

Re Carbonelli & Conway

IN THE MATTER OF:

**The Rules of the Investment Industry Regulatory Organization of
Canada (IIROC)**

and

The By-Laws of the Investment Dealers Association of Canada (IDA)

and

Loretta Carbonelli and Gerald Trevor Conway

2012 IIROC 56

Investment Industry Regulatory Organization of Canada
Hearing Panel (Alberta District Council)

Hearing: April 23-26, 2012

Decision: October 5, 2012

Hearing Panel:

D. Brian Foster, Q.C. (Chair), Peter McWilliams, Donald Milligan

Appearances:

David McLellan & Tayen Godfrey, Enforcement Counsel for IIROC

John Blair, Q.C. and Loni Da Costa, Counsel for the Respondent, Gerald Trevor Conway

Loretta Carbonelli, Self-represented

DECISION

I. INTRODUCTION

¶ 1 This Hearing Panel (the "Panel") was constituted to conduct a disciplinary hearing (the "Hearing") brought against Loretta Carbonelli ("Carbonelli") and Gerald Trevor Conway ("Conway") (hereinafter referred to together as the "Respondents") pursuant to By-law 20, Section 20.33. The Hearing proceeded from April 23 until April 26, 2012.

¶ 2 At all material times Conway was the Ultimate Designated Person ("UDP") of Evergreen Capital Partners Inc. ("Evergreen") and Carbonelli was Evergreen's Chief Compliance Officer ("CCO") and Chief Operating Officer ("COO").

¶ 3 IIROC issued a Notice of Hearing dated July 20, 2011 (the "NOH") in which it is alleged that Carbonelli and Conway committed the following contraventions:

Count 1

Between June 2008 and October 2008, Loretta Carbonelli failed to establish and maintain adequate internal controls for the use and operation of Evergreen Capital Partners Inc.'s client accumulation accounts, contrary to IIROC Dealer Member Rule 17.2A.

Count 2

Between June 2008 and October 2008, Gerald Trevor Conway failed to establish and maintain adequate internal controls for the use and operation of Evergreen Capital Partners Inc.'s client accumulation accounts, contrary to IIROC Dealer Member Rule 17.2A.

¶ 4 At the Hearing, IIROC filed as an Exhibit six binders of records, including but not limited to copies of emails, transcripts of interviews with various parties, trading records and other reports. Conway and Carbonelli filed eight binders of records, including but not limited to copies of email correspondence, transcripts of interviews with various parties and trading records.

¶ 5 IIROC called one witness, Gil Gauthier ("Gauthier"), the Manager of Investigations with IIROC. Both Carbonelli and Conway testified. There were no other witnesses. No expert evidence was called by either side.

¶ 6 The Counts alleged involve a review and interpretation of Dealer Member Rule 17.2A which states:

Rule 17

DEALER MEMBER MINIMUM CAPITAL, CONDUCT OF BUSINESS AND INSURANCE

17.2A Every Dealer Member shall establish and maintain adequate internal controls in accordance with the internal control policy statements in Rule 2600.

¶ 7 Dealer Member Rule 2600 deals with Internal Control Policy Statements that provide some guidance with respect to compliance with Rule 17.2A.

¶ 8 Evergreen entered into a Uniform Type 2 Introducer/Carrier Broker Agreement (the "Type 2 Agreement") with Penson Financial Services Canada Inc. ("Penson") pursuant to which Penson was the Type 2 Carrying Broker and Evergreen was the Type 2 Introducing Broker. Therefore, this case also involves an examination of the relationship between a Carrying Broker and an Introducing Broker, and the responsibilities of the Carrying Broker and of the Introducing Broker.

¶ 9 While the facts are addressed in more detail below, most of the trades initiated by Evergreen that were conducted through Penson were for institutional clients and in large volumes with significant purchase costs. The order fill of the trades could extend over various periods of time and as a result partial fills were placed into a client accumulation account, also known as an average price inventory account (the "API Accounts") where they would remain until the order was filled. Upon the complete fill of the order, Evergreen was to take steps to instruct Penson to book the securities out of the API Accounts to a client account whereupon Penson would carry out the settlement of the trades.

¶ 10 Unfortunately, significant positions of securities remained in the API Accounts for periods of time and were not booked out to client accounts. Over a four month period from May, 2008 until late October, 2008 the purchase price cost of the securities held within the API Accounts grew to approximately \$69.3 Million. During the same period of time there was a significant downward market correction and by late October, 2008, the market value of the securities in the API Accounts was approximately \$31.6 Million. When the securities were ultimately booked out to the two significant institutional trading clients of Evergreen, the clients rejected the trades as being unauthorized. As a result, there was a loss on liquidation of the securities of approximately \$37.7 Million. This caused the failure of Evergreen and has resulted in civil claims brought by Penson against other parties, including the institutional clients and David Connacher ("Connacher"), Evergreen's head of trading.

¶ 11 In Reasons for Decision ([2011] IIROC No. 28) (the "IIROC Connacher Decision") Connacher was found to have engaged in conduct that was described as "contemptible" and "tantamount to fraud". More details of his conduct are described below.

¶ 12 It is alleged in paragraph 30 of the NOH that "a reasonable and diligent supervisor would have

established and maintained adequate internal controls for the use and operation” of the API Accounts, including, but not limited to, some or all of the following:

- Prohibiting or limiting new orders until the existing positions in the API Accounts were booked out to clients;
- A requirement that all traders produce and provide Evergreen with a daily record of all orders that they placed and particulars of any partial or complete fills that they receive; and
- A requirement that a position be booked out within a reasonable period of time, even if the entire order had not been filed.

¶ 13 In argument, counsel for Conway, in submissions agreed to by Carbonelli, raised the following in defence:

- (a) The obligation described in Member Dealer Rule 17.2A is the obligation of the “Dealer Member”, and not a personal one. It is not imposed, like some other rules, on the UDP, the CCO or the COO. The obligation is placed on the investment house to have policies in place;
- (b) Evergreen did establish policies as required by Member Dealer Rule 17.2A and the said policies complied with the requirements of the Dealer Member Rules;
- (c) The policies were approved by IIROC;
- (d) The policies included a specific provision that the pricing of securities would be carried out by Penson;
- (e) It could not have been anticipated that Penson would fail in its obligation to provide correct average price information to Evergreen and the Member Dealer Rule 17.2A did not require Evergreen to have in place contingency policies for such an unanticipated situation;
- (f) Dealer Member Rule 35 describes the requirements of an Introducing Broker and Carrying Broker relationship. It is the Carrying Broker’s responsibility to calculate and maintain the margin for any business carried on for the Introducing Broker and clients introduced to the Carrying Broker shall be considered to be a client of the Carrying Broker for the purposes of the Rules, Rulings and Forms (Member Dealer Rule 35.3, Subsections (b) and (n)). The IIROC regime set out in the Dealer Member Rules requires the clients to be the responsibility of the Carrying Broker;
- (g) The counts raised by IIROC do not allege a failure to supervise. Therefore, any suggestion or reliance on a lack of supervision in relation to the charges made is not relevant. Nor is it relevant to consider failures to meet duties under Dealer Member Rule 38 that describes the duties of a UDP and a COO. Specifically, the CCO has the obligation to establish and maintain policies and procedures. No such obligation rests with the UDP so the UDP should not face that sort of charge. The count alleged relies on Member Dealer Rule 17.2A that is limited to creation of adequate internal control policies and does not involve breaches of other duties; and
- (h) The losses were the result of an unforeseeable "perfect storm" of what Conway's counsel described as a “monumentally incompetent Carrying Broker”, a near unprecedented world-wide economic collapse and then in the words of Respondent's counsel, “crooked clients who wouldn’t pay.” For all three of these things to happen at the same time is highly unlikely and not the kind of things that policies could have dealt with. The Respondents are not to be held to a level of absolute perfection and it was asserted that this Panel should not apply 100% hindsight in their decision-making. Further, who could have anticipated that the Carrying Broker would have been unable to correct what initially looked like a simple problem.

¶ 14 Penson entered into a Settlement Agreement with IIROC ([2011] IIROC No. 56) (“Penson Settlement Agreement”). In the Penson Settlement Agreement, that was approved by a panel, Penson admitted to the

following contraventions of IIROC Rules, Guidelines, IDA Bylaws, Regulations or Policies:

- (i) From March to October 2008, Penson contravened IDA Bylaw 17.2A and Dealer Member Rule 17.2A by:
 - (i) failing to establish and/or maintain adequate internal controls related to certain Evergreen's Capital Partners Inc.'s ("Evergreen") accounts; and
 - (ii) failing to establish appropriate controls and procedures to ensure the proper reporting of margin required on Introducing Broker's accounts; and
- (j) From March to October 2008, Penson contravened IDA Bylaw 29.27 and Dealer Member Rule 29.27 by failing to ensure that each partner, director, officer, registered representative, employee and agent of Penson understood his responsibilities relating to the review of all Introducing Broker's inventory accounts and accumulation accounts.

The Penson Settlement Agreement is described in more detail below.

¶ 15 Penson and Connacher have been sanctioned for their conduct that played a part in the very significant losses that occurred.

¶ 16 The issue for this Panel to decide is whether, on the evidence submitted at the hearing, Carbonelli or Conway, or both, had a duty to establish and maintain adequate internal controls for the use and operation of Evergreen's API Accounts from June, 2008 until October, 2008 and then failed to meet their duty.

II. RELEVANT DEALER MEMBER RULES

Rule 17.2A

¶ 17 Dealer Member Rule 17.2A states:

Every Dealer Member shall establish and maintain adequate internal controls in accordance with the internal policy statements in Rule 2600.

¶ 18 Dealer Member Rule 2600 is titled "Internal Control Policy Statements" and contains eight separate Internal Control Policy Statements. The Statements prescribe requirements for and provide guidance on compliance with Rule 17.2A. The Statements that are relevant to this matter are Statement 1 - General Matters and Statement 7- Pricing of Securities.

¶ 19 Portions of Statement 1 - General Matters are set out below (with emphasis added):

INTERNAL CONTROL POLICY STATEMENT 1

General Matters

This policy statement is one in a series that prescribes requirements for and provides guidance on compliance with Rule 17.2A that states "every Dealer Member shall establish and maintain adequate internal controls in accordance with the internal control policy statements in Rule 2600."

Internal control is defined as follows:

"Internal control consists of the policies and procedures established and maintained by management to assist in achieving its objective of ensuring, as far as practical, the orderly and efficient conduct of the entity's business. The responsibility for ensuring adequate internal control is part of management's overall responsibility for the day-to-day activities of the entity". (CICA Handbook, 5200.03)

The effectiveness of specific policies and procedures is affected by many factors, such as management philosophy and operating style, the function of the board of directors (or equivalent) and its committees, organizational structure, methods of

assigning authority and responsibility, management control methods, system development methodology, personnel policies and practices, management reaction to external influences, and internal audit. These and other aspects of internal control affect all parts of the Dealer Member's firm.

In addition to compliance with required policies and procedures set out in these Policy Statements, a Dealer Member must consider the following, to the extent that they suggest a higher standard than would otherwise be required:

...

(v) Industry practice.

Determining whether internal control is adequate is a matter of judgement. However, internal control is not adequate if it does not reduce to a relatively low level the risk of failing to meet control objectives stated in this series of Policy Statements and, as a consequence, one or more of the following conditions has occurred or could reasonably be expected to do so:

- (i) A Dealer Member is inhibited from promptly completing securities transactions or promptly discharging the Dealer Member's responsibilities to clients, to other brokers, or to the industry;
- (ii) Material financial loss is suffered by the Dealer Member, clients or the industry;
- (iii) Material misstatements occur in the Dealer Member's financial statements;
- (iv) Violations of regulations occur to the extent that could reasonably be expected to result in the conditions described in (i) to (iii) above.

¶ 20 Portion of Internal Control Policy Statement 7 states (emphasis added):

INTERNAL CONTROL POLICY STATEMENT 7

Pricing of Securities

This policy statement is one in a series that prescribes for and provides guidance on compliance with the requirement in Rule 17.2A that states "every Dealer Member shall establish and maintain adequate internal controls in accordance with the internal control policy statements in Rule 2600." It should be read in the context of Policy Statement 1 dealing with General Matters."

This policy statement specifically addresses the control environment in which a Dealer Member prices securities. For guidance on the valuation of securities or definition of "market value", refer to Corporation Form 1 - General Instructions and/or Regulation 96 made under the Ontario Securities Act.

CONTROL OBJECTIVE

To ensure that:

- a) There is independent and timely verification of security prices designed to detect errors or omissions in the pricing of securities;
- b) Security pricing discrepancies are identified and corrected on a timely basis and reviewed and approved by senior management.
- c) There is consistency of procedures in the pricing of all types of securities.
- d) There is accuracy and completeness of the pricing of securities and to

ensure the reliability of prices.

MINIMUM REQUIRED FIRM POLICIES AND PROCEDURES

1. Information sources used for the Dealer Member's pricing records should be reputable and independently verifiable. The continued use of these pricing sources should be reviewed on an annual basis by senior management to ensure that they are still appropriate and meet the needs of the Dealer Member firm.
2. Verification of security prices must take into consideration documented member policies as to criteria in determining the market value of securities consistent with SRO Rules.
3. There should be documented procedures in place to ensure appropriate pricing for all security records of the member for purposes of preparing management reports used to monitor profit and loss, and the regulatory capital position of the member. These functions should be performed by a knowledgeable, authorized individual who is properly supervised.
4. Personnel involved with trading of securities do not have access to back office security price records and should not be involved in the pricing process, recording and storage of pricing data; and if they are involved there should be compensating controls, appropriate review and approval.
5. Independent security pricing verification must be carried out for each month-end at a minimum. The results of the verification procedures must include quantification of all differences (distinguished between adjusted and unadjusted differences) and follow-up of any material differences to the Dealer Member including a review and approval by senior management.
6. Supporting documentation must be maintained evidencing verification of securities pricing and adjustments.
7. Procedures are in place to ensure daily mark to market of a Dealer Member's security positions "owned and sold short" for profit and loss reporting in accordance with SRO requirements.
8. Dealer Members inventory profit and loss information must be reviewed by knowledgeable and authorized staff who are adequately supervised and are independent of the Dealer Member's trading function.

Rule 38

¶ 21 Dealer Member Rule 38 addresses Compliance and Supervision. Of note, the Counts specified in the NOH do not allege a lack of supervision. However, Dealer Member Rule 38 does describe the requirements of certain positions within the firm and the responsibilities of those persons:

38.5 Ultimate Designated Person

- (a) A Dealer Member must designate an individual who is approved under the Corporation's rules in the category of Ultimate Designated Person and who shall be responsible to the Corporation for the conduct of the firm and the supervision of its employees and to perform the functions described in paragraph (c).
- (b) A Dealer Member must not designate an individual to act as the firm's Ultimate Designated Person unless the individual is:

- (i) the chief executive officer or sole proprietor of the Dealer Member;
 - (ii) an Officer in charge of a division of the Dealer Member, if the activity that requires the firm to register under provincial or territorial securities laws occurs only within the division, or
 - (iii) an individual acting in a capacity similar to that of an Officer described in paragraph (a) or (b).
- (c) The Ultimate Designated Person must
- (i) supervise the activities of the Dealer Member that are directed towards ensuring compliance with the Corporation's Dealer Member rules and applicable securities law requirements by the firm and each individual acting on the Dealer Member's behalf, and
 - (ii) promote compliance by the Dealer Member, and individuals acting on its behalf, with the Corporation's Dealer Member rules and applicable securities laws.

...

38.7 Chief Compliance Officer

- (a) Every Dealer Member must designate an individual who is approved under the Corporation's rules in the category of Chief Compliance Officer to perform the functions described in paragraph (h).

...

- (h) The Chief Compliance Officer of a Dealer Member must do all of the following:
 - (i) establish and maintain policies and procedures for assessing compliance with the Rules and applicable securities laws by the Dealer Member and individuals acting on its behalf;
 - (ii) monitor and assess compliance by the Dealer Member, and individuals acting on its behalf, with the Rules and applicable securities laws;
 - (iii) report to the Ultimate Designated Person as soon as possible if the Chief Compliance Officer becomes aware of any circumstances indicating that the firm, or any individual acting on its behalf, may be in non-compliance with the Rules or applicable securities laws and
 - (A) the non-compliance creates a reasonable risk of harm to a client;
 - (B) the non-compliance creates a reasonable risk of harm to the capital markets; or
 - (C) the non-compliance is part of a pattern of non-compliance;
 - (iv) submit an annual report to the firm's board of directors, or individuals acting in a similar capacity for the firm, for the purposes of assessing compliance by the firm, and individuals acting on its behalf, with the Corporation's Dealer Member rules

and applicable securities laws.

- (i) The Chief Compliance Officer must have access to the Ultimate Designated Person and the board of directors (or equivalent) at such times as the Chief Compliance Officer may consider necessary or advisable in view of his or her responsibilities.

Rule 35

¶ 22 Dealer Member Rule 35 sets out the requirements of the relationship between an Introducing Broker and a Carrying Broker. An Introducing Broker may only introduce clients to one Carrying Broker. The Introducing Broker and Carrying Broker shall enter into a written contract in a form prescribed by and approved by IIROC.

¶ 23 Dealer Member Rule 35.3 describes the requirements of any Type 2 relationship. It is the responsibility of the Carrying Broker to calculate and maintain the margin for any client business that it carries on, on behalf of the Introducing Broker. It is the responsibility of the Carrying Broker to meet any financing requirements for clients introduced to the Carrying Broker.

¶ 24 Dealer Member Rule 35.3(n) states:

Clients Introduced to the Carrying Broker

Each client introduced to the Carrying Broker by the Introducing Broker shall be considered to be a client of the Carrying Broker for the purposes of complying with the Rules, Rulings and Forms.

III. UNIFORM TYPE 2 INTRODUCER/CARRIER BROKER AGREEMENT

¶ 25 The Type 2 Agreement is in a form that was approved by IIROC. Pursuant to the Type 2 Agreement each of Penson and Evergreen contracted to do certain things and to retain certain responsibility. Throughout the Type 2 Agreement there is reference to the defined term "Client". The Type 2 Agreement defines "Client" as:

"Client" means a client of the T2IB who is introduced by the T2IB to the T2CB and for whom the T2CB opens an account.

¶ 26 Pursuant to the Type 2 Agreement, Penson agreed to provide trading services, clearing services, segregation/safekeeping services and recordkeeping/information services. Penson agreed to make deliveries and settlements of cash and securities in connection with trades made for Clients. Penson was to use its reasonable best efforts to clear all trades effected on the exchanges and markets. Penson maintained the right, in its sole discretion, to refuse to open or clear any account or any order, and to liquidate and close any account if in its opinion such account or order represented an unreasonable credit risk or could give rise to a breach of applicable law or SRO Requirements.

¶ 27 Pursuant to the Type 2 Agreement, Penson agreed to the following with respect to recordkeeping and information services (emphasis added):

4.6 The T2CB shall maintain and keep current and proper all records and accounts in respect of Client accounts and T2IB principal business as prescribed by applicable law and SRO Requirements, including records and accounts of trades, of securities segregated and/or held in safekeeping on behalf of, and cash balances accruing to the credit of, Clients and the T2IB.

4.7 The T2CB shall provide the T2IB and the Applicable SROs with such information, including by way of access to electronic databases, in respect of the accounts of Clients and of the T2IB and as the T2IB and the applicable SROs may reasonably require in order to be fully informed with respect to the Clients' accounts, and the T2IB's principal business. Such information shall include the information described in Schedule "B" hereto.

¶ 28 With respect to the treatment of accounts, Penson undertook to do the following:

5.2 The T2CB shall act:

- (a) on behalf of the T2IB in relation to Clients; and
- (b) in connection with the principle business of the T2IB, in every respect as it would act in relation to its own clients.

5.3 The T2CB shall administer the accounts of Clients and the principal business of the T2IB in compliance with applicable law and SRO Requirements.

¶ 29 Evergreen undertook to remain responsible for some aspects of its business conduct and for compliance with applicable law and SRO Requirements. The following is stated in the Type 2 Agreement (emphasis added):

E, Applicable Law and SRO Requirements

6.10 Except for those Services and other matters and proceedings contemplated by this Agreement to be performed by the T2CB, the T2IB shall be and remain responsible for its business conduct and for compliance with applicable law and SRO Requirements contemplated by this Agreement for each account introduced to the T2CB by the T2IB.

6.11 In particular, the T2IB shall be responsible for account supervision, including, without limiting the generality of section 6.10:

- (a) obtaining account opening documentation from Clients;
- (b) the application of applicable law and SRO Requirements with respect to:
 - (i) "know your client" rules; and
 - (ii) determining the suitability of:
 - A. trading activity; and
 - B. the nature of securities purchased.

(c) The T2IB shall, and acknowledges its obligation under this Agreement to, review for accuracy the records and reports provided to or prepared for the T2IB by the T2CB as set out in Schedule "B" hereof in connection with the Services under, and matters and proceedings contemplated by, this Agreement, and to report any discrepancies to the T2CB.

¶ 30 Pursuant to the Type 2 Agreement, Penson had the obligation to maintain sufficient financial resources for the operation of each Client account and to ensure that all Client cash accounts are operated in compliance with applicable law and SRO Requirements, including the ongoing calculation and provision of margin for such accounts. Pursuant to the Type 2 Agreement, Evergreen was required to pay a \$250,000.00 deposit in order to secure the payment and performance of all obligations of Evergreen and the Clients to Penson. Offsets against the deposit were allowed in accordance with the terms of the Agreement (emphasis added):

9.6 The T2CB may, upon notice to the T2IB pursuant to section 13.7 hereof, offset against the Deposit as provided in sections 9.1 and 9.4 hereof:

- (a) any unsecured receivables or margin deficiencies in the accounts of Clients; and
- (b) any unsecured receivables in the accounts of the T2IB;

as required to be posted pursuant to clauses 8.2, 8.3 and 8.5 of this Agreement, and

(c) any secured receivables that the T2CB, in its sole discretion, determines represent an unreasonable credit risk,

all in the manner and to the extent permitted by SRO Requirements. The T2CB shall offset against the Deposit, firstly, receivables and margin deficiencies in the accounts of Clients and, secondly, receivables in the account of the T2IB.

...

10.1 The T2CB shall indemnify and save harmless the T2IB with respect to any loss, liability, damages, costs or expenses which the T2IB may incur arising out of errors or omissions committed by the T2CB in carrying out instructions given to it by the T2IB.

10.2 The T2CB shall indemnify and save harmless each Client, except where such loss or damage is as a result of the negligence of the T2IB, from all claims, actions, causes of action, demands, losses, damages, costs or expenses or any other liability whatsoever suffered or incurred by such Client resulting from any errors or negligence on the part of the T2CB in the performance of its obligations under this Agreement.

10.3 The T2IB acknowledges that all obligations to pay for securities purchased and to deliver securities sold by Clients rest with the Clients and the T2IB and not the T2CB. Should the Deposit be insufficient to cover the receivables or deficiencies described in section 9.6, the T2IB will, upon notice from the T2CB, pay to the T2CB an amount, up to the amount of excess Risk Adjusted Capital of the T2IB as determined by the T2IB on its most recent Joint Regulatory and Financial Questionnaire and Report (the "Indemnity Amount"), required to satisfy the obligations described therein. If the first Indemnity Amount paid is insufficient to satisfy the obligations of the T2IB to the T2CB, then the T2IB acknowledges that its obligation to deliver further Indemnity Amounts continues until such time as the T2IB has delivered such further Indemnity Amounts to the T2CB as are required to satisfy said obligation. Without limiting the generality of the foregoing, the T2IB:

(a) agrees to indemnify and save harmless the T2CB from any loss, liability, damages, costs or expenses which the T2CB may suffer or incur by reason of the failure of the T2IB or any of the Clients to make any payment of money or delivery of securities to the T2CB as and when required by it including, without limitation, payment of all commissions, margin and interest charges on late payments charged to the T2CB up to the Indemnity Amount and such further Indemnity Amounts as are necessary to be paid to satisfy the obligation hereunder; and

(b) agrees to indemnify and save harmless the T2CB from any loss, liability, damages, costs or expenses, suffered or incurred by it arising out of any act or failure to act on the part of the T2CB in the course of it in good faith carrying out its obligations or exercising its discretion hereunder, up to the Indemnity Amount and such further Indemnity Amounts as are necessary to be paid to satisfy the obligation hereunder, except where such loss, liability, damages, costs or expenses are suffered or incurred as a result of the negligence of the T2CB.

¶ 31 Entered into evidence was an interview of RE, whom at all material times held the position of Vice-President, Credit Risk Management with Penson. In his interview he was asked questions about the responsibilities of both the Carrying Broker and an Introducing Broker in an agreement such as the Type 2

Agreement. He stated that a Type 2 Introducing Broker (in this case, Evergreen) is responsible for sales compliance and the Carrying Broker (such as Penson) is responsible for financial compliance. Further, the Carrying Broker is responsible for the financing of all positions in client accounts. The Introducing Broker is responsible for the financing of positions in proprietary inventories. He stated that it was Penson's responsibility to monitor all of Evergreen's client accounts. However, he did not categorize the API Accounts as client accounts. He viewed the API Accounts as being different from client accounts. He did in his interview agree that Penson would be responsible for reviewing the API Accounts but he did not believe that that task was his role when he reviewed client accounts. He believed that another person within Penson was at one time reviewing API Accounts.

¶ 32 With respect to the use of accounts such as API Accounts, he stated the following:

Typically, for the institutional type of customers who do buy large blocks of shares you just don't go to the marketplace and put a popup buying market, it will go through in accumulation average price, pricing (inaudible) account upon total fill of the client's order, it will be recontracted out of the inventory or the average pricing account into the COD account. Some customers use cash accounts as average pricing accounts, some correspondents, might, use a normal plain vanilla cash account as a client accumulation account. Some use the inventories, just depending on what they felt that they wanted to use.

In this case, Evergreen used API Accounts and did not accumulate shares in client COD accounts. Each of the traders at Evergreen had their own separate API Account.

¶ 33 At page 58 and 59 of the transcript of RE's interview, he was asked the following questions and gave the following answers:

Q. The type 2 agreement, what's the main difference between ... what's the particularities of such an agreement for a type 2 introducing broker?

A. As a type 2 introducing broker, the type 2 introducer is responsible for sales compliance and the carrying broker is responsible for financial compliance. However, the carrying broker is responsible for the financing of all positions.

Q. Even for COD accounts?

A. Correct. The only ... the responsibility of the introducing broker is to capitalize proprietary inventories.

...

Q. So, in a type 2 introducing arrangement that Penson had with Evergreen, Evergreen would be responsible for sales compliance?

A. Correct.

Q. And Penson would be responsible for financial compliance?

A. Correct.

Q. And along with that, then it would be Penson's responsibility to monitor all accounts in Evergreen ... on Evergreen's books and records?

A. Customer accounts, correct.

Q. Client ... Evergreen's client accounts.

A. Correct.

Q. Does that negate or does that eject out Evergreen's inventory accounts?

- A. No.
- Q. So, are there any accounts at Evergreen that Penson would not be responsible for reviewing?
- A. In what regards?
- Q. From the financial compliance perspective in relationship to the type 2 introducing carrying agreement.
- A. Is that inclusive of general ledger accounts, comfort deposit accounts, commission revenue accounts...
- Q. Well, is Penson responsible for looking at those?
- A. I'm not sure.
- Q. You don't know, okay. But your understanding is that Penson would be responsible for looking at the inventory account at Evergreen?
- A. Correct.
- Q. Now, your evidence is clear that you weren't looking at the inventory accounts?
- A. Correct.

Penson Settlement Agreement

¶ 34 The approval of the Penson Settlement Agreement is found at 2011 IIROC 56. Penson agreed to pay \$225,000.00 plus costs of \$20,000.00. The Panel found that “the sanction was somewhat low in view of the seriousness and financial impact of the contraventions admitted to by the Respondent (Penson).” The Penson Settlement Agreement includes the following admissions (paragraph numbers correspond to the Decision):

31. By virtue of the Agreement, Penson was Evergreen's Type 2 carrying broker and agreed to perform certain services including trade execution, trade clearing and settlement, and record-keeping activities for Evergreen, the Type 2 introducing broker.

PENSON'S TREATMENT OF AVERAGE PRICE INVENTORY/ACCUMULATION ACCOUNTS

33. Penson did not realize that certain Evergreen inventory accounts were considered by Evergreen to be client accumulation accounts and consequently Penson did not maintain any margin relative to these Evergreen accounts.
34. Only in November 2008, did Penson undertake detailed steps to assist its Introducing Brokers to mitigate the risk with respect to inventory account monitoring and clarification as to capital reporting on inventory accounts with its correspondent customers.

PENSON'S INTERNAL CONTROL FAILURES

39. During the period from March to October 2008, Penson ought to have identified a number of red flags to indicate that Evergreen's inventory accounts were being considered by Evergreen as API accounts (and not firm inventory accounts) and that the margin required should have been included by Penson at month-end.
40. However, Penson did not identify certain red flags (as discussed in detail below) in a timely manner and failed to identify Evergreen's treatment of

the API accounts.

RED FLAGS

41. In May 2008, at Evergreen's request, Penson provided to Evergreen's trading desk staff double alpha coded inventory accounts.
42. Evergreen's position is that it considered the API or double alpha inventory accounts as non-proprietary client accumulation accounts.
43. In or around May 2008, Evergreen noticed that Penson was treating the API accounts as proprietary accounts.
44. As a result, Penson was valuing these accounts mark to market which automatically generated month-end write-offs.
45. Due to the write-offs, Evergreen incurred problems relative to the pricing of securities positions in the inventory account.
46. "EE" requested that Penson, through "DD", reverse the profits and losses generated by the mark to market valuations; "DD" in turn redirected the issue to "BB".
47. "BB" manually reversed the write-offs for the following months, from July to September 2008, for a total of approximately \$25 million.
48. "BB" failed to question the reasons for the reversal of write-offs and/or the financial impact of these reversals on Penson and/or Evergreen.
49. During this same time, Evergreen and Penson personnel tried to resolve valuation problems associated with the inventory accounts.
50. Evergreen's continued requests to reverse the write-offs should have been an indication to Penson that Evergreen considered the inventory accounts as API accounts, instead of firm inventory accounts.
51. Penson had inappropriate controls to monitor reversals of write-offs.
52. Evergreen treated its inventory positions as client positions and was not putting up any margin on a regulatory capital perspective.
53. At that time, there was no internal written procedure relating specifically to the monitoring of the reversals of the write-offs by Penson staff.
54. At that time, the application of Penson's Credit & Risk Policies and Procedures was unclear relative to the supervision of Introducing Broker's accumulation accounts for clients.

2. DAILY INVENTORY REPORTS

55. Penson did not diligently review Daily Inventory Reports it prepared and forwarded to Evergreen.
56. A more careful review of these reports would have shown:
 - The market value and the cost price of securities positions.
 - The write-offs.
 - The approximate exposure to Penson.
57. Ultimately, the Daily Inventory Reports presented a red flag for Penson.
58. During the relevant period, neither the CFO, the VP Credit nor the VP

Integrated Management Risk at Penson reviewed the Daily Inventory Reports.

3. FAILED TRADES REPORTS

59. Penson prepared Failed Trade Reports for Evergreen.
60. The Failed Trades Reports are generated when the positions in inventory accounts are booked to clients and are not settled in the delay T+3.
61. According to Penson's own internal Credit & Risk Policies and Procedures, Introducing Broker's clients' accounts were subject to being restricted from trading unless the trades are properly settled.
62. As early as of May 2008, the transactions contained in Evergreen's Failed Trades Report far exceeded Evergreen's financial capacity to withstand its clients potential failure to settle booked trades.
63. Penson's Failed Trades Reports showed that restrictions on Evergreen accounts were not applied by Penson on unsettled booked trades.
64. The review and/or control of these reports by Penson was inadequate in regard to the high value of recurrent unsettled trades.
65. Penson did not proactively address with Evergreen the issue of the potential risk exposure relative to the importance of the amount of unsettled trades in the Failed Trades Reports.

PENSON'S CREDIT & RISK POLICIES AND PROCEDURES

66. Penson's Credit & Risk Policies and Procedures ("Policies and Procedures") were unclear and failed to clearly outline a procedure relating to the supervision of Introducing Broker's API accounts.
67. Penson's Policies and Procedures indicated that Penson would assist in the review of inventory accounts.
68. According to "BB", he did not have the responsibility to review specific inventory accounts of Evergreen.
69. However, according to "CC" and "AA", "BB" was responsible for reviewing all inventory accounts and was responsible for the application of Penson's policies and procedures.
70. In fact, there was insufficient supervision by Penson of Evergreen's API accounts.

¶ 35 Clearly, Penson failed to meet its obligations to Evergreen pursuant to the Type 2 Agreement and failed in its obligations as a registrant. Penson's policies were unclear and failed to clearly outline a procedure relating to the supervision of API Accounts. There was insufficient supervision by Penson of Evergreen's API Accounts. Penson failed to apply restrictions on Evergreen's API Accounts in relation to unsettled booked trades and its review of the Failed Trades Reports was inadequate in regard to the high value of recurrent unsettled trades. Penson failed to resolve the valuation issues that were caused by Penson's own conduct when it continually valued the accounts at marked to market instead of at cost and as well when it continued to manually reverse write-offs from July until September, 2008 for approximately \$25 million. Despite repeated requests from Carbonelli, Penson did not provide accurate pricing of the securities in the API Accounts. It was Penson's obligation to provide accurate pricing of the securities in the API Accounts.

IIROC Connacher Decision

¶ 36 At 2011 IIROC No. 28 is the IIROC Connacher Decision. Connacher was found guilty of engaging in

conduct unbecoming or detrimental to the public interest, contrary to IIROC Member Rule 29.1 by:

- (a) conducting trades in his firm's average price client inventory account (API) in a manner that was misleading and deceptive; and
- (b) entering into several loan agreements with two of his clients without the knowledge or consent of his employer.

¶ 37 Connacher did not appear at the hearing, nor was he represented by counsel. The facts found by the hearing panel included:

THE FACTS

4 During the summer and fall of 2008, the Respondent, the Head Trader for Evergreen Capital Partners Inc. ("Evergreen"), intentionally through deceptive means, traded in the average price inventory account ("API") at his own discretion without obtaining instructions from any clients. This was clearly contrary to the true purpose of the API, namely to accumulate large non-contingent client orders.

5 The Respondent accumulated significant securities positions in the API and would only later decide which clients would receive the securities positions. The accumulated positions would often not be booked out of the API in a timely manner, remaining in the account for weeks, at times months. There were many instances where the Respondent would allocate the trades to a client only once a profit was generated.

6 As the general market declined in the fall of 2008, the accumulated positions also declined in value, thereby making it more difficult for the Respondent to book out to any of his clients. In late October 2008, attempts were made to book out over \$63 million in securities to two of the Respondent's biggest clients, whose directing minds had also loaned the Respondent approximately \$345,000. Both clients denied placing these orders and the trades failed to settle.

7 Evergreen was unable to pay for these failed trades and ceased operations on October 29, 2008. On or about November 4, 2008, Evergreen's IIROC membership was suspended. On or about December 2, 2008, Evergreen filed an Assignment in Bankruptcy.

8 The Respondent first joined Evergreen in March 2008 as an institutional trader. In July 2008, he was promoted to Head Trader. Evergreen hired him with the intent of growing its institutional sales and trading business.

The Accumulation of the API

10 At Evergreen, an API was used to accumulate securities positions (usually through multiple trades) to fill large non-contingent client orders. Once the order was filled, the trader responsible for the order was required to promptly transfer the position from the API to the client's account at the average price.

12 Evergreen's API were non-proprietary client accounts and therefore financed by the carrying broker of Evergreen, Penson Financial Services Canada Inc. ("Penson"). However, Evergreen was liable for any unsettled trades.

13 From June to October 2008, the Respondent accumulated increasingly larger positions in his API. The month-end positions as of settlement date were as follows:

Settlement Date	Net Inventory Position
June 30, 2008	\$16,470,201.17

July 31, 2008	23,729,204.32
August 30, 2008	21,467,524.05
September 30, 2008	31,326,644.97
October 27, 2008*	44,534,477.39

**October 27, 2008 was the last date before the majority of the positions were booked out to clients.*

14 The majority of the accumulated positions were in 3 securities: Yamana Gold Inc., Barrick Gold Corp. and Timminco Ltd. As of Oct 27th, these securities constituted approximately 80% of net inventory positions accumulated in the Respondent's API.

15. The Respondent admitted to freely trading in his API at his own discretion without specific prior instructions from any of his clients. He was effectively using the API as his own trading account to generate profits that would ultimately be allocated to his clients. As part of this trading strategy, the Respondent would at times engage in the following improper and/or deceptive practices:

- i. Execute both the buy and sell of a particular security in the API and subsequently book out to his clients. In doing so, he used Penson and/or Evergreen's capital to finance winning trades for his clients;
- ii. Allocate positions to his clients at prices less than the market price at which the security was bought. Such pricing discrepancies provided a benefit to his clients at the expense of Penson and/or Evergreen;
- iii. Transfer some of his accumulated positions to the API of the other Evergreen traders, thereby creating a misleading impression to the firm that he managed down his own API; and
- iv. Book out positions to clients and immediately cancel them days later, thereby creating a misleading impression to the firm that he was managing down his own API.

16 The majority of the accumulated positions were booked out to two of the Respondent's biggest clients: BC and LH, who each held a non-discretionary Delivery Against Payment account at Evergreen. Individuals who were directing minds of these corporate clients provided loans to the Respondent during the same period of time.

17 According to the Respondent, he engaged in this trading activity in the API to impress both his clients and the firm. The clients received winning trades without the risk of putting up their own capital and at times obtained a better price. The firm would benefit from increased business in institutional trading, the primary reason it hired the Respondent.

Personal Loans from Clients

25 At the relevant time, BK was Chief Executive Officer and sole shareholder of LH. BK provided the majority of trading instructions for the LH account at Evergreen.

26 At the relevant time, LB was the executive vice-president of BC who was

duly authorized to give trading instructions to the Respondent for the BC account at Evergreen.

27 Prior to joining Evergreen, BK loaned the Respondent \$100,000 so that the Respondent could purchase shares in the Member firm where he was employed. Upon leaving the Member firm, the Respondent was to sell the shares and pay back BK with the proceeds. The loan remains outstanding.

28 In or around June 2008, BK loaned the Respondent an additional \$150,000 for the Respondent to use as capital for a personal trading account. The loan remains outstanding.

30 In or around September 2008, BK loaned another \$45,000 to the Respondent for personal finance issues. The loan remains outstanding.

31 The Respondent borrowed \$345,000 in total, comprised of \$295,000 from BK and \$50,000 from LB.

32 The Respondent did not disclose these loan arrangements to Evergreen.

¶ 38 The penalty imposed on Connacher was a lifetime ban from any form of registration in any capacity with a Member Firm of the Association, a fine of \$500,000.00 and full indemnity costs of \$71,315.50.

¶ 39 Connacher engaged in conduct that was "tantamount to fraud" in the words used by the panel in the IIROC Connacher decision.

¶ 40 Connacher was engaging in deceptive conduct and used the API Accounts to carry out his deception. This Panel is mindful of the fact that the allegations made against the Respondents do not include an allegation of a failure to supervise Connacher.

Evergreen's Policies and Procedures

¶ 41 While Evergreen was a smaller dealer that had only commenced its operations in 2007, it did have written policies and procedures in place that had been reviewed by IIROC. Those policies and procedures included the following:

- (c) Policies and Procedures Manual dated November, 2006;
- (d) Trade Desk Manual dated November, 2007;
- (e) Trade Desk Manual dated July, 2008; and
- (f) Internal Controls document executed by the Board of Directors of Evergreen.

¶ 42 There was a Sales Compliance Review conducted by IIROC. The report of that review is dated January, 2008. It was sent by IIROC to Conway with a copy to Carbonelli with correspondence dated May 12, 2008 with a request that Evergreen provide a reply addressing all topics and that the reply be provided on or before June 9, 2008. There is no evidence that Evergreen failed to respond appropriately to any issues raised in the Sales Compliance Review.

¶ 43 With respect to internal controls, Evergreen had a written "Internal Control Policy Statements" document dated June, 2008. A portion of that document addresses "Pricing of Securities." The policy concerning the pricing of securities was stated as follows:

VI: PRICING OF SECURITIES

Control Objective:

To ensure that:

- (a) there is independent and timely verification of security prices to detect errors or omission in the pricing of securities;

- (b) security pricing discrepancies are identified and corrected on a timely basis and reviewed and approved by senior management;
- (c) there is consistency of procedures in the pricing of all types of securities;
- (d) there is accuracy and completeness of the pricing of securities and to ensure the reliability of prices.

The pricing of client securities is the responsibility of the carrying broker (Penson), however for the purpose of ensuring the value of the Firm's Inventory accounts is accurate, the CFO will:

- (a) manually price any securities not normally given value (i.e. broker warrants) a per the market value of the underlying security; and
- (b) review and approve the pricing for any significant inventory positions on a monthly basis.

¶ 44 There was also a written "Inventory Infrastructure Memorandum" dated May 31, 2008 that addresses the API Accounts. Stated in the Memorandum is the following:

Average Price Accounts

Evergreen accumulates purchases and sales in average price accounts for their institutional clients. The client orders for those transactions are not "all or none", and there are pre-existing, time-stamped tickets, therefore they are treated as client positions for margining purposes. Margin is provided on all trade date positions commencing on the regular settlement date of the first accumulation amount purchased by Penson as these are client receivables not firm inventory.

Gauthier's Evidence

¶ 45 Gauthier is the Manager of Investigations with IIROC, and holds a Bachelor of Commerce degree and is a Chartered Accountant. Prior to joining IIROC he was with the Vancouver Stock Exchange in the surveillance department and prior to that was with the Alberta Securities Commission as an investigative accountant for approximately five years. He has been conducting securities related investigations for approximately 20 years.

¶ 46 In cross-examination Gauthier admitted that he had no industry experience working in a brokerage firm. He had taken the Chief Compliance Officer course and the Chief Financial Officer course with the Canadian Securities Institute. He had never served as a CCO or UDP. He had no experience working at a trading desk.

¶ 47 He first became involved with the investigation of Evergreen on October 29, 2008. Early on he met with Carbonelli who advised him that records for the API Accounts did not show the cost of the securities but instead showed current market prices. Carbonelli told him that she was having difficulty booking the securities to the client accounts since she could not determine the costs. She had been going through TSX trade records to attempt to find the exact costs but that caused delay in booking the trades to client accounts.

¶ 48 Gauthier obtained records of Evergreen that consisted essentially of trading records, trading blotters, API Account records showing the number of shares in the API Accounts on a daily basis and other records. He also interviewed Conway, GC (the CFO of Evergreen), TD (the Branch Manager in Toronto of Evergreen) and others.

¶ 49 Gauthier did not interview Connacher, but reviewed a transcript of an interview of Connacher conducted by the Trustee in Bankruptcy of Evergreen. Connacher admitted in that interview that he conducted many of his trades without any authorization from clients. This was in breach of Evergreen's policies and procedures.

¶ 50 Gauthier gave evidence about the process of completing a trade at Evergreen. The process that he

described was:

- If an order was placed by a client the person taking the order would fill out a manual trade ticket. The ticket could be filled out by a sales person or by a trader;
- The trader would then input the information into a computerized trading system that was provided by Penson. The trading system would send the order to the Stock Exchange;
- When the order was filled, the trader would receive information confirming the fill of the order. At that point, the securities would be held in the API Account of the trader. After the order was filled and the average price for the securities purchased was calculated by Penson, the trader would then book the trade out to the client by again completing a manual trade ticket. The ticket would be given to an administrative person in the Evergreen office who would enter into the system the order;
- The client would then be notified by way of confirmation that the trade was filled and that would start the settlement process;
- In this process, every trade that was filled resulted in the securities being placed into the API Accounts. Steps would then have to be taken by the trader to book the securities from the API Accounts to the client accounts, that would then trigger the settlement process;
- The day after any securities were purchased, Penson would produce a trading blotter that would show the average price paid or received on that particular trade. The trade could take several fills to complete if it was a large volume. Penson would list every fill and the price and number of the shares filled and would provide an average price for the fill;
- Typically, the shares that Gauthier observed in his review were purchased in a day. However, it could take more than one day to complete an order;
- After the trader books out the securities from the API Accounts to the client account, Penson then completes the settlement process and Penson sends a confirmation statement to the client. It is at that point that a commission is also charged to the client; and
- Securities held in the API Accounts were purchased by Penson and were financed by Penson.

¶ 51 Gauthier also testified that the day after any trades were completed, Penson provided to Evergreen an API Report (examples are at Tab 93 of Exhibit 1). The API Report was sent to Carbonelli among others. The API Report includes the following information:

- Identification of the trader responsible for the trade;
- The description of the security;
- The quantity of the security held in the API Account;
- The cost price paid on the market for the security;
- A "P/L" column showing the profits and losses on the positions;
- The market price for the security;
- The total market value of all of the securities; and
- Finally, a "TD Balance" that represents the money that Penson had paid for the particular position and that was owed to Penson for that position.

¶ 52 Gauthier also testified that Carbonelli would also receive, on a daily basis, the trading blotters that showed the purchases and sales through the market that day as well as any shares booked out to clients. Any trade processed through the Penson trading devices would be detailed on the trade blotter received each day.

¶ 53 The API Reports and the trade blotters were also sent to TD, the branch manager located in Toronto and to NS. They were required to review the daily trade activity and report to Carbonelli immediately should there be any issues.

¶ 54 Carbonelli also received trade reconciliation reports, the commission reports and the actual manual trade tickets. She reviewed all of these things looking for issues from a compliance perspective including deceptive trading practices and making sure that the tickets were filled in properly. She would check the trading blotter and the trade reconciliation to make sure that people were not taking winning trades out of average price and putting it into their personal accounts. She received these reports anywhere from weekly to monthly.

¶ 55 Based on the reports available to Evergreen Gauthier prepared a document summarizing the daily amounts owing to Penson for the inventory in Connacher's API Account. This record does not include inventory in the API Accounts of the other traders.

¶ 56 In June, 2008 the amount owing to Penson for securities in the Connacher API Account varied widely on a daily basis but was often in excess of \$4 million and reached highs of over \$13 million.

¶ 57 In July, 2008 the daily value of the inventory in Connacher's API Account was often in excess of \$10 million and reached a high of \$15.5 million.

¶ 58 In August, 2008, the value of the inventory in Connacher's API Account was never less than \$14.5 million and reached a high of \$29.1 million.

¶ 59 In September, 2008, Connacher's API Account had a value that was never less than \$13.6 million and reached a high of \$26.9 million.

¶ 60 In October, 2008, the value of Connacher's API Account was never less than \$15.9 million and by mid October, 2008, the value of the securities in Connacher's API Account increased dramatically to approximately \$40 million by October 22 and remained at that level until Penson stepped in and began booking positions to clients.

¶ 61 Tab 92 of Exhibit 1, a record prepared by Gauthier, contains a daily summary of the specific securities held in Connacher's API Account. He appears to have traded in a limited number of securities (usually there were eight or less securities on any specific day that were held in the API Account of Connacher). Therefore, while the dollar values were high, the number of different securities held in Connacher's API Account at any one time was usually in the range of about eight securities. Further, the record shows that a number of the securities were held in the API Account for periods of time. As an example, 210,200 shares of Timminco at a cost of \$4,661,983.76 were held in Connacher's API Account beginning on August 15, 2008. On August 26 about 34,000 Timminco shares were transferred out but the next day it appears that the same number of shares was transferred back into the API Account and 210,200 or more Timminco shares remained in the Connacher API Account until October 28, 2008.

¶ 62 Similarly, large positions in Yamana Gold worth millions of dollars were held in Connacher's API Account from August 1, 2008 until October 28, 2008, except for several days when it appears that the positions were cleared out. Overall, the record prepared by Gauthier shows large positions held in specific securities for more than several days. The impression obtained from a review of Gauthier's summary is that the API Accounts were not being used solely to accumulate positions until large orders were filled but instead became a holding account without being booked out to the clients. This is not a document that Carbonelli had.

¶ 63 Gauthier acknowledged that Penson at month-end was taking the cost price of the securities in the API Reports and was converting their cost price to a market price as at the end of the month. Therefore, for those positions that carried over at month-end, the reports made it difficult to determine what the actual average price was. The costs in the report should not have been changed by Penson.

¶ 64 Carbonelli advised Gauthier that by June, 2008 she was concerned that they were booking trades to clients at the wrong prices. Despite being told by Penson that the marked to market changes to the prices that occurred at month-end had been reversed, Evergreen, when it booked out trades, found that there were still

profits and losses left in the API Accounts. That suggested that prices were being booked out to clients based on erroneous information.

¶ 65 Important evidence given by Gauthier was that in his opinion there were records provided to Evergreen by Penson that would allow Evergreen to extract information that could then be used to manually calculate the correct average prices of the securities in the API Accounts. He stated that the trade blotters would show the exact prices of the securities. He stated that in order to determine the correct prices "you'd have to go back and go through the trades, through the trading blotter to see what was actually paid through the market on that - - for that security."

¶ 66 He stated that similar information would be available in the trade diaries that show the individual fills for the trade blotters. That would be a document produced by either the TSX or Penson.

¶ 67 During Gauthier's Examination-in-Chief, he read in portions of information provided to him by Carbonelli. The evidence of Carbonelli that was read in stated that by August she brought in JV to help deal with the review of documents to calculate the average price of the securities. They had been unable to make any headway with Penson on that issue. She also asked staff at Penson to escalate the pricing issue further to more senior management. Carbonelli stated that JV advised her that prices "are really messed up, and he does not know where to even begin. We came up with a plan to start booking out any positions where we knew the price."

¶ 68 In September and October, Carbonelli had all reports sent to her in Calgary. The evidence read in during Gauthier's Examination-in-Chief was that Carbonelli stated that there were a couple of positions where she came up with three different prices for the same security. She worked through the positions where they were sure of the price and they booked those securities out. Staff at Penson was working with JV trying to come up with a resolution. Carbonelli had stated that she had asked repeatedly of Penson for a report to help her out to reconcile positions against the actual TSX diaries. She stated that "this was taking an enormous amount of time. Finally, towards the end of October, I had a conference call with a senior VP at Penson in Montreal."

¶ 69 Gauthier prepared a chart (Tab 94 of the Exhibit 1) that he stated showed the amount from the API Accounts that were financed at the end of each month, the amount that was owed to Penson for those positions and the market values of those positions at month-end. The document also shows Gauthier's calculation of the cost of the securities.

¶ 70 Tab 94 of Exhibit 1 shows that by the end of June, 2008, the securities in the account had a cost price of \$11.6 million but only had a market value of \$10 million for a deficiency of \$1.6 million. By July 31, 2008, the deficiency was \$3.8 million. By August 31, 2008 the deficiency was \$9.7 million. On September 30, 2008 the deficiency was \$14.8 million. By October 31, 2008 the deficiency was \$37.6 million.

¶ 71 Gauthier then read at the hearing a portion of the transcript of further information provided by Carbonelli. In that statement Carbonelli stated that she came up with a plan to start booking out any positions where they knew the price. They would sit down with the TSX reports and manually calculate the prices for positions that they could. To carry out that calculation they would have to look at all of the trades in a particular stock and then they would have to go and identify which one belonged to whom. They would have to identify which security was traded for which client. They then started to book out trades and clean up the inventories.

¶ 72 Gauthier also gave evidence about his interview of Conway. In the period May, 2008 to August, 2008 Conway was not dealing with the pricing issues. Carbonelli was left to deal with operational issues and he focused more on corporate issues. Conway and Carbonelli would talk on a daily basis about different issues that Carbonelli might be having. In his view, she was dealing with the issues.

¶ 73 By September, 2008 Conway became more involved with the API Account issues. There had been some failed trades with the client LE. He discussed the matter with Carbonelli and it was agreed that Carbonelli would "stay close and stay on top of ... Connacher and make sure that trades got booked out in a timely

fashion." As far as he knew, the failed trades ultimately did settle.

¶ 74 In September, 2008, Carbonelli came to Conway and said that she was concerned because there were trades in the API Accounts that they could not calculate the price for and that could not be booked out. She also advised that there were large losses due to the declining market. She also advised that they might have booked out trades at an incorrect price. She advised Conway of her prior discussions with Penson. That is when "alarm bells started to go off for me" according to Conway.

¶ 75 Gauthier referred to an email from Carbonelli dated August 27, 2008 in which she requested that Connacher sort out the prices for the older positions in the API Accounts and book everything that could be booked out. The inventories at that point in the API Accounts were close to \$35 million. Conway was aware of that email. Prior to that email Conway did not believe that he had knowledge of the magnitude of the problem. We now know that Connacher was at the time carrying out a deception. This was not at the time known to Carbonelli nor is it alleged she should have known.

¶ 76 Carbonelli, in early September, after becoming aware that Penson had again converted the prices in the API Accounts to market prices, took steps to speak with Penson's Vice-President. The Vice-President advised that he would arrange to reverse the entries. He also agreed to stop charging interest on the cost of the inventories.

¶ 77 By early October, TD had corresponded with Carbonelli and Conway expressing concerns about the values in the API Accounts.

¶ 78 By October 24, 2008, TD expressed that a policy should be implemented to track positions held in the various API Accounts on a go-forward basis and that all positions be booked out on a weekly basis. However, by then the problem had become overwhelming and within days, Evergreen was out of business.

¶ 79 While Gauthier gave evidence that he was able to calculate the cost of the securities in the API Accounts by going to source documents such as documents provided by the TSX and the trade blotters, he did not give evidence about how complex that task was or how long it took him to complete those calculations or what problems he encountered when completing his calculations. That information would have been helpful to the Panel to determine whether there was a reasonable ability on the part of Carbonelli or others to on a timely basis unravel the pricing problem created by Penson that was compounded by Penson's continued changes at month-end to the cost of the securities. Gauthier also did not address the impact of Connacher's deception on the ability of Carbonelli or others to reasonably unravel the problem.

¶ 80 In cross-examination of Gauthier he was asked whether Evergreen did have in place at any relevant time all of the proper and usual policies that would be required by the IDA or IIROC, and in particular, Dealer Member Rule 2600. He responded that Evergreen had "the typical policies you would see in most firms, yes." However, he indicated in cross-examination that he did not see any policy dealing with the average price accounts. The above-noted Internal Control Policy Statements dealing with pricing of securities was then brought to his attention and he advised that he had not seen that document as part of his review.

¶ 81 The Internal Controls document approved by the Board of Directors of Evergreen contains written guidelines to address the pricing of securities. It states that Penson is responsible for the pricing of all client accounts. In cross-examination, Gauthier admitted that the wording used in the Internal Controls document on that issue was "something that comes right out of Rule 2600." Gauthier admitted that Penson produced all of the reports and was to also produce any prices for the cost of the securities. Gauthier also admitted that to the extent that there were any deficiencies identified in the review carried out by IIROC in 2008, those deficiencies were dealt with.

¶ 82 At a further point of the cross-examination, Gauthier was asked questions about the responsibilities of the Introducing Broker and of the Carrying Broker with respect to trades and dealing with clients. Gauthier stated that Evergreen would have some responsibilities when booking trades out to clients since it is the Introducing Broker that is actually dealing with the clients. However, he admitted that Evergreen should not be the party that is keeping the records, setting the prices and "all of those duties that led to the problem here." He

responded that those were not duties of Evergreen and that Penson carried out the back office function and produced the reports. There was this exchange of questions and answers commencing at page 221, line 16 of the transcript of Gauthier's cross-examination:

- Q. So with all of that, you wouldn't normally be expecting the introducing broker to having to be reconstructing trades and figuring all these things out on their own, would you?
- A. Because the introducing broker is actually conducting the trades and dealing with the clients, there's a certain amount of work they'll have to -- still have to do when booking those trades out to clients. That information will not be readily available from the Penson reports.
- Q. But they shouldn't be the ones that are doing all these duties I've just talked, like keeping the records, setting the prices, all of those duties that led to the problem here?
- A. No. Penson carried out the back-office function and produced the reports.
- Q. So at the very minimum, the introducing broker, Evergreen, in this case, should be expecting the carrying broker to provide accurate numbers about the prices that are paid for securities?
- A. Yes.
- Q. And Ms. Carbonelli was on them about that, really, from day 1, wasn't she?
- A. From early June, when she noted that they had treated the API accounts -- the client API accounts as proprietary accounts she was, yes.

Carbonelli's Evidence

¶ 83 Carbonelli gave evidence about her own background, the background of Evergreen's Chief Financial Officer and the development of internal controls. She first held a position of a CCO in 2001 with another company. She has been employed in the industry since 1987.

¶ 84 She started with Evergreen in August of 2007. When she first started with Evergreen the Policies and Procedure manuals that Evergreen was using were the ones that had been used to obtain Evergreen's membership with the IDA. She reviewed the policies and procedures and forms of Evergreen and updated forms and the Trade Desk Manual.

¶ 85 With respect to internal controls, she worked with GC, the CFO. GC had extensive experience in the industry and held senior positions with the IDA prior to becoming a consultant. Updates to the internal control policies were completed as of June, 2008.

¶ 86 Carbonelli, in her Examination-in-Chief, referred to a document titled "Credit and Risk Policies and Procedures" that was provided by Penson. That document states that Penson is responsible for managing the overall risk of all accounts carried.

¶ 87 Carbonelli testified that there were numerous problems with the reports provided by Penson. Sometimes Penson would correct trades at their own discretion. Often, there would be other firms' trades on their trade records and she would have to deal with Penson to rectify those problems.

¶ 88 Each of the four traders at Evergreen had their own trading device and API Account. She testified that Penson recommended the use of a program called Ticket Writer to capture all trades for each trading terminal to a specific inventory so that they could capture all trades and be provided with an average price the next day.

¶ 89 Penson was to provide various daily reports that would provide information about the trading, including commission reports, inventory reports, a CDS report that was a clearing report and also trade blotters. Those

reports would be provided to TD, her Toronto branch manager, Connacher, GC, the CFO and to Carbonelli. Each of TD and Connacher had responsibilities for the review of the reports. Those responsibilities are set out in the Policy and Procedures Manual.

¶ 90 Carbonelli testified that May 7, 2008 was the beginning of the inventory problems with the API Accounts. By that date there were problems with the calculation of the average prices for the securities in the API Accounts. Then on June 1, 2008 the reports provided by Penson again included profit and loss information for the API Accounts, which should not have happened. The API Accounts were not proprietary accounts and therefore should not have been priced with profit and loss information. The average price of the inventory should not have changed. Penson had incorrectly priced the API Accounts inventory to marked to market which reset all of the inventory pricing.

¶ 91 Evergreen immediately raised this issue with Penson. Penson then reversed the write-offs which in theory should have recalculated the correct average price for the inventories.

¶ 92 Then again on July 2 Penson re-priced the inventories based on a marked to market. Carbonelli advised GC, the CFO of this issue. She also spoke to Penson. Based on the information provided by Penson on July 2, Carbonelli could not make sense of the pricing.

¶ 93 During May and June there were trades that were being booked out. But trades not settling at month-end had the inventory prices incorrectly stated in the API Account records provided by Penson.

¶ 94 In early July, Carbonelli still expected that Penson would reverse the marked to market prices and that the inventory pricing problem should then be resolved. That is what she believed based on her discussions with senior members of Penson with whom she spoke on a regular basis about the problem. During July, they were still able to book out many trades, but for others the reports provided by Penson did not provide proper average prices for the securities purchased and those trades were not being booked out to a client account. For some of the institutional clients that traded heavily and were in and out of positions all of the time, Evergreen started to lose track of exactly where the positions were in relation to pricing. As a result, the unbooked positions in the API Accounts increased. Penson had completed the trades but had not been paid money since the trades had not been booked to client accounts.

¶ 95 In July there were some trades that were booked out to clients that failed. Carbonelli took steps to halt trading for at least one client until the issue with respect to the failed trade was resolved.

¶ 96 The pattern that occurred at the month-ends of May and June continued at the month-ends of July, August and September, 2008. Penson's reports, that priced the securities in the inventories, were marked to market every month-end and Carbonelli would then speak to the vice-president at Penson who would then reverse the month-end entries.

¶ 97 By August, 2008 Carbonelli was becoming more concerned. In August, 2008 she brought in JV to assist with calculations of average prices for the outstanding inventory positions. She described this as "an enormous amount of work, because the marked to markets on these inventories had changed the prices so many times; we had lost track of some of the positions and between the tickets, the TSX diaries, the trading blotters, and the inventory reports, you are looking at about an inch of paper per day to have to go through, sometimes more." JV had access to all the records that he needed and Penson was coming into assist him with that task.

¶ 98 By September 2, 2008 she restricted trading for one of the large institutional clients. This was confirmed by evidence taken in a transcript from the principal of the client, BK. She did so because of pricing issues and she wanted the inventory cleared up.

¶ 99 By September 12, 2008, some of the trades for a large client LE had to be cancelled because the prices presented for the trades were not what LE believed they should be.

¶ 100 Then on October 1, 2008 Penson yet again priced the inventory at marked to market. Carbonelli contacted Penson and they advised that they would "once again reverse the triggers." Carbonelli escalated her inquiries with Penson up to a senior person within Penson who advised that he would get back to her but he

never did so. JV, in a memorandum to Carbonelli dated October 17, 2008, expressed concerns with respect to a number of matters involving Penson. Carbonelli forwarded the memorandum to her contact at Penson but matters were never rectified.

¶ 101 To conclude, Carbonelli's evidence was that she continually tried to get information that was reliable in relation to the pricing of the securities in the API Accounts but was never able to obtain that information from Penson. As a result, some securities in the API Accounts were not booked to client accounts, the inventories grew and by September, 2008 the market correction was causing the value of those inventories to decline dramatically. She was not aware of the deceptive activities of Connacher. Attempts were made by Evergreen, and in particular JV, to calculate the average prices of the positions in the inventory. It was according to Carbonelli a very difficult task. She stated that one would have to go all the way back to the initial positions at its inception to truly figure out what the average costs were. That led to difficulty and in her view "even impossibility" to book out the positions to the clients.

¶ 102 Carbonelli also expressed doubt about the accuracy of the final cost numbers used in late October by Penson to book the trades out to clients. She points out that the chart used in Connacher's hearing that is referred to in the Connacher for Decision does not seem to compare to the information used in the NOH for this hearing. She also went through other records to show inconsistencies. She therefore does not accept that Penson was ever able to accurately determine the costs of the inventory positions. This made it impossible to book the trades to clients.

¶ 103 With respect to concerns about the risk of not booking the inventory, Carbonelli stated that from May through to August she believed that the problem would be solved. That was what she was being told by Penson. Further, the markets did not begin a steep decline until September, 2008. By September she then started to feel more concerned about making sure the trades were getting booked out. She stopped trading by LE until existing positions were booked. LE was one of their bigger trading clients. She instructed the trade desk to book out trades as they happened and instructed TD, the branch manager, to watch trading.

Conway's Evidence

¶ 104 Conway has a degree in Economics and a Master's degree in Business Administration. He completed numerous courses through the Canadian Securities Institute and held the designation of Fellow of the Canadian Securities Institute. He has completed the Partner's, Director's and Officer's examination. He completed the Branch Manager's examination. He wrote the Chief Compliance Officer's examination. He has completed option courses. He has been registered with IIROC since 1993 except for minor periods of time since then.

¶ 105 Conway has held vice-president level positions with other dealers. He and others started Evergreen in 2006 and he was the CEO and the UDP at Evergreen until it ceased operations in October, 2008.

¶ 106 Conway had worked with Carbonelli in the past. He believed that she was "eminently qualified" as a CCO and as Evergreen's COO.

¶ 107 Conway believed that TD, as the Branch Manager in Toronto, was responsible for overseeing all trading and sales activity in the Toronto office. Carbonelli was in charge of day-to-day operations and compliance. As UDP he did not have regular contact with Penson. He did not receive the API Reports that were delivered by Penson but would receive monthly reports from Carbonelli that highlighted issues that may have arisen with respect to trades. At no time did he ever suspect Connacher might be making fictitious trades or engaging in a deception.

¶ 108 Conway testified that in early June, 2008 he first became aware that there were problems booking out positions in the API Accounts. He and Carbonelli discussed the issue during that timeframe and it did not "strike me as something that was particularly serious." Carbonelli was aware of the issue as was Penson and he assumed that the issue would get resolved.

¶ 109 With respect to the memorandum from GC to Carbonelli dated June 11, 2008, in which GC raises a concern about the level of inventory in the API Accounts, Conway did not specifically recall receiving the email even though he is shown as being a recipient. He does not think that it would have necessarily raised a red flag

with him because the API Accounts by their nature accumulated large positions. He believed that GC and Carbonelli were dealing with the issue. He understood that Carbonelli was dealing with a Vice-President at Penson to resolve the problem.

¶ 110 By September or early October, Conway became aware that the problem had increased in magnitude. By then Carbonelli had already stopped trading by LE. He stated that LE constituted probably 90% of Evergreen's trading. Given that trading by LE was halted, he does not understand how any records that are produced for the month of October, 2008 could show an increase in the API Account inventories. His only explanation was that Penson may have reversed \$25 million in losses that then could have affected the October, 2008 numbers. Also, Connacher may have been hiding some of the positions which then became known in October.

¶ 111 Conway stated that he did not receive the API Reports so was not watching the levels of inventory increase. Further, Penson was not charging Evergreen large interest charges so there was nothing that led him to believe that there was a "huge" unbooked position. If securities are sitting in the books for extended periods of time he would have expected to see large interest charges from Penson and that was not happening.

¶ 112 After Carbonelli advised him that the problem was becoming more significant, he gave Carbonelli support. He emphasized to Carbonelli that all positions that could be booked out should be booked out. He asked that Carbonelli elevate the issue within Penson.

¶ 113 To conclude with respect to Conway's evidence, he was generally aware of the pricing problems in June and July but the problem did not appear to be significant and Carbonelli was taking steps to raise the issue with Penson. By September, 2008 he was aware that the problem was more significant, but by then Carbonelli had stopped the trading of one of the larger clients and in his discussions with Carbonelli, he instructed her to attempt to book out all positions that could be booked out. By the time that Conway became aware of the significance of the problem it was too late to avoid the ultimate collapse of Evergreen.

IV. ANALYSIS

¶ 114 There is no dispute with respect to the following:

- Carbonelli was Evergreen's CCO and COO and Conway was Evergreen's UDP.;
- From May 2008 to October 2008, Evergreen's API Accounts held increasingly larger positions that were not booked out to clients. Gauthier testified that he reviewed the underlying trading records and determined that by late October 2008 the cost of the unbooked positions was \$69,349,876 and the market value of the positions was only \$31,672,332, resulting in a deficiency of \$37,677,544;
- In late October, 2008, Evergreen's carrying broker, Penson, booked out \$63,200,000 in positions to Evergreen's clients. However, the trades failed to settle, as the clients denied placing any orders for these securities, which then led to Evergreen ceasing operations and filing for bankruptcy;
- Carbonelli received reports that showed that significant positions in the API Accounts were not being booked out to clients in a timely manner. The positions continued to grow larger as the months progressed;
- One of the key reports that Carbonelli received was the API Report that showed the inventory in each API Account. Large institutional orders could take a period of time to be filled. Portions of the order could be filled at different prices. Penson was to provide an average price for the purchases so that prior to transferring the securities to the client accounts, Evergreen would receive from Penson an average price for the complete fill of the order. The average price would normally be calculated to four decimal places;
- In the case of a proprietary API Account (where trading was conducted for Evergreen and not for a client), the price is to be marked to market to reflect losses or gains in the account. However,

for client accounts, and securities held in the API Accounts, the securities should have been recorded in the API Reports at cost, and that cost should not have varied whether or not the securities' market value went up or down;

- Shortly after the end of May 2008, Carbonelli knew that Penson was incorrectly treating the API Accounts as proprietary accounts. The API Accounts were being marked to market at the end of each month; and
- Carbonelli repeatedly informed Penson that the API Accounts were being incorrectly marked to market at the end of each month. Penson led Evergreen to believe that it would resolve the valuation problems associated with the API Accounts, but it never did. As a result, Evergreen was not provided with correct average price information by Penson that would allow it to accurately price and then book the securities to client accounts. To obtain accurate price information Evergreen would instead have to review trade blotters and manually calculate the average price, which Carbonelli testified was a difficult and time consuming task.

¶ 115 When reviewing the Counts alleged in this matter, this Panel accepts the arguments of counsel for Conway that the standard to be applied to the Respondents is not one of perfection. The standard to be applied is not whether or not the Respondents could have done something that might have provided a better result. Instead, the standard expected of the Respondents is that they act as reasonably proficient and diligent individuals as stated in a Notice issued by IIROC (MR0435) dated November 30, 2006 and titled "Joint Notice of the Staff of Market Regulation Services Inc., Mutual Fund Dealers Association of Canada, Bourse de Montréal Inc., and Investment Dealers Association of Canada" which addresses the role of compliance and supervision:

When individuals will be subject to enforcement action by SRO's

The standards against which the conduct of board members, management, Compliance Officers and other individuals will be measured in a discipline hearing is that of a reasonably proficient and diligent individual in that position. The standard is an objective one; it is not what the respondent actually knew or did but rather what he or she ought to have known or done....

¶ 116 The Counts described in paragraph 3 of this Decision do not allege a failure to supervise but allege that Carbonelli and Conway "failed to establish and maintain adequate internal controls for the use and operation of Evergreen Capital Partners Inc.'s client accumulation accounts, contrary to IIROC Dealer Member 17.2A." It is alleged in paragraph 30 of the NOH that "a reasonable and diligent supervisor" would have done certain things. We were provided with no expert evidence to assist this Panel with whether or not the internal controls that were established were "adequate" within Dealer Member Rule 17.2A or what a "reasonable and diligent supervisor" would be expected to do.

¶ 117 Dealer Member Rule 2600 prescribes the requirements for and provides guidance on compliance with Rule 17.2A. Internal Control Policy Statement 1 of Dealer Member Rule 2600 under the heading "Industry Practice" states that determining whether internal control is adequate is a matter of "judgment." It then lists some conditions that may indicate whether the internal control is not adequate. Expert evidence would have been helpful to this Panel on the issue of whether or not the internal controls of Evergreen were adequate and what a "reasonable and diligent" supervisor would be expected to do in the circumstances of this case.

¶ 118 The assessment of whether Evergreen had adequate policies must also have regard to Dealer Member Rule 35 and the Type 2 Agreement. Penson, in relation to the API Accounts had the obligation to comply with the Rules, Rulings and Forms of IIROC. It was Penson who had the obligation to maintain and keep current and proper all records and accounts in respect of the client accounts. While Evergreen had some responsibilities in relation to the client accounts, those responsibilities were more limited to obtaining proper account opening documentation, to compliance with the "Know Your Client" rules and with respect to determining suitability. It was Penson that had the obligation to assess margin requirements and to meet any financing requirements for clients introduced to it. It was Penson that contracted to provide trading services, clearing services,

segregation/safekeeping services and record-keeping/information services. It failed in its obligations to Evergreen.

¶ 119 It is not alleged that the internal controls of Evergreen for the period prior to June, 2008 were inadequate. In fact, Gauthier admitted that Evergreen had "the typical policies you would see in most firms...."

¶ 120 IIROC instead argues that commencing in the period June, 2008, the Respondent, as "a reasonable and diligent" supervisor had a duty to change the internal controls to do the following three things:

- Prohibiting or limiting new orders until the existing positions in the API Accounts were booked out to clients;
- A requirement that all traders produce and provide Evergreen with a daily record of all orders that they placed and particulars of any partial or complete fills that they received; and
- A requirement that a position be booked out within a reasonable period of time, even if the entire order had not been filled.

(See paragraph 30 of the NOH).

¶ 121 Counsel for IIROC argued that even if the policies and procedures in place prior to June, 2008 were adequate, there were emerging circumstances and red flags that required the Respondents to act to change the internal controls to address the increasing amount of unbooked positions in the API Accounts.

¶ 122 Counsel for IIROC argues that on June 11, 2008 there was a significant red flag that should have caused Carbonelli to act differently. GC, the CFO for Evergreen, who had significant positions with the IDA in his prior career, wrote to Carbonelli and stated:

I am worried about the average price inventory. The amounts in it are enormous.
I refer you to IDA Bulletins MR0280 and CO65....

¶ 123 The IDA Bulletins referred to set out the requirements for margin. Carbonelli discussed this matter with GC. She pointed out to him that Penson had the obligation to assess margins for the API Accounts. GC was interviewed by IIROC. In his interview he stated that he believed that inventories at that point were about \$2.6 million. He spoke to Carbonelli the morning of June 11. He confirmed that they discussed the issue and that when he sent the memorandum he had forgotten that the API Accounts were not Evergreen's responsibility, that the API Accounts were traded as client accounts and a client account is therefore the responsibility of the Carrying Broker in a Type 2 relationship. So his primary concern, that of the regulatory capital of the firm, was addressed. He still was concerned about the API Accounts because no matter what a client may say, there is always potential liability until the time that the trades settle. While he was concerned about the numbers in the API inventories, he stated that the numbers "really didn't make that much sense to me, I couldn't believe that they were correct, frankly, and I guess Loretta's commentary was, what she said there, that we were having a hard time getting these things ticketed correctly, that the accounting was incorrect", and we are having serious problems with getting our accounting correct, and on that basis he understood that Carbonelli was on top of the issue and was taking care of it. He understood that the issue involved Penson not providing the historical cost information that was required to appropriately bill the client at a later date. GC did not press his concerns after June 11, 2008. Of note, he was the CFO and had previously held senior positions with the IDA.

¶ 124 Another red flag was that from June 2008 to October 2008, Evergreen's API Accounts accumulated even larger positions, the vast majority of which were due to the positions in Connacher's API Account or to positions which Connacher transferred to other traders' API Accounts. While some of the positions were booked out to clients within a matter of days, significant positions were held in the API Accounts for weeks, and in some cases months.

¶ 125 Countering this red flag was the fact that Penson repeatedly advised Evergreen that they would correct the problem. Further, large interest charges on the cost of purchasing the securities were routinely waived and reversed by Penson. This action on the part of Penson is consistent with recognition that it was Penson's responsibility to provide accurate inventory cost information. Due to its failure to do so it took responsibility

for the interest charges and had those charges reversed.

¶ 126 Penson's actions led Carbonelli to believe, at least until mid August, 2008, that Penson would resolve the problem. Notwithstanding this, by mid August she then retained JV to assist with the manual calculation of prices. She halted trades for some clients for a period of time.

¶ 127 By September, 2008 she escalated her concerns to Conway. She took steps to have Penson escalate the problem to a higher level. She continued with efforts to manually calculate the average price of positions and to book out positions where she could. She described this as a very difficult and time consuming task. She halted trading for one of the larger clients.

¶ 128 A third potential red flag are a series of emails from TD, the Branch Manager, to Carbonelli and Conway in October, 2008. TD had responsibilities to review the trading against the records provided by Penson. He was in the same office as Connacher in Toronto. On October 2, 2008, at a point when the API Accounts had very high inventories, TD wrote to Carbonelli asking about the status of the marked to market issue. He expressed that he was "uncomfortable" with the positions that were carried over month-ends "for some time now." Carbonelli wrote back the same day advising that the continued write-offs over the months had complicated the calculation of the "true prices." She stated that it was "an overwhelming amount of work, even with JV's help."

¶ 129 As Conway pointed out in an email of October 2, 2008, it was "rather ironic" that TD would question the account inventories so aggressively when in Conway's view TD was the "first line of defence" with supervisory responsibilities as branch manager. Conway then made intemperate comments about TD's motives. In the end, TD correctly expressed the risks involved although by October 2, 2008 the die had been cast and there was little to be done to save Evergreen from the deceitful actions of Connacher and the inability of Penson to provide accurate cost information for the API Accounts.

¶ 130 TD's inquiries did however bring Conway into further heightened involvement with directions to Carbonelli that the issue had to be resolved. Unfortunately, Penson was unable to provide the cost information and in any event, the markets turned dramatically to the downside with significant declines in the value of the two largest API Accounts. There was a subsequent refusal by the clients to accept the trades.

¶ 131 Carbonelli did not ignore the problem that first became evident in May, 2008. At that time there was every reason to believe that the problem would be rectified. The problem at that point was still manageable. In June she had increasing concerns and continued to press Penson for a solution. Penson led her to believe that the problem would be corrected. In July she took a firmer stand with respect to some failed trades with one of the larger clients. In August she took steps to hire JV to attempt to obtain pricing information. She directed that all transactions that could be booked were to be booked. She continued with her discussions with Penson and attempted to elevate the problem to a more senior level within Penson. In September she stopped trading for a large client. By that time the ongoing changes and alterations by Penson to the cost prices within the API Reports had magnified the complexity of correcting the problem. To correct the problem involved a review of large volumes of documents in an attempt to track back to the beginning transactions the costs as displayed in the trade blotters.

¶ 132 In argument the Panel asked counsel for IIROC to identify the date by which IIROC says the actions identified in NOH paragraph 30 should have been taken. No specific date was given. There was a suggestion that action should have been taken by June or at least by July, 2008.

¶ 133 On the evidence, Carbonelli was faced with an emerging situation. In May and June, the accounting inventories had not increased dramatically. She believed, and with some reasonable basis to do so, that Penson would correct the problem so that Evergreen could book the positions to client accounts and Penson could then complete the trades. We would not expect Carbonelli to have taken the significant steps identified in NOH 30 in May or June, 2008.

¶ 134 In July, 2008 Carbonelli still believed that the problem was manageable and that Penson would take corrective steps. By August, 2008 she took specific steps to try to deal with the problem. She had hired JV.

She halted trading in some accounts. Her evidence was that they booked securities that they were able to calculate the costs for. She was pressing Connacher to keep track of trades and to book what could be booked. However, by August, due to the continued changes to the pricing of securities by Penson, the task of unraveling the pricing issue was more complicated and took significant time to correct.

¶ 135 While Gauthier testified that he was able to calculate the cost of the securities, Carbonelli raised some doubt with respect to the accuracy of his calculations. The calculations of the costs used in the Connacher decision and the calculation of the costs used in paragraph 18 of the NOH in this matter are different, although the Connacher decision may have relied on numbers prepared by the Trustee in Bankruptcy for Evergreen. However, Gauthier gave no evidence as to how long it took him to prepare his calculations and the difficulties that he encountered when doing so. Therefore, it is not possible to determine whether the manual calculations could have been performed on a timely basis by August of 2008.

¶ 136 With respect to IIROC's position that Carbonelli and Conway, at some point, should have prohibited or limited new orders until the existing positions in the API Accounts were booked out to clients, Carbonelli's evidence is that she did limit new orders. She did retain JV to attempt to calculate prices so that the trades could be booked out to clients at a price that she had some confidence was accurate.

¶ 137 With respect to IIROC's position that she should have imposed a requirement that a position be booked out within a reasonable period of time, even if the order had not been filed, Carbonelli's evidence was that they were booking out trades that were filled in a short period of time. However, for trades that were not filled in a reasonably short period of time, there was significant difficulty with determining an accurate average price.

¶ 138 As for Conway, he was not informed that there was a significant problem until September, 2008. When he was informed of the significance of the problem he took appropriate steps to instruct Carbonelli. It cannot be said that he should have become aware of the problem at an earlier date or that he failed to establish and maintain adequate internal controls.

V. CONCLUSION

¶ 139 We are not here dealing with a situation where the CCO and the UDP ignored an emerging situation. They instead were dealing with a situation that was becoming more complicated over time. In the early stages, Carbonelli believed, with good reason, that Penson would correct the problem and would provide to Evergreen the average pricing information. As time progressed and the problem was becoming greater, she took active steps to limit trading, to retain someone to do manual calculations and to continue in her efforts with Penson to have the problem corrected.

¶ 140 At the same time, her head trader was actively carrying out a deception, the particulars of which we do not have full evidence of but the Connacher Decision provides ample details of a planned deception. Neither Carbonelli nor Conway is charged with any Counts dealing with a failure to supervise and detect that deception.

¶ 141 We also have no expert evidence that would assist us in determining whether an alternative course of conduct or additional measures should have been implemented.

¶ 142 As a result, we do not have in this case sufficiently clear, convincing and cogent evidence to satisfy the balance of probabilities that Carbonelli failed to establish and maintain adequate internal controls for the use and operation of Evergreen's client accumulation accounts, contrary to IIROC Dealer Member Rule 17.2A, during the period June, 2008 until October, 2008.

¶ 143 With respect to Conway, as UDP, his responsibilities for the firm did not include involvement in day-to-day operational matters. He was apprised by Carbonelli of the issues. As the issues became more serious, Carbonelli, by late August or early September, made him aware of her increased concerns. He involved himself in the issue and gave appropriate directions to Carbonelli to attempt to resolve the issue. We find no breach of his obligations.

¶ 144 To conclude, the Counts brought against Carbonelli and Conway are dismissed.

DATED at the City of Calgary, in the Province of Alberta, this 5th day of October, 2012.

Chair - D. Brian Foster, Q.C.

Industry Member - Peter McWilliams

Industry Member - Donald Milligan

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