

INVESTIGATION REPORT

Date: July 31, 2012
Client: Mrs. B
Firm: Octagon Capital Corporation (Octagon)

CONFIDENTIALITY

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INVESTIGATION SUMMARY

Investment Advisor:	Mr. H	
Account:	Non-registered margin accounts, non-registered short account, RRSP	
Period:	February 2004 to February 2008	
Key Conclusions:	<ul style="list-style-type: none"> ▪ Mrs. B was primarily a low-risk investor. She needed income from her investments to last her lifetime. ▪ Mr. H traded frequently in Mrs. B's accounts, and often without her authorization. The securities he traded, most of which were high-risk equities, and the margin and short selling strategies he used, were too risky for Mrs. B. Overall Mrs. B's accounts were unsuitably invested. ▪ Mrs. B was an unsophisticated investor. She did not know that her authorization was required or that her investments were not suitable until shortly before transferring away from Octagon. ▪ Octagon is responsible for compensating Mrs. B for the financial harm she incurred. 	
Recommendation:	\$173,605	Compensable losses in the Canadian margin account, U.S. margin account, and RRSP
	\$7,734	
	\$181,339	
		Interest
		Total Recommendation

OVERVIEW

This case arises from a complaint that Mrs. B's son-in-law brought to OBSI on her behalf in February 2009. Mrs. B is currently 70 years old. Her complaint involves unsuitable investment recommendations and frequent and unauthorized trading in her accounts by her former investment advisor, Mr. H, while she was invested at Octagon from February 2004 to February 2008.

Mrs. B married in her late 20s after which she did not work outside her home. Her husband [PERSONAL INFORMATION REDACTED]. He died [PERSONAL INFORMATION REDACTED] leaving Mrs. B on her own with limited assets and no experience in business or investing. Needing help with her investments, she was encouraged by her husband's former accountant to open an account at Firm A where she met Mr. H. She followed Mr. H from Firm A to Firm B and then to Octagon where she continued as his client for almost four years from February 2004 to January 2008. By the time Mr. H left Octagon in early 2008, Mrs. B's portfolio had declined in value significantly. Mrs. B transferred to another investment firm in February 2008.

Mr. H completed Mrs. B's Know Your Client (KYC) form to indicate she had good investment knowledge and was willing to take high risk with 25% of her investments. During our interviews of Mrs. B, we found her to be an unsophisticated investor with almost no investment knowledge who trusted and relied completely on Mr. H. In her personal and financial situation, we conclude Mrs. B was not in a position to take high risk with her investments. Octagon argues that Mrs. B knows more about investing than she lets on and that because she came to Octagon with high-risk investments, she should receive no compensation. However, Octagon failed to interview Mrs. B during their complaint investigation and they have no evidence beyond the KYC form completed by Mr. H that she was a knowledgeable investor.

Ultimately, Mr. H invested most of Mrs. B's portfolio in high-risk investments and used high-risk strategies such as investing on margin and short selling. So not only did Mr. H and Octagon not know their client, they failed even to follow their own unreasonable assessment of her risk tolerance. These fundamental failures caused Mrs. B losses she simply could not afford given the limited income and assets she had to live on.

Mr. H was the subject of an IIROC hearing in December 2011 concerning unsuitable investments and unauthorized trading in Mrs. B's account. Mrs. B testified under oath at the hearing and the IIROC Panel found her to be credible. Mr. H did not attend and he is no longer in the investment industry. Consistent with our findings, the IIROC Panel concluded that Mrs. B had limited investment knowledge, she was a low-risk income investor, the investments Mr. H recommended were unsuitable for her, she was not consulted about trades, and that Mr. H traded excessively in her accounts. The panel fined Mr. H \$125,000 and suspended his registration, among other things. Octagon is responsible for Mr. H's unsuitable recommendations and for its own compliance deficiencies that led to Mrs. B's unsuitable portfolio at Octagon. Mrs. B received no compensation as a result of the IIROC Panel Decision, because that is not the Panel's role. It is now time that Octagon accepts its responsibility and compensates Mrs. B for her losses.

BACKGROUND

- Mrs. B was not employed outside the home and did not manage any of the household finances or investments until her husband died in [PERSONAL INFORMATION REDACTED]. Mrs. B was 57 years old at the time and owned her home outright. She relied on government pensions for income and made occasional withdrawals from her investments. She had about \$500,000 to invest and needed assistance. Mrs. B became a client of Mr. M at Firm A in May 1999. Mr. H was Mr. M's assistant at the time and Mrs. B began to deal with him.
- From January 2001 to January 2004, Mr. H was registered with Firm B. Mrs. B transferred her accounts with Mr. H at his suggestion.
- Mrs. B followed Mr. H to Octagon in February 2004. She was 62 years old when she opened her Octagon accounts, which included an RRSP and Canadian and U.S. margin and short accounts. Mr. H had Mrs. B sign a new New Client Application Form (NCAF), among other documents, showing investment parameters of 0% low risk, 45% moderate to higher-risk income-producing securities, 30% moderate-risk growth-oriented securities, and 25% higher-risk speculative securities and trading strategies.
- Mr. H left Octagon in early 2008. Mrs. B transferred to a new firm in February 2008. We calculate that while at Octagon, Mrs. B's account values declined by \$121,241, as shown in Table 1.

Table 1: Gains or losses on all accounts while invested at Octagon

	Accounts [#1, 2, 3, 4] Margin and Short CDN and US¹	Account [#5] RRSP	Total Gain (Loss)
Net amount invested²	\$448,501	\$48,928	\$497,429
Ending Equity	\$322,770	\$53,418	\$376,188
Gain (Loss)	(\$125,731)	\$4,490	(\$121,241)

MRS. B'S COMPLAINT

On February 20 and September 25, 2008, Mrs. B's son-in-law and authorized representative, Mr. G, wrote to Octagon saying:

- Mrs. B lost \$130,000 (net of \$48,000 in withdrawals) and paid \$47,000 in commissions over the four-year period she invested with Octagon;
- Mrs. B was 62 years old when she transferred to Octagon. She was widowed and had not worked outside of the home since she was married at age 27. She did not know anything

¹ For simplicity and since the USD account was relatively small, the USD is assumed at par with the Canadian dollar in our calculation.

² Funds transferred in less funds transferred out (including withdrawals).

about investments or investing. She said she did not want risk and wanted to make money. Despite these instructions, Mr. H rated her at 0% low risk, 45% moderate to higher-risk income securities, 30% moderate-risk growth securities and 25% high-risk/speculative. Her investment knowledge was rated good, which was clearly not the case. She signed the document because she had trusted Mr. H to represent her properly;

- There was no long-term plan for Mrs. B's portfolio, but rather a series of quick turnovers and hundreds of transactions. Only one moderate-risk equity was held for more than one year (First Capital Realty Inc.) despite the 30% moderate risk allocation on the documents. Mr. H never called Mrs. B to discuss any trades. He never reassessed her risk position and ignored his own initial assessment;
- Mrs. B was never made aware of all the money that was being transferred to the Canadian short account and \$61,452 was lost in this account.

OCTAGON'S RESPONSE

Octagon did not speak with Mrs. B during its investigation of her complaint. By letters dated June 27, 2008 and January 23, 2009, Octagon responded saying:

- Octagon relies on documents signed by its clients, especially the NCAF. The form Mrs. B signed showed annual income of over \$50,000, liquid assets of \$600,000 and fixed assets of \$500,000. Mrs. B transferred assets into Octagon worth over \$500,000. Only \$48,000 was withdrawn from the account over four years. This shows that she was not relying on her investments at Octagon to make up a large part of her \$50,000 income. Approximately \$350,000 was transferred out of Octagon, which will allow Mrs. B to withdraw about \$12,000 per year for the next 28 years;
- Regarding suitability, it is not unreasonable for a retired person who does not derive much of their income from their investments to split their investments into 50% equities (common shares) and 50% income producing securities (like income trusts). The degree of risk that a person should undertake is a personal decision and not determined by some formula or rule. If the person does not rely on their investments for income, a higher degree of risk is not unreasonable. The amount of income securities in her account remained over 50% year-over-year which is consistent with the objective Mrs. B provided;
- The accounts transferred into Octagon reflect the investment objectives that Mrs. B told Octagon she wanted and were not unreasonable from a suitability perspective. The margin account had a debit balance and a short position was transferred in. Therefore, it is not credible that Mrs. B did not understand her investments, trading on margin or short selling;

- About half of her losses (\$78,000) were as a result of securities Mrs. B had already purchased and transferred to Octagon. The biggest loss on securities purchased at Octagon was with Southwestern Resources Corp. (approximately \$26,000). This loss was a direct result of a fraud perpetrated by the president of the company.

Octagon did not offer any compensation to Mrs. B.

IIROC PANEL DECISION

The IIROC Panel issued a decision on December 16, 2011 concerning Mr. H's handling of Mrs. B's account at Octagon. Mr. H did not appear and he is no longer registered in the securities industry. Mrs. B appeared and testified. The IIROC Panel found the following:

- Mrs. B wanted income from her portfolio. The Panel accepted that she had told Mr. H she did not want any risk and she relied upon Mr. H to do what she asked.
- Mrs. B did not sign NCAFs produced by Mr. H while he was at Firm B. The NCAFs overstated her risk tolerance, investment knowledge, income, and financial assets.
- Mrs. B did sign a NCAF when she moved to Octagon in February 2004, as part of a series of seven documents put before her. She signed without reading them, because she trusted Mr. H to invest her funds as she had directed him. However, the risk allocation was again unsuitable for Mrs. B and, again, her investment knowledge, income and financial assets were overstated.
- The Panel described Mrs. B as a risk adverse, unsophisticated elderly widow living on a modest fixed income. It found a low-risk income portfolio would have been suitable for her.
- The trading in her margin accounts at Octagon, including the short transactions, was clearly unsuitable for her. Mr. H also engaged in unauthorized trading in Mrs. B's accounts.
- Although the trading in her accounts was "somewhat in line" with the investment objectives in the NCAF, that is not an acceptable response to serious allegations of unsuitable trading. The investment objectives were not accurate for Mrs. B and it is the responsibility of the investment advisor to ensure the appropriate objectives are set out for the client. That duty cannot be transferred to the client. Otherwise, the investment advisor could overstate the investment objectives of the client to ensure that trading would be considered suitable.
- Mr. H was fined \$125,000, ordered to disgorge \$17,000 in commissions, was suspended from the industry for five years, and ordered to pay costs of \$25,000.

OBSI ANALYSIS

In the course of our investigation, we reviewed, among other documents, correspondence between Mrs. B's authorized representative (Mr. G) and Octagon, Octagon's NCAF and the NCAF from Firm A where Mrs. B had first invested, Octagon trade confirmations, Octagon statements and statements from the previous firms where Mrs. B had invested with Mr. H. We

interviewed Mrs. B and Mr. G regarding the complaint. We discussed the complaint with Octagon's Chief Compliance Officer, Mr. L. Mr. H is no longer a registered representative and we were unable to contact him for an interview. Unfortunately, there were no notes from Mr. H in Mrs. B's file. It appears that Mr. H did not keep any. We have also considered the applicable industry rules, regulations and practices, IIROC Panel Decisions, and case law.

OBSI examined the following key issues in respect of Mrs. B's complaint:

1. What were Mrs. B's investment objectives and risk tolerance and what was her level of investment knowledge?
2. Were the investments and trading in Mrs. B's accounts suitable for her?
3. If not suitable, did Mrs. B incur financial harm?
4. Who should bear responsibility for Mrs. B's financial harm, if any?

Issue 1 – What were Mrs. B's investment objectives and risk tolerance and what was her level of investment knowledge?

- Mrs. B signed an Octagon NCAF on February 6, 2004 which included the following information:

Table 2: NCAF Information for Mrs. B signed on February 6, 2004

Date of Birth	DATE OF BIRTH
Account Profile	Widowed
Employment	N/A
Annual Income	\$50,000 +
Net Worth	\$600,000 liquid plus \$500,000 fixed = \$1.1 million
Investment Knowledge	Good
Risk Tolerance	0% lower-risk, income producing securities 45% moderate to higher-risk income-producing securities 30% moderate-risk growth oriented securities 25% higher-risk, speculative securities and trading strategies
How long have you known the client?	7 years

- Mrs. B says that when Mr. H filled out her NCAF information at Octagon, he did not discuss it with her at all, but simply asked her to sign the document. She says she did not review the NCAF nor receive a copy. She says she signed the NCAF because she had dealt with Mr. H since 1999 (five years at that point) and had built a level of trust. Mr. H made no file notes about the information recorded on the NCAF.

- The IIROC Panel found that the NCAF was one of a group of seven documents Mr. H had her sign when she opened her Octagon account and that she did not read it when it was presented to her because she trusted Mr. H. The IIROC Panel concluded the risk allocation on the NCAF was unsuitable and it overstated Mrs. B's income, financial assets and her investment knowledge. IIROC found that the NCAF did not capture Mrs. B's investment objectives accurately, but rather that as a risk adverse, elderly and unsophisticated widow on a fixed income that she ought to have been invested according to Octagon's definition for lower-risk income producing investments including investments such as cash, money market funds, government treasury bills and Canada Savings Bonds.

Investment Knowledge

- The February 4, 2004 NCAF indicates that Mrs. B's investment knowledge is "good", which is defined on the NCAF as: "Good experience would include those individuals who have either traded in or have some knowledge of the basic characteristics of both fixed income securities and common shares, as well as a basic understanding of the degree of risk and reward inherent in these types of securities." Octagon says that Mrs. B understood her investments, but Octagon did not take the opportunity to speak with Mrs. B during its investigation. It appears to rely solely on the NCAF completed by Mr. H.
- Our conclusions regarding Mrs. B were consistent with the IIROC Panel. During our discussions with Mrs. B, we found she had very limited investment knowledge. We found she was unable to understand basic investment terms and was unable to explain what type of investments she had held at Octagon or the reason behind their purchase. She knew that Government of Canada bonds are low-risk, but she could not explain the concept of risk versus return.
- Mrs. B says she would look at the bottom line on her monthly statement when she received it, and during the last year she was invested with Mr. H, she called him to express concern about the decline in value of her investments. She also says when she received reporting from the common stock issuers whose shares she held, she would call Mr. H to ask why she was invested in the various companies, and whether she should be invested in bonds. She says he always reassured her that her investments and her portfolio were fine. She does not own a computer to do online research, and says she never did any other research on her own. She did not follow the financial markets. We find Mrs. B relied entirely on Mr. H's direction and management of her investments.

Income and Net Worth

- Mrs. B's net worth is shown on the February 6, 2004 NCAF as \$1.1 million (\$500,000 home, \$600,000 liquid assets) and her income as \$50,000+. Mrs. B says, and the IIROC Panel found these amounts are overstated. Mr. H made no files notes to indicate how he arrived at these amounts.
- Mrs. B says other than the portfolio she held at Octagon (which was worth about \$550,000 when she opened her accounts in 2004), she held no other investments and had no additional

savings or assets aside from her home. Her husband had only ever invested in his [PERSONAL INFORMATION REDACTED] business which was sold just before he died. They had purchased their Scarborough home in 1981 for \$60,000 and paid off the mortgage over time. She estimates it was worth approximately \$200,000 in 2009 when we interviewed her. Therefore, her total net worth in 2004 was at most \$750,000, in contrast to the \$1.1 million recorded on the NCAF.

- Consistent with her testimony to the IIROC Panel, Mrs. B told us that she received survivor CPP and OAS benefits and survivor pension benefits (which ended when she turned 65) from her husband and she took additional income from her investments. Mrs. B says, and we have confirmed by reviewing her 2005 and 2006 income tax Notices of Assessment, that her income was only \$25,000 to \$35,000 annually (not \$50,000 as shown on the NCAF) while she was invested at Octagon. Her Octagon account statements show she supplemented her income by withdrawing \$14,000 in 2004, \$13,000 in 2005, \$14,000 in 2006 and \$7,000 in early 2008 from her Octagon accounts.
- We find Mrs. B had limited pension income and modest savings on which she relied to supplement her income. Since she had not worked since her 20s and she was in her 60s when she opened her Octagon account, it was not foreseeable that she would ever earn any income beyond her pension income.

Investment Objectives and Risk Tolerance

- The February 4, 2004 NCAF indicates Mrs. B's investment objectives and risk tolerance as:
 - 0% lower-risk, income producing securities,
 - 45% moderate to higher-risk income-producing securities,
 - 30% moderate-risk growth-oriented securities, and
 - 25% higher-risk, speculative securities and trading strategies.
- Octagon argues the NCAF is an accurate reflection of Mrs. B's investment objectives and risk tolerance. On the other hand, Mrs. B told us she needed income and wanted her investments to grow but was concerned about keeping the capital of her portfolio intact given that it was the only money she had, she thought she may need it for another 30 years, and may eventually need to pay for long-term care or other health facilities.
- We provided Octagon with our original settlement proposal in October 2009 (before the IIROC hearing in December 2011) having considered what both Mrs. B told us and Octagon's comments and arguments. For the purpose of reaching a settlement, we accepted all of the investment objective/risk tolerance allocations recorded on the NCAF as appropriate for Mrs. B except the 25% higher-risk, speculative securities and trading strategies category. We said that instead Mrs. B should have had 25% lower-risk, income producing securities and no high-risk exposure.
- Mrs. B testified before the IIROC Panel that she wanted no risk. The IIROC Panel concluded that it would have been suitable and consistent given Mrs. B's risk aversion for

her to have been invested according to Octagon's description for low-risk income-producing securities shown on the NCAF as follows:

"I agree to allocate the following (approximate) percentage of my assets held in my accounts with your firm to relatively low risk, income-producing securities which may include but are not limited to, government Treasury Bills, Canada Savings Bonds, Money Market Mutual Funds, and other higher quality, income producing securities, with little or no reliance on margin."

- In light of Mrs. B's subsequent testimony to the IIROC Panel and its findings, we have further considered the matter. We can agree it could have been reasonable for all her investments to be low-risk investments like those described on the NCAF. However, while low-risk returns may have produced enough income without risk to her capital if her income needs remained at about \$15,000 per year, it is likely that her expenses, and therefore her investment withdrawals would increase over time, particularly if she needed health care or residential services as she aged. Therefore, she faced a real risk of depleting her capital too soon. Hence, we can also see that it would have been reasonable, and arguably prudent to invest up to 30% of her investments at no more than medium risk in good-quality equity securities (as shown on the Octagon NCAF) that could provide the opportunity for growth and some dividend income, with the remainder of her accounts in low-risk income investments. According to modern portfolio theory, such an allocation among different asset classes may potentially reduce risk while improving returns. While Mrs. B was concerned with protecting her capital, and her investment knowledge was limited, if Mr. H had advised her appropriately and explained, in terms she could understand, the risks and reasons why taking virtually no risk may have been a risk in itself, we believe Mrs. B could have understood and agreed to allocating a modest portion of her investments for growth.

Conclusion

Mrs. B had limited investment knowledge and she relied entirely on Mr. H. She needed income from her investments and was primarily a low-risk investor. She certainly could have been fully invested in low-risk income investments. However, given her concerns about having funds for the long-term and the likelihood that her expenses would increase as she aged, it also could have been reasonable and arguably prudent, for up to 30% of her portfolio to have been invested in medium-risk growth investments. Therefore, we examined the suitability of her actual investments relative to this range of potentially suitable investment parameters.

Issue 2 – Were the investments and trading in Mrs. B's accounts suitable?

- Mrs. B complained that there was frequent trading in her accounts, including in high-risk stocks that were not appropriate in her circumstances. The IIROC Panel found that Mrs. B's investments were traded frequently, and included short trading and highly speculative penny stocks, which were not suitable.

Investment Suitability Analysis

- Mrs. B complained that her investments were not suitable. The IIROC Panel found that Mrs. B's accounts held unsuitable high-risk investments.
- Our analysis is consistent with IIROC's and shows that from March 2004 to February 2008, Mrs. B's combined accounts held on average 65% equities, 25% in bonds and 10% in cash, providing insufficient income investments and too much equity exposure. From a risk perspective, our analysis shows that on average 19% of her combined investments were lower-risk, 18% medium and the remaining 65% was higher-risk. In our calculations, we assumed the U.S. dollar at par with the Canadian dollar for simplicity since the U.S. margin account represented about 1% to 6% of the portfolio total.
- Based on our analysis, we conclude that Mrs. B's portfolio was lacking in lower-risk investments and had too much high-risk exposure, even relative to the inaccurate KYC information recorded on the Octagon NCAF, and certainly relative to our view of Mrs. B being suitably invested primarily in low-risk income investments with at most 30% in medium-risk growth investments. Therefore, we find her investments were unsuitable overall, even before we consider the added risk of short trading, the use of margin and the frequent trading in the account.
- While Octagon points out that a number of Mrs. B's higher-risk positions were transferred into the account, Mr. H was the advisor who originally recommended the higher-risk positions and he, along with Octagon, was responsible for the suitability of the investments when they were transferred to Octagon and trading commenced.
- Octagon also takes the position that the investments in the accounts were in line with Mrs. B's NCAF, and therefore the investments were suitable for her. However, Octagon's position misstates its responsibilities. At page 4 of the IIROC Panel's decision, it said:

It should be noted that the trading which took place in NB's accounts was somewhat in line with the investment objectives which were stated on the NCAF. However, it is not an acceptable response to serious allegations of unsuitable trading to observe that the trading aligned with the investment objectives. If that were to be the case, it would become common practice to overstate investment objectives to ensure that trading (inappropriate by reference to the client's financial situation) would be considered to be "suitable". By doing so, the registered representative is attempting to transfer the responsibility of suitability to the client who has signed the NCAF which sets out the investment objectives. Regardless of that acknowledgement by the client, it is the responsibility of a registered representative to ensure that appropriate investment objectives are set for the client. The decision of *Re Daubney*, OSC (2008) 31 OSCB; 2008 LNONOSC 338, clearly stated that the duty of care with respect to the recommendation of suitable investments is placed upon "the registrant who is better placed to understand the risks and benefits of any particular investment product. That duty cannot be transferred to the client (at paragraph 210). A similar

conclusion was reached in the *Re Lamoureux*, Alta. S.C. 2001 LNABASC 433; [2001] A.S.C.D. No. 613, decision which stated that “this responsibility cannot be substituted, avoided or transferred to the client, even by obtaining from the client an acknowledgement that they are aware of the negative material factors or risks associated with the particular investment”.

- Octagon further argues that it should not be responsible for some of Mrs. B’s losses (\$26,000) which came from unanticipated management fraud in her Southwestern Resources Corp. holding. In our view, this investment was high-risk, so it never should have been added to Mrs. B’s portfolio in the first place. Therefore, how it lost value is irrelevant. The ASC in *Re Lamoureux* said: “During this hearing, it was suggested that these Partnership investments failed as a result of fraud and that, but for that fraud, they would have been successful and, therefore, suitable investments. There was insufficient evidence for us to reach any conclusion as to what led to the failure of these Partnerships, but we reject any suggestion that the subsequent performance of an investment or the actual reasons for its success or failure are relevant to the suitability assessment.”

Short account

- Mrs. B complained that she did not know there was short trading taking place in her accounts or of the losses she was incurring on the short trades.
- Octagon points out that Mrs. B transferred a short position into her Octagon account and argues that it should not be held accountable for trades placed before Mrs. B transferred in, despite the fact that Mr. H had been her advisor for many years. As her advisor, Mr. H was responsible for suitability of the short account. Octagon became responsible for suitability of the short account once Mr. H joined Octagon and short trading commenced in Mrs. B’s accounts.
- A short position in Harley Davidson Inc, that transferred into the U.S. short account ([Account #4]) in March 2004 was closed on March 31, 2004, less than a month after it was transferred in. Thereafter, Mr. H traded in short positions in Mrs. B’s Canadian short account ([Account #3]) at Octagon, on several securities such as Canada bonds, S&P/TSX i-shares, Trinidad Energy Services trust units, First Calgary Petes Ltd, Fibre Optic Systems Technology Inc., Banro Corp. and Lululemon Athletica Inc.
- Octagon has acknowledged, and we agree, that short accounts are very risky, must be monitored closely and are only for aggressive, knowledgeable investors. The IIROC Panel said in its decision that the use of shorting was not suitable for an investor such as Mrs. B.

- Octagon could not provide us with a copy of its policy from 2004 related to short accounts. We asked Octagon how it supervised short trades in 2004, but it was unable to explain how short trades were reviewed other than to tell us that short trades were closely monitored. Given the additional supervision generally required for short trades, we believe Octagon should have questioned Mr. H when the short account was opened and with each short trade. Octagon has not been able to provide evidence of its reviews of the short trading in Mrs. B's accounts. It also cannot explain the purpose of this short strategy for her or why it was appropriate.
- During our interview with Mrs. B, we found she was unable to explain a short trade and did not realize that she held a short account. Further, at 62 years old, she needed her liquid assets (all of which were at Octagon), primarily to provide low-risk income. In her circumstances, we conclude that she was not a suitable client for higher-risk investments or strategies like short trading. Therefore, we concur with the IIROC Panel that Mr. H should not have involved Mrs. B in short trading.

Trading in the accounts

- Mrs. B complained about frequent and unauthorized trading in her account.
- The IIROC Panel saw evidence that there were hundreds of trades in Mrs. B's accounts from 2004 to 2008, when it found the accounts should have been relatively stable. We agree. If Mrs. B had primarily held low-risk income investments along with some medium-risk equities from blue chip-type companies, very little trading would have been required. We also note there were debit balances in the Canadian and U.S. margin accounts from time to time, indicating the use of margin. In Mrs. B's personal and financial situation, we see no basis for exposing her to the added risk of trading on margin.
- Similar to our analysis, the IIROC Panel also found there was strong corroborating evidence for Mrs. B's testimony that she was never consulted or advised about the trades in her accounts.
- Mrs. B told us each year she would take a trip with a tour company and although she would alert Mr. H that she would be travelling for a couple of weeks, she would come home to find trade confirmations in her mail. She says she called Mr. H each time to ask about what he was doing and she says he would simply reassure her that everything was fine.

- We reviewed various flight and travel agent itineraries, credit card bills, and passport stamps showing Mrs. B's trips from:
 - [Date Range], [Year]
 - [Date Range], [Year]
 - [Date Range], [Year]
 - [Date Range], [Year]
 - [Date Range], [Year]
 - [Date Range], [Year]
 - [Date Range], [Year]
- Mrs. B says she does not own a cell phone, and never provided Mr. H with a contact phone number, so he did not contact her during any of these trips.
- We estimate that 33 trades occurred during Mrs. B's absences, including several in the short account. Mr. H has no notes in his file indicating he discussed these trades with Mrs. B. The IROC Panel further noted that Octagon's phone records show no long-distance calls to Mrs. B in the periods that she was away. While Mrs. B let the trades stand after she returned from her trips, given her lack of investment knowledge and the trust she reposed in Mr. H, it is not surprising that she accepted Mr. H's assurances. This evidence is indicative of the control Mr. H exercised over Mrs. B's portfolio.

Conclusion

Mrs. B investments were too risky for her, whether we completely disregard Octagon's KYC document and conclude that Mrs. B should have been invested in 100% low-risk investments only, or we accept Octagon's KYC document in part and conclude that Mrs. B could have invested up to 30% of her investments in medium-risk equities. Not only did her accounts not include the low-risk income investments that she wanted and needed, they also had the added risk of frequent trades, some on margin, and short trading, which made her portfolio completely unsuitable for her. In addition, the evidence shows that many, if not all of the trades were placed without Mrs. B's authorization, confirming our view that she relied entirely on Mr. H.

Issue 3 – Did Mrs. B incur financial harm?

- To determine what Mrs. B's investment performance would have been had she been suitably invested, we compared the performance of the actual investments in her accounts to the performance of two potentially suitable portfolios:
 1. The first portfolio, a ladder of cashable 1-year and non-cashable 3- and 5-year GICs representing lower-risk, income-producing investments, assumes that Octagon's KYC document should be completely disregarded and Mrs. B should have been invested in 100% low-risk income investments.

2. The second portfolio, allocating 70% to the same GIC ladder and 30% to the S&P TSX 60 representing moderate-risk, dividend-paying equity securities that offer the potential for growth, assumes that Octagon's KYC document should be preserved in part with Mrs. B investing up to 30% of her investments in medium-risk equities.
- The IIROC Panel was concerned that Mr. H may have been motivated to trade frequently in Mrs. B's accounts by a desire to earn commissions. We agree that the commissions incurred were unnecessary given that a primarily low-risk income-oriented portfolio would have required little, if any cost to establish and that little trading would have been necessary once it was set up. For example, Mrs. B would not have incurred any cost to purchase GICs, and therefore, we made no deduction from the GIC returns in our suitable portfolio calculations. However, if Mrs. B had used 30% of her capital to buy and hold good-quality equities, at a 2% commission rate we estimate she would have paid \$3,300 (\$550,000 approximate portfolio value at account opening x 30% x 2%) in purchase commissions. In our calculations we made a deduction from the equity performance for this amount (for simplicity, the deduction was made only from the margin account calculations). The results of our calculations are summarized below:

Table 4: Suitable performance calculation – 100% GICs

	Accounts [#1, 2, 3, 4] Margin CDN and USD	Account [#5] RRSP	Total
Amount invested ³	\$448,501	\$48,928	\$497,429
Suitable Ending Value	\$495,928	\$53,865	\$549,793
Gain (Loss)	\$47,427	\$4,937	\$52,364
Financial Harm (\$121,241 actual loss + \$52,364 suitable gain)			\$173,605

Table 5: Suitable performance calculation – 70% GICs, 30% TSX 60

	Accounts [#1, 2, 3, 4] Margin CDN and USD	Account [#5] RRSP	Total
Amount invested ⁴	\$448,501	\$48,928	\$497,429
Suitable Ending Value	\$593,375	\$63,892	\$657,267
Less: Commissions	(\$3,300)		(\$3,300)
Gain (Loss)	\$141,574	\$14,964	\$156,538
Financial Harm (\$121,241 loss + \$156,538 suitable gain)			\$277,779

³ Funds transferred in less funds transferred out (including withdrawals).

⁴ Funds transferred in less funds transferred out (including withdrawals).

Conclusion

Octagon argues that the risk tolerance parameters in the February 4, 2004 KYC document should be used to determine whether Mrs. B's investments were suitable for her. Those risk tolerance parameters are as follows:

- 0% lower-risk, income producing securities
- 45% moderate to higher-risk income-producing securities
- 30% moderate-risk growth oriented securities
- 25% higher-risk, speculative securities and trading strategies

In our original settlement proposal to Octagon, we proposed making only one change to Mrs. B KYC parameters. Given that higher-risk, speculative securities and trading strategies were clearly not suitable for her, we proposed replacing that category with 25% lower-risk, income producing securities. After completing our notional portfolio calculations, this resulted in proposed compensation of \$338,640.

If, as outlined in the sections above, Mrs. B should have invested 30% in moderate-risk growth oriented securities as per the KYC document, but invested the 70% remainder of her portfolio in lower-risk, income producing securities, then her financial harm is \$277,779.

If we disregard the KYC document in its entirety, determine that Mr. H's assessment of Mrs. B's investment objectives and risk tolerance was completely wrong, and conclude that she instead should have been invested in 100% low-risk income investments, then Mrs. B financial harm is reduced to \$173,605.

Mrs. B testified under oath at the IIROC hearing that she wanted only low-risk investments. Therefore, while we strongly believe a portfolio including up to 30% moderate-risk equities would have been suitable for her, there is no question that a 100% GIC portfolio, as recommended by the IIROC Panel, would be considered suitable. For this reason, we are recommending that Octagon compensate Mrs. B at least \$173,605.

Issue 4 – Who should bear responsibility for Mrs. B's financial harm?

Investment dealers are vicariously liable to their clients for the actions of their investment advisors in regard to securities-related business. Investment dealers also have a direct responsibility to their clients to properly supervise advisor conduct. Below, we examine how both of these responsibilities apply to Octagon in this case. We also consider whether Mrs. B should be held responsible for a portion of her loss.

Vicarious Liability and Supervision

- The case law is clear that investment firms are vicariously liable for the actions of their investment advisors in regard to securities-related business. As Mr. Justice D.J. Gordon said in *Blackburn v. Midland Walwyn Capital Inc.* (2003) 32 BLR (3d) 11 (SCJ) affirmed [2005]

OJ no 678 (CA) [Blackburn] at para 191 regarding vicarious liability: "...a firm is absolutely responsible for the conduct of its stockbroker." The reasons for holding investment firms liable for the conduct of their investment advisors were explained by McLachlin J., as she then was, in *Bazley v. Curry*, [1999] 2 S.C.R. 534 (S.C.C.), at para 31:

Vicarious liability is arguable fair in this sense. The employer puts in the community an enterprise which carries with it certain risks. When those risks materialize and cause injury to a member of the public despite the employer's reasonable efforts, it is fair that the persons or organization that create the enterprise and hence the risk should bear the loss. This accords with the notion that it is right and just that the person who creates a risk bear the loss when the risk ripens into harm.

- In this case, Octagon allowed Mrs. B's accounts to be unsuitably invested and traded, even relative to the inaccurate NCAF Mr. H completed, let alone against the investment parameters that would have been suitable in her circumstances. It appears to have done little or nothing to identify or address the suitability problem.
- The best chance to prevent Mrs. B's losses rested with Octagon. If it had followed a compliance program capable of identifying accounts invested contrary to KYC information it had on record or to ensure its advisors understood how to collection accurate and reliable KYC information, this issue may never have arisen. Mrs. B should not be required to pay for the insufficiency of the compliance program at Octagon that allowed the kind of unsuitable trading in unsuitable securities that caused her losses.

Client Responsibility

- Mrs. B was unsophisticated investor with very little investment knowledge. She relied entirely on Mr. H to make recommendations that suited her needs and circumstances. She followed and accepted Mr. H's advice and answers throughout. It turns out that Mr. H overstated Mrs. B's risk tolerance and objectives, invested her in securities that were unsuitable and was not discussing the trades with her. Octagon seeks to impose on its client the responsibility for ensuring that her investments were suitable for her by saying that Mrs. B signed the NCAF and transferred high-risk securities into Octagon, and therefore the investments and trading strategies were suitable. However, regardless of any acknowledgement by the client, as the IIROC Panel noted in reference to *Re Daubney* and *Re Lamoureux*, it is the responsibility of the advisor to ensure that appropriate investment objectives are set out for the client and the "responsibility cannot be substituted, avoided or transferred to the client, even by obtaining from the client an acknowledgement that they are aware of the negative material factors or risks associated with the particular investment." We further note in *Re Lamoureux*, at Part VI (B)1, it states "Similarly, the probative value of a signed acknowledgement may vary greatly, depending upon the sophistication of the investor, the content of the acknowledgement and the circumstances under which it was signed." Mrs. B is not a sophisticated investor. There is no evidence that Mr. H explained the NCAF or reviewed it with Mrs. B or that she understood it and it is clear that he completed it inaccurately. There is also no evidence that he explained the risks of the investments he traded in her account or the strategies he employed. To the contrary, we find it clear that she

was not aware of the risk of her portfolio or of the individual securities she held with Mr. H. The evidence also supports Mrs. B's position she was never consulted and that the trading was unauthorized.

- Given her lack of investment knowledge, it is unclear from Mrs. B's perspective what more she could have done. It does not appear to us that there is any basis to impose contribution on her, because she does not appear to have acted negligently. When she did ask Mr. H about her account, he reassured her and told her everything was fine. It was not until he departed in the beginning of 2008 and her new Octagon advisor, Mr. W told her that her accounts were very high-risk that she knew there was a problem. But even Mr. W recommended that they should leave it for a few months to see if performance improved. Mrs. B transferred away from Octagon shortly thereafter in February 2008. Mrs. B relied on Mr. H, in his capacity as her trusted advisor, and there is nothing unreasonable about her reliance. To require her to bear responsibility for the financial harm arising from unsuitable investments and strategies she did not know of or understand is not fair to her.

Conclusion and Recommendation

Octagon is vicariously liable for Mr. H's unsuitable activities in Mrs. B's accounts. Octagon also had responsibility through its compliance function to ensure that Mrs. B was suitably invested. By not identifying that Mrs. B's accounts were unsuitable even relative to the inaccurate KYC information on record, Octagon enabled Mr. H to continue to invest Mrs. B's money in unsuitable investments and to conduct trades without authorization. Octagon was responsible and best positioned to prevent Mrs. B's losses and we recommend Octagon compensate her 100% of her financial harm being at least \$173,605. In addition, we recommend \$7,734 in interest on the losses from February 20, 2008⁵ for total compensation of \$181,339.

⁵ Interest is calculated using the average 3-month Canadian Treasury Bill yield of 1.13% (as calculated by the Bank of Canada) compounded annually from February 20, 2008 to the date OBSI's report is final.