

# INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

IN THE MATTER OF:

THE RULES OF THE INVESTMENT INDUSTRY REGULATORY  
ORGANIZATION OF CANADA

AND

JOHN GORDON KELLY

## SETTLEMENT AGREEMENT

### I. INTRODUCTION

1. IIROC Enforcement Staff (“Staff”) and John Gordon Kelly (the “Respondent”), consent and agree to the settlement of this matter by way of this agreement (the “Settlement Agreement”).
2. The Enforcement Department of IIROC has conducted an investigation (the “Investigation”) in the conduct of the Respondent.
3. The Investigation discloses matters for which the Respondent may be disciplined by a hearing panel appointed pursuant to IIROC Transitional Rule No.1, Schedule C.1, Part C (the “Hearing Panel”).

### II. JOINT SETTLEMENT RECOMMENDATION

4. Staff and the Respondent jointly recommend that the Hearing Panel accept this Settlement Agreement.
5. The Respondent admits to the following contraventions of IIROC Dealer Member Rules, Guidelines, Regulations or Policies:

Between July 2007 and July 2012, the Respondent:

- a. Failed to use due diligence to learn and remain informed of the essential facts relative to his client, JRM, contrary to Dealer Member Rule 1300.1 (a) (IDA Regulation 1300.1 (a) prior to June 1, 2008); and
- b. recommended the purchase of the securities to a client, JRM, without using due diligence to ensure that the recommendations were suitable for the client based on

her financial situation, investment knowledge, investment objectives and risk tolerance contrary to Dealer Member Rule 1300.1 (q) (IDA Regulation 1300.1 (q) prior to June 1, 2008).

6. Staff and the Respondent agrees to the following terms of settlement:
  - a) A fine in the amount of \$10,000; and
  - b) A six (6) month period of strict supervision.
7. The Respondent agrees to pay costs to IIROC in the sum of \$2,000.

### **III. STATEMENT OF FACTS**

#### **(i) Acknowledgment**

8. Staff and the Respondent agree with the facts set out in this Section III and acknowledge that the terms of the settlement contained in this Settlement Agreement are based upon those specific facts.

#### **(ii) Factual Background**

#### **Overview**

9. The Respondent opened an account for a new client, JRM, a single 72 year old retiree, in July 2007. Following a face to face meeting with her, the Respondent determined that JRM's investment objectives were "Balanced", which required that a percentage of her assets be allocated to lower risk, fixed income investments. Shortly thereafter, the Respondent recommended investments in her account which consisted solely of equity mutual funds, which did not meet the requirements of the "Balanced" objective.
10. The Firm's compliance group queried the investments and the "Balanced" objectives and suggested that changes to the asset allocation be made. Instead of changing the asset allocation as suggested, the Respondent asked JRM to sign an account update which changed her objectives to "Growth". This allowed the account to remain invested in the equity mutual funds while still generating the cash flow which the Respondent understood JRM to want. As a result, JRM's account was exposed to more risk than was appropriate given her actual objectives and financial situation.
11. In 2010, following a decrease in JRM's account value, as well as a decrease in the monthly distributions that JRM was receiving from her investments, the Respondent recommended changes to the portfolio, with a view to increasing the distributions. The Respondent recommended a portfolio of three securities which resulted in an increased monthly distribution, but also increased the risk associated with her investments. These investments were inconsistent with JRM's actual and recorded investment objectives and were unsuitable for her.

### **Registration and Disciplinary History**

12. Since March 1987, the Respondent has been registered as a Registered Representative with a Toronto, Ontario branch of BMO Nesbitt Burns Inc. (“BMO”), an IIROC Dealer Member.
13. In September 1996, the Respondent entered into a settlement agreement with the IDA in which he admitted to opening accounts for 3 clients and accepting trading instructions from undisclosed third parties on those accounts. The Respondent agreed to pay a fine and to rewrite the Conduct and Practices Handbook examination. In the 24 years the Respondent has been registered he has not been subject to any other regulatory proceedings or an internal discipline or client complaints.
14. On June 1, 2008, the Respondent became a regulated person of IIROC.

### **The Client - JRM**

15. JRM became a client of the Respondent in July 2007. She had been referred to the Respondent by a friend who had previously worked with the Respondent.
16. On or about July 17, 2007, the Respondent met with JRM for the first time. At that meeting, a New Account Application Form (“NAAF”) was completed. This included the relevant Know Your Client (“KYC”) information for JRM. At the time, JRM was a single 72 year old retiree. Her investment knowledge was recorded as “Minimal/None” and her previous investment experience consisted solely of GICs.
17. JRM had net liquid assets of approximately \$290,000 which represented all of her total assets. This amount consisted primarily of the proceeds from the sale of her home. JRM was looking to invest \$250,000.
18. During her meeting with the Respondent, JRM’s investment objectives were recorded as “Balanced”, which the NAAF described as:

My emphasis is on preserving the money I have invested, with enough growth to keep me ahead of inflation. With few exceptions, I have a low to moderate tolerance for risk, but I am willing to accept short-term price volatility in order to achieve better long-term returns. I may or may not require income from my portfolio at this time.
19. The Balanced objective allows for an asset mix of 0-40% cash and equivalents, 30-70% fixed income, and 30-70% equities.
20. The Respondent presented 3 potential investment strategies to JRM. The first consisted of an investment in GICs, which would provide limited return. The second consisted primarily of bonds, which would have a slightly greater return, but would only pay

interest semi-annually. The third option presented consisted of an investment in T-series mutual funds, which would provide JRM with monthly distributions of 8% per annum.

21. The distributions from the T-series funds were to be reset on an annual basis to total approximately 8% of the net asset value of the fund at the beginning of the year. At the time, this represented a monthly distribution of approximately \$1,500. If the unit value of the funds fell, the distributions would be reset to a reduced amount at the beginning of the following year. Conversely, if the unit value of the funds rose, the distributions would reset to a higher amount.
22. The Respondent did not adequately explain that the T-series distribution could include a return of JRM's capital. Though the Respondent did make an effort to advise JRM of the potential volatility of investing in mutual funds, he did not adequately explain the potential downside exposure and the risks associated with the investment in mutual funds as opposed to the risks associated with either bonds or GICs. Ultimately, JRM agreed to the purchase of the mutual funds.
23. The proposed purchase, as noted on JRM's NAAF, was for the \$250,000 to be invested equally in the T-series of "MFC Growth Income" (the "Mackenzie Fund") and "DYN Global Dividend" (the "Dynamic Fund"). The Mackenzie Fund was a Canadian balanced mutual fund, which invested in both fixed income and equity securities of primarily Canadian based companies. The Dynamic Fund was a global equity fund.
24. On July 18, 2007, two mutual funds were purchased in JRM's account. However, instead of the Mackenzie Fund, the Respondent purchased the T-series of the Mackenzie Founders Fund (the "Founders Fund"). This was a fund of funds, which held an equal weighting of four global equity funds. Accordingly, instead of half of the initial investment being made in a Canadian balanced fund, the full amount was invested solely in global equities, with no allocation to fixed income.
25. On July 20, 2007, the Firm's Compliance group questioned the suitability of 100% equity holdings in an account that was marked as "Balanced". BMO Compliance suggested that the Respondent to "reduce equity in the account to 70% by August 23, 2007."
26. The Respondent did not recommend reducing the equity holdings in the account. Instead, less than a month after the initial NAAF was completed, the Respondent asked JRM to complete an update to her KYC information, despite the fact that there was no actual change in her financial circumstances. The updated KYC form changed her investment objectives from "Balanced" to "Growth", which the NAAF described as:

My emphasis is on the potential for above-average return. With few exceptions, I am willing to accept a moderate-to-high level of risk to achieve it. I will tolerate short-term price volatility in the pursuit of long-term growth. I have little-to-no requirement for income from my portfolio at this time.
27. The "Growth" objective no longer required any allocation to fixed income securities. The Respondent mailed JRM the KYC update form, which she signed on August 9, 2007 and returned to him. The Respondent did not adequately discuss the increase in the potential

downside exposure and risks associated with account holdings consisting entirely of global equities.

28. Between July 2007 and November 2010, the value of JRM's mutual fund holdings declined by approximately \$42,000, net of distributions. In addition, the monthly distributions decreased from over \$1,500 per month when the investments were initially made to approximately \$1,100 in 2010.
29. In or around October 2010, in response to JRM's concerns about the reduced distributions and the reduced market value of her account, and in an attempt to obtain a higher monthly distribution for JRM, the Respondent recommended the sale of the mutual funds and the purchase of securities of three issuers.
30. In October and November 2010, the mutual funds were sold and the proceeds were used to purchase trust units of Avenir Diversified Income Trust ("Avenir"), Retrocom Mid-Market Real Estate Investment Trust ("Retrocom") and Pizza Pizza Royalty Income Fund ("Pizza Pizza"). A Deferred Sales Charge was incurred on the sale of one of the mutual funds.
31. The anticipated yield from these trust units would have increased the monthly distributions to JRM to approximately \$1,400 per month. However, these purchases also resulted in JRM's entire account being concentrated in portfolio of securities with increased risk over the prior portfolio, which increased the potential downside risk to which she was exposed.
32. By April 2011, following cuts to the distributions of Avenir and Pizza Pizza, the monthly distributions to JRM had declined to approximately \$1,100 per month.
33. In May 2011, the units of Retrocom were sold and shares of Superior Plus Corp. ("Superior") were purchased in JRM's account. Following these transactions, the monthly distributions increased to almost \$1,300 per month, however JRM's account remained invested in only three securities.
34. Following the purchase of shares of Superior, the Firm's Compliance group again questioned the appropriateness of JRM's account holdings and specifically noted that a significant portion of her indicated net worth was concentrated in three securities.
35. The Respondent advised the Firm's Compliance group that JRM had realized a gain on the sale of the units of Retrocom and that he had used the proceeds to purchase shares of Superior which had a higher payout. He further advised that "the client has had to give up some security to receive a maximum return with reasonable risk. She cannot live on 1.30% GIC's and / or 3.493% five year Bell bonds or 3.14% five year BMO bonds."
36. No further steps were taken at the time to recommend changing the holdings in JRM's account.
37. In September 2011, the Firm's Compliance group again inquired about the holdings in JRM's account. The Respondent's Branch Compliance Officer asked the Respondent to

confirm certain client information and to comment on the “suitability of growth objective given minimal investment knowledge, older age and small net worth and income”.

38. The Respondent replied that JRM “totally relies & lives on this income. If investments were switched to bonds, I would have to sell the bond \$ send her principle [sic].”
39. Following a meeting with the Branch Compliance Officer, the Respondent was asked to update JRM’s KYC information to reflect a “Balanced” objective, and to reduce the equity in the account to 70% or less.
40. Following further discussions between the Respondent, the Branch Compliance Officer and the Branch Manager, the request to reduce the equity was rescinded. Instead, the Respondent agreed to recommend the sale of one of the holdings and to replace it with a lower risk, exchange traded fund. On October 7, 2011, JRM’s Pizza Pizza units were sold and units of BMO Covered Call Canadian Banks ETF were purchased in her account.

### **Client Complaint and Settlement**

41. In July 2012, JRM complained to BMO. In November 2013, JRM and BMO agreed to a settlement, pursuant to which JRM received \$41,247.03. The Respondent has paid this full amount.

### **Mitigating Circumstances**

42. At all times the Respondent sought to maximize the income for JRM, which is what the Respondent understood JRM’s main and overriding investment goal to be.

### **Summary**

43. Despite JRM’s relative lack of investment knowledge and experience and the material impact on her net worth associated with a significant drop in her capital, the Respondent nonetheless recommended implementing an investment strategy consisting of 100% equities. This was done with the well-intended goal of enhancing the monthly distributions to JRM.
44. When this asset allocation was questioned, instead of recommending an adjustment in the account holdings, the Respondent recommended updating the account objectives, even though JRM’s circumstances had not changed.
45. Following a significant drop to the value of the account and in an attempt to obtain higher distributions, the Respondent made recommendations that further increased the risks to

the account by concentrating JRM's investments in three securities, which were unsuitable for a person in her situation.

#### **IV. TERMS OF SETTLEMENT**

46. This settlement is agreed upon in accordance with IROC Dealer Member Rules 20.35 to 20.40, inclusive and Rule 15 of the Dealer Member Rules of Practice and Procedure.
47. The Settlement Agreement is subject to acceptance by the Hearing Panel.
48. The Settlement Agreement shall become effective and binding upon the Respondent and Staff as of the date of its acceptance by the Hearing Panel.
49. The Settlement Agreement will be presented to the Hearing Panel at a hearing ("the Settlement Hearing") for approval. Following the conclusion of the Settlement Hearing, the Hearing Panel may either accept or reject the Settlement Agreement.
50. If the Hearing Panel accepts the Settlement Agreement, the Respondent waives his/her/its right under IROC rules and any applicable legislation to a disciplinary hearing, review or appeal.
51. If the Hearing Panel rejects the Settlement Agreement, Staff and the Respondent may enter into another settlement agreement; or Staff may proceed to a disciplinary hearing in relation to the matters disclosed in the Investigation.
52. The Settlement Agreement will become available to the public upon its acceptance by the Hearing Panel.
53. Staff and the Respondent agree that if the Hearing Panel accepts the Settlement Agreement, they, or anyone on their behalf, will not make any public statements inconsistent with the Settlement Agreement.
54. Unless otherwise stated, any monetary penalties and costs imposed upon the Respondent are payable immediately upon the effective date of the Settlement Agreement.
55. Unless otherwise stated, any suspensions, bars, expulsions, restrictions or other terms of the Settlement Agreement shall commence on the effective date of the Settlement Agreement.

AGREED TO by the Respondent at the City of \_\_\_\_\_Toronto\_\_\_\_\_ in the Province of Ontario, this \_\_\_2\_\_\_ day of October, 2014.

\_\_\_\_\_  
"Witness"  
Witness

\_\_\_\_\_  
"John Kelly"  
Respondent

AGREED TO by Staff at the City of Toronto in the Province of Ontario, this \_\_\_2\_\_\_ day of October, 2014.

\_\_\_\_\_  
"Witness"  
Witness

\_\_\_\_\_  
"Rob DelFrate"  
Rob DelFrate  
Enforcement Counsel on behalf of  
Staff of the Investment Industry  
Regulatory Organization of Canada

ACCEPTED at the City of Toronto in the Province of Ontario,  
this \_\_\_22\_\_\_ day of October, 2014, by the following Hearing Panel:

Per: \_\_\_\_\_  
"Thomas Lockwood"  
Panel Chair

Per: \_\_\_\_\_  
"Daniel Iggers"  
Panel Member

Per: \_\_\_\_\_  
"Guenther Kleberg"  
Panel Member