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COMPLIANCE & LEGAL SECTION

Ask the Regulator

Case Study #1 - Whistleblower

Desmond Sharp is a branch manager with Excelsior Securities. He had personal and professional issues with Stan Sly, a high-producing portfolio manager in his branch, who he suspected was placing client assets in high-risk securities issued by a company from whom he was receiving secret commissions. One evening he entered Desmond's office and copied a number of documents that demonstrated without any doubt that his suspicions were correct. But the scope of Stan's illicit activities was far greater than Desmond had imagined: $5 million in undisclosed commission income. Recently, the Ontario Securities Commission introduced a whistleblower policy giving financial rewards of up to $1.5 million if a whistleblower provides concrete information not known to the OSC that leads to a successful prosecution. Desmond realized that if he brought the information that he received to the attention of Excelsior's chief compliance officer the matter would be investigated and reported on COMSET, and would likely come to the OSC's attention. Accordingly, Desmond did not make Excelsior's chief compliance officer aware of Stan's activities.

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Case Study #2 – Exempt Products & Outside Business Activities

Deborah Clueless is a planner at the Fund Factory, a mutual fund dealer who also sells exempt products to her customers. One evening she made the acquaintance of Steve Slick, an entrepreneur in the mobile potato processing business (i.e. he ran a fleet of chip wagons). Steve told her that he was looking to raise $2 million to finance the expansion of Ye Olde Chippery, his potato business. She brought the opportunity to her branch manager who sent the investment brochure to the dealer's head office for review. Sammy Blind, a product approval specialist at the dealer, felt that the food processing business had great potential but did not realize that Steve planned on selling french fries out of beaten up trucks. Sammy was impressed by the Chippery's financial statements but did not realize that the cash on its balance sheet had been recently raised, and did not result from any actual sales.

Based on his review of the financial statements and a brochure that described the investment opportunity, Sammy approved the convertible debentures for sale. Deborah contacted a large number of her clients to solicit them to buy Ye Olde Chippery debentures. She told them that to participate in the investment they needed to have a "net worth" in excess of $1 million. Many of her clients qualified because real estate values had increased considerably in the GTA. Deborah did not think to cross-reference the information contained in the accredited investor forms attached to the Chippery subscription agreements with the new client information forms for her participating clients. But this did not matter because the forms were all out of date.

Steve was so impressed with Deborah's ability to raise money that he appointed her as the Chippery's CFO. Deborah forgot or neglected to disclose this to the Fund Factory. Part of her job as CFO was to raise money from investors who did not have accounts with her at Fund Factory. Some of them were Deborah's insurance clients. One afternoon, the receptionist at Deborah's Fund Factory branch remarked to Sid Sleepy, the branch manager, that Deborah regularly met with people in the office who the receptionist did not recognize to be clients and that she was occasionally asked to photocopy cheques made out to Ye Olde Chippery.

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Case Study #3 – Credit for Cooperation

Upon becoming aware of Deborah's activities, Fund Factory engaged in a top to bottom review of its product approval processes, as well as its supervision procedures for ensuring that exempt products are only sold to qualified investors. The Fund Factory also reports the incident to the MFDA on METs and self-reports to the Ontario Securities Commission. The Fund Factory determines it appropriate to pay compensation to affected clients even in the absence of a civil proceeding but that no payments would be made to non-clients that Deborah solicited. Fund Factory approaches the Ontario Securities Commission and the MFDA and asks that any enforcement proceedings against it be resolved by way of a no-contest settlement. OSC Staff declined this proposal because Fund Factory was not fully cooperative (no compensation was paid to non-clients) and that enforcement proceedings were more appropriate before the MFDA which does not permit no-contest settlements.

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Case Study #4 – DMA Accounts

Engulf and Devour Asset Management, a small U.S. based hedge fund, is a longstanding client of Excelsior Securities. Starting in about January of this year, Manny Pulator, an Engulf and Devour trader began to acquire shares in Crapshoot Resources. Engulf and Devour ultimately built a position of just under 10 percent of the Crapshoot shares. An Excelsior trader was slightly surprised that there seemed to be a fair bit of liquidity for Engulf and Devour’s purchase orders given that the public float was quite small, but he attributed this to the fact that there probably were a number of investors who wanted to take the opportunity to liquidate their positions.

During the same period, a large number of mostly buy and some sell orders were being placed for Crapshoot shares by an Excelsior DMA client, a Swiss brokerage that was affiliated with a large multi-national bank. Excelsior was not aware of this broker’s client, but was confident that a globally recognized financial institution had adequate compliance procedures in place to know its client. The DMA client’s sell orders did tend to cross with Engulf and Devour’s buy orders with a reasonable degree of frequency.

As could be expected the buying interest in Crapshoot had a very positive impact on the trading price. Over a three week period the price moved from about $0.25 per share to about $1.25 on reasonable volumes. Engulf and Devour advised Excelsior that it had decided to sell its position in the marketplace. At this time the DMA client (which had accumulated about 8 percent of the shares) also sold most of its position. It was only later that Excelsior learned that the Swiss broker’s client was, in fact, Manny Pulator’s brother in law.

Ask the Regulator

Case Study #5 – Spoofing

On several trading days, Engulf and Devour placed orders in the pre-opening session for Crapshoot shares and then cancelled these orders after the market open. Each time, the Excelsior trader was told that the initial orders were placed in error. These orders affected the calculated opening price for Crapshoot. During several trading sessions, Engulf and Devour placed a significant number of bids for Crapshoot that were cancelled before execution. Engulf and Devour generally sold large amounts of shares in the trading session. The Excelsior trader asked Manny why this was occurring. The explanation received was that his superiors kept changing their minds about the volume that they wished to acquire and the prices that they were willing to pay.