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# ORGANIZATION OF CANADA

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THE DEALER MEMBER RULES OF THE INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

**AND** 

**BENOÎT BEAULNE** 

#### **NOTICE OF HEARING**

**TAKE NOTICE** that, pursuant to Part 10 of Rule 20 of the Investment Industry Regulatory Organization of Canada (IIROC) and s. 1.9 of Schedule C.1 to Transition Rule No. 1, a hearing will be held before a hearing panel of IIROC (Hearing Panel) on September 12 and 13, 2012, at 10:00 a.m., or as soon thereafter as the hearing can be heard, at Centre Mont-Royal, 2200 Mansfield Street, Montréal, Québec, Mansfield 2 Room.

**TAKE FURTHER NOTICE** that, pursuant to Rule 6.2 of the Dealer Member Rules of Practice and Procedure, the hearing shall be designated on the:

The Standard Track
The Complex Track

**TAKE FURTHER NOTICE** that on June 1, 2008, IIROC consolidated the regulatory and enforcement functions of the Investment Dealers Association of Canada (IDA) and Market Regulation Services Inc. (RS). Pursuant to the *Administrative and Regulatory Services Agreement* between the IDA and IIROC, the IDA has retained IIROC to provide services for the IDA to carry out its regulatory functions with respect to the conduct of IDA registrants occurring before June 1, 2008.

**THE PURPOSE OF THE HEARING** is to determine whether Benoît Beaulne (Respondent) has committed the following contraventions that are alleged by the staff of IIROC (Staff):

- 1) Between October 2008 and April 25, 2010, the Respondent failed to exercise due diligence to ensure that his investment recommendations in leveraged exchange-traded funds constituted a suitable investment for two (2) of his clients, given their financial and personal circumstances and their investment objectives, contrary to IIROC Dealer Member Rule 1300.1 (a), (p) and (q);
- 2) Between June 2008 and April 25, 2010, the Respondent failed to exercise due diligence to ensure that he had the necessary knowledge of the features and risks inherent in leveraged exchange-traded funds before recommending such an investment to two (2) of his clients, contrary to IIROC Dealer Member Rule 1300.1 (a).

#### **PARTICULARS**

**TAKE FURTHER NOTICE** that the following is a summary of the facts alleged by Staff and which are to be relied upon at the hearing of this matter:

#### SUMMARY OF THE RESPONDENT'S ALLEGED MISCONDUCT

- The Respondent recommended to two (2) of his clients that they invest in complex financial instruments involving leveraging and a high degree of risk, whereas he did not have sufficient knowledge of these products and the products were unsuited to the financial and personal circumstances of these clients, and to their investment objectives;
- 2. Also, the Respondent failed to ensure that the information relating to two (2) of his clients was updated regularly, so that they could be made aware of material changes in their circumstances and thus might constantly give their informed consent regarding the investment recommendations made by the Respondent.

#### THE RESPONDENT

- 3. From August 1997 to March 1999, the Respondent worked at Midland Walwyn Capital Inc., an IDA Member firm, as a Registered Representative (Retail);
- 4. Subsequently, toward the end of March 1999, the Respondent was hired by Desjardins Securities Inc. (DS), an IDA Member firm, as a Registered Representative (Retail);
- 5. On or about January 29, 2008, the Respondent was dismissed for cause by DS;

- 6. On or about February 8, 2008, the Respondent was hired by Laurentian Bank Securities Inc. (LBS), an IDA Member firm (and subsequently an IIROC Dealer Member), as a Registered Representative (Retail);
- 7. On or about May 2, 2008, at the IDA's request, LBS agreed that the following requirement should be imposed so that the Respondent might act in the capacity of Registered Representative (Retail):

#### [TRANSLATION]

"That LBS fill out and keep in the Respondent's file a monthly <u>close supervision</u> report of his daily transactions."

- 8. At the material time, the branch manager (Manager) in charge of the Respondent's supervision was Mr. A. In fact, Mr. A exercised <u>strict supervision</u> of the Respondent's daily transactions;
- 9. On June 1, 2008, the Respondent became a registrant of IIROC;
- 10. On or about October 3, 2011, the Québec Superior Court handed down a decision against the Respondent, ordering him to pay DS the sum of one hundred and forty-one thousand two hundred and thirty-three dollars and ninety-six cents (\$141,233.96). A reading of this decision reveals the following facts:
  - i. DS was suing the Respondent for reimbursement of the sums paid out to compensate a client;
  - ii. The compensation offered by DS was to compensate this client for financial losses generated by an investment strategy recommended by the Respondent. The strategy consisted in purchasing a money market product and leveraging it to purchase speculative securities;
  - iii. However, it was established that this strategy was clearly counter to the client's short-term investment objectives, since the funds needed to be available for a real estate investment. Moreover, this client had never authorized any margin trading, whereas the Respondent had been buying on margin.
- 11. Currently, the Respondent is no longer approved in any registered capacity with an IIROC-regulated firm.

# INSUFFICIENT KNOWLEDGE OF LEVERAGED EXCHANGE-TRADED FUNDS, GIVING RISE TO UNSUITABLE RECOMMENDATIONS

- 12. In or around April 2006, the Respondent met "Mrs. B" and "Mr. C", who were referred to him by two (2) of his other clients. The Respondent was employed with DS at the time;
- 13. When the Respondent first met Mrs. B and Mr. C, they were a couple and had been retired for approximately nine (9) years;

- 14. Mrs. B had a Secondary 4 (high school) education and was working as an administrative assistant at Bell Canada prior to her retirement;
- 15. For his part, Mr. C had completed Grade 12, taken courses at the Institut de technologie de Montréal for three (3) years and earned his electrician's license. Prior to retiring, he sold automation solutions for hydro generation utilities;
- 16. Mrs. B and Mr. C retained the Respondent's professional services to look after their portfolio. They also hoped to improve their prospects for a better return, knowing that they would be dealing with an investment professional;
- 17. Mrs. B and Mr. C were aware of the risks connected with stock market fluctuations, but they were confident that by retaining the professional services of the Respondent, an employee of LBS, they would be assured of obtaining the essential information they would need to make informed decisions regarding their investments, decisions that would take into account their personal and financial circumstances as well as their capacity for risk;
- 18. On or around April 24, 2006, Mrs. B and Mr. C each opened a brokerage account at DS, numbered 7AMWC and 7AMWF respectively, and stating the following investment objectives: 70% moderate-risk growth securities, and 30% higher-risk speculative securities and stock market strategies. Investment knowledge was listed then as good for both Mrs. B and Mr. C. At that point, the combined value of Mrs. B's and Mr. C's portfolios was approximately four hundred and ninety thousand dollars (\$490,000);
- 19. From the outset of their business relationship with the Respondent, Mrs. B and Mr. C made it clear that they needed an approximate annual income of forty thousand dollars (\$40,000) to cover their routine expenses, since aside from their Old Age Security and Québec Pension Plan benefits, they had no other income sources. They also informed the Respondent that they wanted to replace one of their cars within two (2) years;
- 20. In or around October 2007, for the first time, the Respondent recommended to Mrs. B and Mr. C the purchase of leveraged Exchange Traded Funds (ETFs). Mrs. B and Mr. C were unfamiliar with leveraged ETFs and had never held such complex financial instruments in their portfolios, but accepted the recommendation based on the explanations given by the Respondent who, by reason of his training, had more specialized knowledge than they did;
- 21. Following the Respondent's transfer to LBS, on or around March 8, 2008, Mrs. B and Mr. C each opened a brokerage account, numbered 5AAGW and 5AAGX respectively, which stated the following investment objectives: 60% growth, 20% short-term growth and 20% speculative;
- 22. On new account application forms number 5AAGW and 5AAGX, the following information is found: Mrs. B's net annual income was two thousand dollars (\$2,000) and Mr. C's net income was sixteen thousand dollars (\$16,000). On these

- forms, the investment knowledge is described as Average for Mrs. B, and as Good for Mr. C;
- 23. In June 2008, the combined value of Mrs. B's and Mr. C's portfolios was approximately four hundred and thirty-eight thousand one hundred and thirty-five dollars (\$438,135);
- 24. In or around mid-June 2008, Mrs. B and Mr. C, being dissatisfied with the Respondent's professional services, requested the transfer of their accounts to the discount broker Scotia iTrade;
- 25. To convince them to maintain their professional relationship with him, the Respondent obtained authorization from his manager, "Mr. A", to waive all service fees connected with Mrs. B's and Mr. C's brokerage accounts for a three (3)-month period. Also, he told them that he would step up his efforts to increase the combined value of their portfolios to achieve the targeted five hundred and fifty thousand dollars (\$550,000). Consequently, on or around June 25, 2008, at the request of his manager, Mr. A, the Respondent filled out an account information change form for both Mrs. B and Mr. C;
- 26. A comparison of the information found on Mrs. B's and Mr. C's new account application forms with that found on the change forms shows that the only significant change made is the addition of the following comments:

#### (i) For Mrs. B:

[Translation]

- "At the client's request and the advisor's suggestion, and the investment advisor explained the risks. \$11,900 of Horizon BetaPro Energy Bear shall be purchased.";
- "No fees or commission will be billed until September 30. Free of charge"

#### (ii) For Mr. C:

[Translation]

- "At the client's request and the advisor's suggestion, and the investment advisor explained the risks. \$31,000 of Horizon BetaPro Energy Bear shall be purchased.";
- "No fees or commission will be billed until June 30, 2008. Free of charge."
- 27. The comment "at the client's request and the investment advisor explained the risks" appears on the change forms for both Mrs. B and Mr. C and was added at the initiative of Mr. A;

- 28. However, when the change forms were signed, Mrs. B and Mr. C asked Mr. A to add the mention "and at the advisor's suggestion" to correct the comment added by the latter which gives the misleading impression that the purchase of the Horizon BetaPro Energy Bear security was initiated by them rather than by Mr. A;
- 29. At the time, despite the fact that Mrs. B and Mr. C already had substantial experience with stock holdings, the Bear title did not appear to them to be a security involving any higher risk than other routine investments, especially since what the Respondent added to the change forms does not specify that it is high risk;
- 30. The fact that Mrs. B and Mr. C did not perceive the leveraged ETFs as being riskier financial instruments than other routine investments makes sense. Indeed, if one considers all the factual elements below, the balance of probabilities tends towards even the Respondent was of the opinion that these financial instruments involved moderate risk:
  - The opinion of the Respondent's manager, Mr. A, is to the effect that these are financial instruments involving moderate risk;
  - Throughout the material period, Mr. A exercised strict supervision of the Respondent's daily activities;
  - There is no evidence that the Respondent was at any time in disagreement with his manager;
  - There is no evidence that the Respondent informed Mrs. B and Mr. C that leveraged ETFs represent high-risk financial instruments;
  - Neither Mrs. B's nor Mr. C's profile was changed after the month of June 2008.
- 31. A reading of the leveraged ETFs prospectus teaches us the following:

#### [Translation]

- "ETF units are highly speculative and involve a high degree of risk (...)";
- "ETFs are designed to provide daily investment results (...)";
- "An ETF by itself does not constitute a balanced investment plan. ETFs
  are not for investors whose main objective is a regular income or the
  preservation of capital. Investors must be prepared to lose a large
  portion or even all of the money that they invest in an ETF (...)";
- "Investing in Units of an ETF is speculative, involves a high degree of risk and may only be suitable for persons who are able to assume the risk of losing their entire investment. (...)";
- "ETFs are subject to increased volatility as they seek to achieve the multiple or inverse (opposite) multiple of the daily performance of an underlying index. (...)".

- 32. At or around the end of July 2008, the combined value of Mrs. B's and Mr. C's portfolios was approximately four hundred and nineteen thousand seven hundred and sixty dollars (\$419,760). At the time, Mrs. B's portfolio was composed of 20% leveraged ETFs. For his part, Mr. C's portfolio was composed of 27% leveraged ETFs;
- 33. Between late September and early October 2008, numerous buy and sell transactions involving leveraged ETFs were executed in Mrs. B's account, as well as in Mr. C's account;
- 34. At or around the end of October 2008, the combined value of Mrs. B's and Mr. C's portfolios was approximately three hundred and forty thousand four hundred and thirty-seven dollars (\$340,437). At that time, leveraged ETFs made up 56% of Mrs. B's portfolio, and 57% of Mr. C's portfolio;
- 35. In spite of this information and the associated risks, the Respondent did not initiate any updates to the clients' investment objectives;
- 36. On or around February 25, 2009, the combined value of Mrs. B's and Mr. C's portfolios was approximately two hundred and thirty-seven thousand three hundred and sixteen dollars (\$237,316);
- 37. On or around February 25, 2009, Mrs. B sent the Respondent an email message to inform him of her concerns regarding the loss of value of their investments. She told him that their deteriorating financial circumstances were a major cause of conflict between her and Mr. C. She added that Mr. C was sleeping poorly due to the stress of the financial losses, considering his age and his pensioner's status. Even though Mrs. B and Mr. C had told the Respondent of their concerns over the substantial deterioration of their portfolios, the latter persisted in the leveraged ETFs investment strategy, henceforth targeting the bear market mainly;
- 38. Towards the end of March 2009, the combined value of Mrs. B's and Mr. C's portfolios was approximately one hundred eighty-one thousand nine hundred and seventy-eight dollars (\$181,978). Mrs. B's portfolio at the time was composed of approximately 59% leveraged Bear Plus ETFs and Mr. C's portfolio, 68% leveraged Bear Plus ETFs;
- 39. Around the end of May 2009, the combined value of Mrs. B's and Mr. C's portfolios was approximately one hundred and forty-nine thousand six hundred and forty-one dollars (\$149,641). At that time, Mrs. B and Mr. C argued with the Respondent, who told them that the stock market would continue to drop and recommended that they invest more in leveraged Bear Plus ETFs to take full advantage of the market activity and recover the lost money. Mrs. B and Mr. C followed the Respondent's suggested strategy and trades were made in that direction in their brokerage accounts;

- 40. Once the trades were executed in Mrs. B's and Mr. C's accounts, their portfolios were composed respectively of 98% and 99% leveraged ETFs. Once again, despite such a high concentration of a complex financial instrument defined as speculative, no change was made by the Respondent to update Mrs. B'x and Mr. C's financial information and investment objectives;
- 41. On or around June 11, 2009, IIROC published Guidance Note 09-0172 concerning the obligations of dealer members that sell leveraged Exchange Traded Funds (ETFs). In this notice, IIROC reiterates the following:
  - "(...) 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. (...)".
- 42. Despite the publication of Guidance Note 09-0172 and despite all the public information circulating on the subject of leveraged ETFs, the Respondent persisted in his strategy and recommended to Mrs. B and Mr. C to be patient and wait in order to benefit from the effects of the bear market. The fact that he tolerated Mrs. B and Mr. C holding leveraged ETFs for an uninterrupted lengthy period and in a concentration that substantially exceeded their investment objectives shows the Respondent's utter recklessness;
- 43. With only the income generated by their investments and Mr. C's Old Age Security and Québec Pension Plan benefits to live on, Mrs. B and Mr. C could not handle having 100% speculative investments;
- 44. At all material times, there is nothing to indicate that the orders to buy leveraged ETFs were unsolicited. Moreover, there is no indication that Mrs. B's or Mr. C's knowledge was sufficiently sophisticated to be able to fully understand all of the complexity connected with a strategy of investing in leveraged ETFs;
- 45. The total losses of the combined value of Mrs. B's and Mr. C's portfolios attributable to leveraged ETFs are evaluated at approximately one hundred and sixty-eight thousand dollars (\$168,000);
- 46. On or around April 25, 2010, Mrs. B and Mr. C sent a written complaint to LBS, in which they criticize it and the Respondent for failing to use due diligence in the exercise of supervision and in the investment recommendations that were made to them considering their personal and financial circumstances.

#### **GENERAL PROCEDURAL MATTERS**

**TAKE FURTHER NOTICE** that the hearing and related proceedings shall be subject to the Rules of Practice and Procedure governing the Dealer Members of IIROC (the Rules of practice and procedure).

**TAKE FURTHER NOTICE** that, pursuant to Rule 13.1 of the Rules of Practice and Procedure, the Respondent is entitled to attend and be heard, be represented by counsel or an agent, call, examine and cross-examine witnesses, and make submissions to the Hearing Panel at the hearing.

#### RESPONSE TO NOTICE OF HEARING

**TAKE FURTHER NOTICE** that the Respondent must serve upon IIROC Staff a Response to the Notice of Hearing in accordance with Rule 7 of the Rules of Practice and Procedure, within twenty (20) days (for a Standard Track disciplinary proceeding) or within thirty (30) days (for a Complex Track disciplinary proceeding) from the effective date of service of the Notice of Hearing.

#### FAILURE TO RESPOND OR ATTEND HEARING

**TAKE FURTHER NOTICE** that, if the Respondent fails to serve a Response or attend the hearing, the Hearing Panel may, pursuant to Rules 7.2 and 13.5:

- (a) proceed with the hearing as set out in the Notice of Hearing, without further notice to the Respondent;
- (b) accept as proven the facts and contraventions alleged by Staff of IIROC in the Notice of Hearing; and
- (c) order penalties and costs against the Respondent pursuant to Dealer Member Rules 20.33, 20.34 and 20.49.

#### **PENALTIES & COSTS**

**TAKE FURTHER NOTICE** that, if the Hearing Panel concludes that the Respondent did commit any or all of the contraventions alleged by IIROC Staff in the Notice of Hearing, the Hearing Panel may, pursuant to Dealer Member Rules 20.33 and 20.34, impose any one or more of the following penalties:

#### Where the Respondent is/was an Approved Person:

- (a) a reprimand;
- (b) a fine not exceeding the greater of:
  - (i) 1,000,000 \$ per contravention; and
  - (ii) an amount equal to three times the profit made or loss avoided by such Approved Person by reason of the contravention.
- (c) suspension of approval for any period of time and upon any conditions or terms;
- (d) terms and conditions of continued approval;
- (e) prohibition of approval in any capacity for any period of time;
- (f) termination of the rights and privileges of approval;
- (g) revocation of approval;
- (h) a permanent bar from approval with IIROC; or
- (i) any other fit remedy or penalty.

#### Where the Respondent is/was a Member firm:

- (a) a reprimand;
- (b) a fine not exceeding the greater of:
  - (i) 5,000,000 \$ per contravention; and
  - (ii) an amount equal to three times the profit made or loss avoided by the Member by reason of the contravention;
- (c) suspension of the rights and privileges of the Member (and such suspension may include a direction to the Member to cease dealing with the public) for any period of time and upon any conditions or terms;
- (d) terms and conditions of continued Membership;
- (e) termination of the rights and privileges of Membership;
- (f) expulsion of the Member from membership in IIROC; or
- (g) any other fit remedy or penalty.

**TAKE FURTHER NOTICE** that if the Hearing Panel concludes that the Respondent did commit any or all of the contraventions alleged by IIROC Staff in the Notice of Hearing, the Hearing Panel may, pursuant to Dealer Member Rule 20.49, assess and order any investigation and prosecution costs determined to be appropriate and reasonable in the circumstances.

(s) Carmen Crépin

### CARMEN CRÉPIN Vice-President, Québec

## Investment Industry Regulatory Organization of Canada

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