. The Respondents attended the first appearance by teleconference in person, that is, not represented by legal counsel.

4. At the first appearance the Respondent O'Brien disclosed that he had sent an e-mail to MFDA Enforcement Counsel on April 14, 2008, and the Respondent Snow disclosed that he had not yet served and filed a Reply in accordance with Rule 8.1(1) of the MFDA Rules of Procedure.

O'Brien offered and it was agreed by the Hearing Panel that his e-mail of April 14, 2008 and attachments would constitute his Reply. The Hearing Panel ordered that Snow serve and file a Reply on or before August 21, 2008.

III PRELIMINARY MATTERS

5. A Hearing on the Merits convened on September 24, 2008. Upon the opening, the Hearing Panel considered two preliminary matters.

6. First, counsel for the MFDA noted that the Respondent Snow had failed to file or serve a Reply. Such failure triggered s. 20.4 of MFDA By-Law No. 1 and Rule 8.4(1)(b) of the MFDA Rules of Procedure which provide that where a Respondent has failed to file a Reply to the Notice of Hearing, the Hearing Panel is permitted to accept the facts alleged and conclusions drawn by the MFDA in the Notice of Hearing as proven and impose any of the penalties and costs described in s 24.1 and 24.2 of the MFDA By-Law No. 1. Based thereon, the Hearing Panel ruled informally that it accepted as proven the facts alleged and conclusions drawn by the MFDA in the Notice of Hearing with respect to Allegation # 2 against Snow. However, the Hearing Panel permitted Snow to call witnesses and make submissions in support of his case. In retrospect, granting such permission may have been unwise because, as will be seen, it had the effect of unnecessarily prolonging the Hearing and allowing Snow to make lengthy submissions which were not based upon facts in evidence.

7. Second, the Respondent Snow made a lengthy and convoluted submission which, in the end, amounted to an application to divide the Hearing into two parts, namely, separate Hearings for each of the two Respondents. The Hearing Panel recessed to consider this submission and, in due course, ruled that it did not accept the submission. The matter could have been and should have been raised at the first appearance or by way of a motion prior to the Hearing or set out in a Reply, so that the Panel and the other side would have prior notice of this Respondent's intentions. Snow had not taken any of these routes, and it was now too late to make this application.

IV THE EVIDENCE

8. The relevant facts are set out in the Notice of Hearing dated May 15, 2008; the Affidavit of

Ian R. Smith sworn September 17, 2008; the Supplementary Affidavit of Ian R. Smith sworn September 18, 2008; the testimony of witness J.W.H.; the testimony of Ian R. Smith; and the several exhibits accepted into evidence at the Hearing.

9. Paragraphs 1 to 11 inclusive of the Notice of Hearing set forth the particulars of the two allegations against the Respondents.

10. The Affidavit of Ian R. Smith consists of two volumes containing 13 paragraphs and a large number of exhibited documents. The facts set out in these paragraphs together with the contents of the exhibited documents tend to prove substantially all of Allegations # 1 and # 2.

11. The Supplementary Affidavit of Ian R. Smith simply confirms that the Respondent Snow had acknowledged that he did not conduct trade reviews with respect to the Respondent O'Brien's trades.

12. J.W.H. was a client of the Respondent O'Brien, and his testimony was highly complimentary of O'Brien's integrity and general character, but the rest of the evidence overwhelmingly confirmed that he did not authorize each and every trade purportedly carried out on his behalf by O'Brien.

13. In his testimony, Ian R. Smith, investigator for the MFDA, confirmed the facts set out in his affidavits, and stated that Allegation # 1 was based substantially upon information communicated to him in interviews with the Respondent O'Brien. He acknowledged that he had not confirmed the information with clients, and had never received complaints from any of O'Brien's clients. The present complaint does not derive from a client complaint. The statements made by O'Brien during the interviews were clear. He did not say anything about being ill or taking medication at the time.

14. The remaining exhibits may be described as a collection of miscellaneous letters and other materials from former clients, employers and supervisors. The letters from former clients tend to confirm that the Respondent O'Brien made excellent investment recommendations and earned significant returns for them. None of them acknowledge that he was not registered to carry on discretionary trading for them. The letters from former employers and supervisors tend to confirm that O'Brien was aware that he was not permitted to conduct discretionary trading on behalf of his

clients.

15. In the result, it is clear that between April 20, 2005 and June 16, 2006, the Respondent O'Brien processed 166 switches in 22 client accounts using limited trading authorizations ("LTA's"). This was confirmed by O'Brien who admitted in his statement to the MFDA that he processed each switch without obtaining instructions, approvals or authorization for the switches from clients: see Affidavit of Ian R. Smith, para 9; and the interview of O'Brien being Exhibit C in the Affidavit of Ian R. Smith sworn September 17, 2008, page 66, line 21; page 67, line 14; page 68, line 19; page 70, line 11; and page 85, line 11.

16. In his closing submission to the Hearing Panel, O'Brien submitted that he had never traded without the authority of clients, that he had always acted with their general authority, and that he had always acted in their best interests. The Panel considers this submission to be irrelevant to the question of whether he had acted within the scope of specific authorizations as alleged in Allegation # 1. O'Brien also submitted that when he had made statements to investigator Ian R. Smith to the effect that he had never received specific instructions to make 166 switches as alleged, he was suffering mental breakdowns and was taking strong medications. That submission was not confirmed by independent evidence, was contradicted by the testimony of Smith, and is not accepted by the Panel.

17. In the further result, it is also clear that between April 20, 2005 and June 16, 2006, the Respondent Snow failed to adequately supervise O'Brien's trading activity. He stated that it was not part of his job description to supervise others such as O'Brien. He referred to others – one at his employer's head office and one in Nova Scotia – as being responsible for such supervision and compliance. The weight of the evidence and the substance of MFDA Rule 2.5.3 are expressly to the contrary.

18. It is noted the Respondent Snow did not call witnesses to confirm much of the substance of his closing submissions. His submissions must therefore be considered to be bare submissions, that is, not based on evidence.

V ANALYSIS

Allegation # 1:

19. Individuals registered as investment counsel or portfolio managers have discretionary trading authority, and investment advisors are permitted to conduct discretionary trades in managed or discretionary accounts, provided they have explicit written consent. However, mutual fund salespeople are not permitted to conduct discretionary trades and must always contact the client prior to making any transactions. Where an Approved Person fails to obtain client instructions prior to executing a trade, he engages in discretionary trading beyond the terms of his or her registration as a mutual funds salesperson: see s. 86 of the Consolidated Newfoundland and Labrador Regulation 805/96, *Securities Regulations* under the *Securities Act*, O.C. 96-286; and **In The Matter of Brian Somerset Campbell**, [2008] (Campbell) Hearing Panel of the Pacific Regional Council, MFDA File No. 200805, Decision dated 26 June, 2008.

20. An LTA is a document which authorizes an Approved Person to execute a trade in a client's account without the necessity of the client providing his or her written instructions. It does not in any way confer general discretionary trading authority. MFDA Rule 2.3.4 provides as follows:

> 2.3.4 No discretionary trading. A limited trading authorization shall not in any way confer general discretionary trading authority upon a Member and Approved Person or any person acting on behalf of the Member.

21. As an employee of a Member, the Respondent O'Brien is an Approved Person within the meaning ascribed in s. 1 of By-Law No. 1 of the MFDA. The existence of an LTA for a client's account does not relieve an Approved Person of the ordinary-course obligation to obtain specific, express instructions from the client for each trade made pursuant to the LTA. In the absence of such instructions, there will be no written authorization or signature of the client against which to later verify the trade. That is why it is important to record and maintain evidence of client trade instructions including, among other things, the account to which the trade instructions apply, the time and date that the instructions were received, the amount of the trade, the price at which it was executed and, the specific details of any costs for fees associated with executing the trade. Such

instructions should also include a note as to how the client's instructions were given to the approved person (e.g. by telephone, in person or by facsimile). See Recording and Maintaining Evidence of Client Trade Instructions, Member Regulation Notice MR-0035.

22. The LTAs used by the Respondent O'Brien expressly stated: "This does not constitute discretionary trading authorization, and this is not a managed account." See interview of O'Brien, Exhibit C in the Affidavit of Ian Smith sworn September 17, 2008, page 66, line 21 and page 67, line 14.

23. Through these discretionary trades, the Respondent O'Brien conducted a short-term frequent trading strategy in which he purported to time the market, similar to what a portfolio manager might do. O'Brien was not registered to make independent investment decisions on behalf of clients. A frequent trading strategy would not be suitable for any of his clients, or any mutual fund client, especially the clients with RRSP accounts. Mutual fund investing is typically geared towards a long term buy-and-hold strategy. A frequent trading or market timing strategy would seldom be appropriate with mutual fund products because of the diversified nature of their holdings and because of the risk inherent in attempting to time the market.

24. Excessive trading can harm a fund's performance and the value of other investors' holdings in the fund. By excessively trading a mutual fund, the long-term investors will be subjected to higher fees due to the transaction costs of the short-term trading. Mutual fund companies discourage investors from trading excessively and possibly engaging in inappropriate market timing strategies by reserving the right to charge the client a fee, commonly referred to within the industry as a "short term trading fee" and typically up to 2% of the amount traded, in respect of redemptions made within, for example, 30 or 60 or 90 days of purchase. The short term trading fee is charged to the client and is payable to the mutual fund.

25. In addition, most mutual funds authorize the individual mutual fund salesperson, in his or her discretion, to charge a client a fee of up to 2%, known as a "switch fee", in respect of all switches between the funds of the same mutual fund family. The switch fee is charged to the client and is payable directly to the mutual fund salesperson.

26. A pattern of frequent trading may suggest that the purpose of the transactions is to earn commissions or to generate some other benefit for the salesperson (e.g. switch fees) at the expense of the client's best interests. The primary means by which mutual fund salespersons generate income is through the collection of sales commissions and trailer fees on investments made by their clients. Although it is open to an Approved Person to charge clients switch fees, their use is comparatively rare. In the present case, switch fees were charged in a widespread and systematic manner. See **Churning**, Member Regulation Notice MR-0065.

27. Approved Persons are obligated to deal fairly, honestly and in good faith with clients and observe high standards of ethics and conduct in the transaction of business in accordance with MFDA Rule 2.1.1. This Rule is obviously intended to protect the public interest.

28. In this case the trading activity carried on by the Respondent O'Brien pursuant to LTAs resulted in him earning approximately $64,000.00 in switch fees in a span of 14 months. These fees were charged by and payable directly to O'Brien in his sole discretion.

29. The Respondent O'Brien has admitted that he did not obtain express, specific instructions from each client prior to executing the switches. Rather, he executed the switches at his own discretion relying upon the purported authority set out in the LTAs. O'Brien never informed the clients, and at least some of the clients never had an opportunity to confirm with O'Brien, that each such switch would result in a fee of 2% of the amount being switched being charged to the client and payed directly to O'Brien.

30. It is impossible to view these switches as other than excessive trading which was not in the best interests of the clients.

Allegation # 2:

31. A branch manager is required to play an important compliance role in the area of investor protection. MFDA Rule 1.2.2 sets out the experience, education and proficiency requirements to be registered as a branch manager. A branch manager's responsibilities include, among other things,

the training and supervision of branch employees to ensure that they understand what practices are and are not acceptable.

32. It is the responsibility of a branch manager to supervise the trading activity at the branch office and to ensure that the business conducted by an Approved Person is in compliance with applicable securities legislation and MFDA By-Laws, Rules and Policies. See MFDA Rule 2.5.3; and **In the Matter of Paul Edward Lloyd**, [2007] Hearing Panel of the Central Regional Council, MFDA File No. 200720, Decision dated February 26, 2008.

33. The minimum standards for account supervision detailed in MFDA Policy 2 include a requirement to review account activity for excessive trading or switching. The branch manager must review the previous day's trading for unusual trading activity. This review should include, at a minimum, a sample of trades in accounts operating under LTAs.

34. Between April 20, 2005 and June 16, 2006, the Respondent Snow, at all material times the branch manager responsible for supervising the Respondent O'Brien, failed to supervise O'Brien's trading activity by failing to conduct trade reviews for O'Brien, failing to make reasonable inquiries with respect to the inordinately high number of switches using LTAs and the substantial switch fees charged in the client accounts serviced by O'Brien that occurred during a comparatively short period, despite prior knowledge of O'Brien's history of previous misconduct; and failing to ensure that O'Brien received client trade instructions prior to executing trades pursuant to an LTA. See Supplementary Affidavit of Ian Smith sworn September 18, 2008, Exhibit A, and interview of Snow in Exhibit D of the Affidavit of Ian Smith, page 83, line 16; page 40, line 19.

35. The Respondent Snow was aware that O'Brien was known to engage in excessive trading activity. Snow had a prior, lengthy association with O'Brien, and knew that O'Brien had been terminated by a previous Member due to concerns relating to the same type of conduct. Snow had ignored O'Brien's excessive trading activity while O'Brien was at the Newfoundland branch of Worldsource. There is no evidence that Snow subjected O'Brien to any form of heightened supervision, expressed any concerns to O'Brien or to head office as to O'Brien's excessive trading activity, imposed any form of discipline on O'Brien or took any steps to prevent O'Brien's activity.

36. The Respondent Snow received an override commission on the switch fees received by O'Brien. This override commission may have provided a financial incentive for Snow to permit the activity to continue. In any event, whether through inaction or by acquiescence, Snow facilitated O'Brien's excessive trading activity and, by doing so, failed to fulfill his supervisory obligations as a branch manager to ensure that the best interests of investors were protected.

VI DECISION

37. This Panel finds that Allegation # 1 against the Respondent O'Brien has been proven, and that Allegation # 2 against the Respondent Snow has been proven.

38. There is no issue in this case as to criminality on the part of either of the Respondents. Both Respondents were concerned about the possible effect upon their reputations due to comments in various Newfoundland media. This Panel can do nothing about such comments. But, it is clear that the only issue in this case is whether the Respondents broke specific rules and policies of the MFDA, as alleged in the Notice of Hearing.

VII SANCTIONS

39. The primary goal of securities regulation is the protection of the investor: **Pezim** v. **British Columbia (Superintendent of Brokers)**, [1994] S.C.J. 58, Iacobucci, J. at paras. 59 and 68.

40. The role of an MFDA Hearing Panel is similar to that of a provincial securities commission insofar as it protects the public interest.

41. In exercising its discretion to impose a penalty, the Hearing Panel has taken into account the following considerations: the protection of the investing public; the integrity of the capital markets; specific and general deterrence; the protection of the MFDA's membership; and the protection of the integrity of the MFDA's enforcement process.

42. In determining an appropriate penalty, the Hearing Panel has considered the following: the

seriousness of the allegations proven against a Respondent; the Respondent's past conduct, including prior sanctions; the Respondent's experience in the capital markets; the level of the Respondent's activity in the capital markets; whether the Respondent recognizes the seriousness of the improper activity; the harm suffered by the investors as a result of the Respondent's activity; the benefits received by the Respondent as a result of the improper activity; and previous decisions made in similar circumstances.

43. This Panel has considered the following aggravating factors:

(a) O'Brien had an extensive prior disciplinary history. He had been terminated by prior employers for similar misconduct. Snow was aware of this prior misconduct and, in fact, was O'Brien's branch manager at his prior employer. In July, 2004, the MFDA had provided O'Brien with a cautionary letter for similar misconduct.

(b) O'Brien's misconduct affected 22 clients over a period of approximately 14 months.

(c) The substantial switch fees charged, compounded with the excessive trading in the client accounts, produced a disproportionately high economic benefit to O'Brien. Snow earned an override on the commission from O'Brien's trading.

(d) Both O'Brien's and Snow's misconduct was a breach of their Member employer's policies and procedures.

44. One mitigating factor with respect to O'Brien is that he made a number of admissions in his statements during the course of the investigation with respect to this matter and, at times, acknowledged his wrongdoing. Offsetting that are his submissions to this Panel that he had been ill and under the influence of medication and had not appreciated what he was saying to the investigator.

45. In light of the foregoing, this Panel orders the following sanctions against the Respondent O'Brien:

(a) A permanent prohibition from conducting securities-related business in any capacity pursuant to s. 24.1.1(e) of the MFDA By-Law No. 1;

(b) A fine in the amount of $60,000.00 for engaging in excessive trading in 22 client accounts using limited trading authorizations without obtaining instructions, approval or authorization from the clients, pursuant to s. 24.1.1(b) of the MFDA By-Law No. 1; and

(c) Costs attributable to conducting the investigation and prosecution of this matter in the amount of $5,000.00, pursuant to s. 24.2 of MFDA By-Law No. 1.

46. This Panel also orders the following sanctions against the Respondent Snow:

(a) A prohibition from acting in a compliance or supervisory capacity with a Member for a period of three (3) years, pursuant to s. 24.1.1(c) of MFDA By-Law No. 1;

(b) A requirement to re-write the appropriate proficiency examination prior to becoming registered in any compliance or supervisory capacity with a Member, pursuant to s. 24.1.1 (c) of MFDA By-Law No. 1;

(c) A fine in the amount of $10,000.00 for failing to supervise O'Brien, pursuant to s. 24.1.1(b) of MFDA By-Law No. 1; and

(d) Costs attributable to conducting the investigation and prosecution of this matter in the amount of $5,000.00, pursuant to s. 24.2 of MFDA By-Law No. 1.

47. The prohibitions and fines of this magnitude reflect the seriousness of the Respondents' misconduct and attempt to ensure that they do not profit from their wrong-doing.

DATED at Halifax, Nova Scotia, this 25th day of November, 2008.

"Hilroy S. Nathanson"
The Honourable Hilroy S. Nathanson, Q.C.
Chair

"Ann C. Etter"
Ann C. Etter,
Industry Representative

"David Losier"
David Losier
Industry Representative

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