IN THE MATTER OF A DISCIPLINE HEARING PURSUANT TO BY-LAW 20 OF THE INVESTMENT DEALERS ASSOCIATION OF CANADA

RE: ZONA PAULETTE ARMSTRONG

(Respondent)

DECISION OF THE ALBERTA DISTRICT COUNCIL

I. INTRODUCTION

Pursuant to By-Law 20 of the Investment Dealers Association of Canada ("the Association") a disciplinary hearing was convened on November 18, 2002, to consider 15 separate allegations of violations of the By-Law, Regulations or Policies of the Association by Zona Paulette Armstrong (the "Respondent"). The alleged violations include:

1. Two counts of failing to learn the essential facts relative to specific clients and to an order or account accepted, contrary to regulation 1300.1(a) (counts 1 and 10 on the Amended Notice of Hearing);

2. One count of failing or refusing to comply with requests from the Association to attend and give information in relation to the investigation of eight complaints, contrary to By-Law 19.5 of the Association (count 15);

3. One count of failing to use due diligence to ensure that price lists submitted by her to her member firm for purposes of pricing certain US corporate debt securities were materially correct, thereby engaging in business conduct or practice which was unbecoming or detrimental to the public interest, contrary to the Association By-Law 29.1 (count 14); and

4. 11 counts of failing to use due diligence to ensure that the recommendations made for individual client accounts were appropriate for the clients and in keeping with the client's investment objectives, contrary to Regulation 1300.1(c) (counts 2 through 9 and 11 through 13). The actual counts on the Amended Notice of Hearing are contained at Tab A of the Decision.

The Respondent did not appear at the November 18th Hearing, but instead filed a Written Reply dated November 7, 2002 in which, in the view of the counsel members, the

Respondent disputed most of the alleged violations and put forward versions of events which, if true, would tend to show that she had not committed many, if not all, of the violations alleged.

As a result of the issues raised by the Respondent in her Written Reply, the District Council adjourned the Hearing to provide both Association counsel and the Respondent with an opportunity to prepare and present further material and evidence before the council on the adjourned Hearing date. The Association enforcement counsel, Mr. Kelertas then provided the counsel with three volumes of materials, which included significant portions of the Respondent's statements made to investigators and copies of most, if not all, of the materials referenced in the Respondent's Written Reply of November 7, 2002.

The Respondent provided the counsel with no further material and did not appear when the Hearing continued on March 6, 2003.

All of the alleged violations arose out of the Respondent's employment with Burns Fry Limited (subsequently BMO Nesbitt Burns Inc.) where she worked as a Registered Representative, Registered Options Representative and Senior Vice President-Trading at the sub-branches of her employer in Camrose and Olds, Alberta, between the years 1995 and 1999. By 1999 the Respondent had worked in the industry as a Registered Representative for approximately 18 years. In 1998 and 1999 the Association received ten complaints against the Respondent in respect of the period of time that she was employed as described above in Camrose and Olds, Alberta.

The Association staff investigated the ten complaints that they had received and determined that the source of all of the complaints involved the Respondent's recommendations and purchases of certain US corporate debt securities, primarily US corporate convertible debentures. The investigation prompted the issuing of the Notice of Hearing described above and the 15 alleged violations contained therein. We will deal with the alleged violations in the four distinct categories that they present themselves:

1. Failure to co-operate in the investigation contrary to By-Law 19.5;

2. Failure to ensure recommendations and trading appropriate for the client and in keeping with the client's investment objectives contrary to Reguation 1300.1(c);

3. Engaging in business conduct or practice which was unbecoming or detrimental to the public interest by submitting price lists for certain securities which were materially incorrect contrary to By-Law 29.1; and

4. Failure to learn the essential facts relative to the client contrary to Regulation 1300.1(a).

1. Failure to co-operate contrary to By-Law 19.5

As a result of the ten complaints described above, the Respondent was asked to provide a compelled statement to the Association in respect of those complaints. On August 26, 1999, that statement was provided. However, the investigative staff of the Association determined that further information was required from the Respondent and several further efforts were made to obtain the attendance of the Respondent for the purpose of further interview. Further correspondence dated October 25, 1999, January 26, 2000 and February 11, 2000 was directed to the Respondent through her legal counsel, directing the Respondent to either attend on certain dates or contact the Association's staff to schedule a date for an interview. Subsequent correspondence received by the Association from the Respondent clearly indicates that the Respondent was aware of the requests, but for various reasons declined to attend. In response to the Association's last letter of February 11, 2000, requiring her attendance at the Association's offices for an interview on February 25, 2000, the Respondent replied by letter dated February 25th that she declined to attend for the interview "because of pending litigation". She did, however, offer to "provide a written response to any queries regarding client complaints".

By-Law 19.5 provides:

> "For the purpose of any examination or investigation pursuant to this By-Law 19, a Member registered representative, investment representative, sales manager, branch manager, assistant or co-branch manager, partner, director, officer, investor, or employee of a Member or any other person approved or seeking approval or under the jurisdiction of the Association pursuant to the By-Laws and Regulations may be required by the Senior Vice-President, Member Regulation, his or her staff or any other person designated by the Board of Directors:
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> a. To submit a report in writing with regard to any matter involved in any such investigation;
> b. To produce for inspection and provide copies of any books, records accounts and documents that are in the possession or control of the Member or the person that the Association determines may be relevant to a matter under examination or investigation and such information, books, records and documents shall be provided in such manner and form, including electronically as may be required by the Association; **and** [emphasis added]
> c. To attend and give information respecting any such matters;
>
> And the person shall be obliged to submit such report, to permit such inspection, provide such copies and to attend accordingly. Any person subject to an investigation conducted to this By-Law

> 19 shall be advised in writing of the matters under investigation and may be invited to make submission by statement in writing, by producing for inspection books, records and accounts, **and by attending before the persons conducting the investigation**. The person conducting the investigation may, in his or her discretion, require that any statement given by any person in the course of an investigation be recorded by means of an electronic recording device or otherwise and may require that any statement be given under oath."

The position that we infer the Respondent is taking from both her letters in response to the request for further interviews and her Written Reply of November 7, 2002 is firstly that her initial attendance for interview coupled with her subsequent agreement to provide answers in writing, was sufficient to comply with the requirements of the By-Law. Secondly, that the possibility or existence of other litigation or violations somehow engaged a right against self incrimination or a right to remain silent pursuant to sections 7 and 8 of the *Canadian Charter of Rights and Freedoms*.

With respect to the Respondent's view that her initial co-operation by attending for questioning, together with her subsequent agreement to provide any further information by way of written interrogatories, this position is rejected by the council. The provisions of By-Law 19.5, with respect to the requirement of personal attendance are clear. While written interrogatories and replies are permitted pursuant to the By-Law, their use is entirely at the discretion of the Association's investigative staff. The By-Law makes it clear that the personal attendance of the industry Member under investigation is entirely at the discretion of the Association's investigative staff and if that discretion is exercised, the Member must comply. In this instance, there is no question but that the Association's staff made their position with respect to the further personal attendance of the Respondence clear. The Respondent refused to comply.

With respect to any contention that the Respondent was properly exercising her right against self incrimination or her right to remain silent pursuant to s.7 and 8 of the *Canadian Charter of Rights and Freedoms*, the council adopts the position put forward by the Association counsel and adopts the reasoning in *BC's Securities Commission* v. *Branch* (1995) 2 S.C. 3 where L'Heureux-Dubé, J. stated at page 26 of that decision:

> "It must be remembered that participants engage in this licensed activity of their own valition and ultimately for their own profit. In return for permitting persons to obtain the fruits of participation in this industry, society requires that market participants also undertake certain corresponding obligations in order to safeguard the public welfare and trust. Participants must conform with the extensive regulations and requirements set out by the Provincial

> Securities Commissions. Many of these requirements are fundamental to maintaining an efficient competitive market environment in a context where imperfect information is endemic. They are also essential to prevent and deter abuses of such asymmetries of information and therefore to maintain the integrity of the securities system and protect public interest."

We agree with the Pacific District Council in their decision in *Re: Robb* (2002) IDA CD No. 1, January 15, 2001, in which the reasoning of L'Heureux-Dubé as it applied to the *Securities Act* of the Province of British Columbia, should apply equally to the By-Laws of the Investment Dealers Association and the investigatory regime envisioned by and encompassed by its By-Laws.

In the result, we find that the Association has proven the alleged violation in count 15 respecting the Respondent's failure or refusal to comply with requests from the Association to attend and give information in relation to the investigation, contrary to By-Law 19.5.

2. Failure to ensure recommendations and trading appropriate for the client and in keeping with the client's investment objectives contrary to Reguation 1300.1(c)

Eleven of the fifteen alleged violations against the Respondent involve alleged failures by the Respondent to use due diligence to ensure that recommendations made for the accounts in question were appropriate for the client and in keeping with his or her investment objections.

Regulation 1300.1(a) requires precisely that:

> "Each Member shall use due diligence to ensure that recommendations made for any account are appropriate for the client and in keeping with his or her investment objectives."

With one exception, all of the complaints and resulting allegations in respect of Regulation 1300.1(c) involved relatively unsophisticated investors with "average" investment knowledge whose primary investment objectives were predominately capital preservation and income oriented and who were prepared to accept "some" risk.

Between 1995 and 1999 the Respondent involved each of the clients in question and each of their accounts, to a lessor or greater extent, in the purchase of certain US corporate convertible debentures. The end result with respect to the ten complainants involved in the allegations in the Notice of Hearing were cumulative losses to the clients of approximately $2 million. It is the position of the Association's counsel that the Respondent's use of the US corporate convertible debentures involved was completely inappropriate in two respects:

1. That the securities in and of themselves, given their medium to high risk nature, were inappropriate given the stated risk tolerance of her clients; and

2. The increased risk associated with this type of security was aggravated in each case by an over concentration of the securities in each of her client's accounts. In short, in addition to the unsuitability of the securities given the inherent risk associated with the individual debentures themselves, the concentration of these securities within the portfolios involved further subjected the Respondent's clients to a higher degree of risk than was acceptable, given the client's stated investment objectives.

In her Written Reply of November 7, 2002, the Respondent offers a number of different defences to the alleged violations relating to inappropriate trading. They include:

1. That her clients were generally aware of the nature of the investments in the US debt securities and had provided them with written material which purportedly addressed the risks associated with various types of securities, including those in question here.

2. That the US corporate debt securities and, in particular, the US corporate convertible debentures complained of, were, in fact, suitable investments being within the risk tolerance indicated by each of the clients.

3. That she relied to a "greater extent" on the ratings provided by her employer, Nesbitt Burns, with respect to the securities in question and further relied on the supervisory capacity of her employer with respect to issues of suitability and concentration.

With respect to the Respondent's defence that she had made her clients aware of the type of investments being made, together with the inherent risks and that they accepted those risks, the evidence presented by the Association's counsel clearly disproves this position.

It is clear from a review of the various client's statements provided during the investigation, that the Respondent did not discuss in any meaningful way with any of them the nature of, or the risks associated with, investing in US corporate convertible debentures. When discussed at all with clients, the Respondent portrayed the securities as being "low risk". The Respondent maintained her position as to the degree of risk involved with this type of security during her interview with the Association's staff on August 26, 1999. She continued to characterize these securities as being "low risk".

The Association's counsel, in written materials provided at the Hearing, has amply demonstrated that the written materials, including a brochure entitled

"LifePath Investments" the Nesbitt Burns "Bond Book, "Eight Essential Facts About Buying Bonds", published by Nesbitt Burns and the "Stock Book" also published by Nesbitt Burns, contained little information that would be helpful to the Respondent's client's in assisting them to properly assess the suitability and applicable risk of any of the US corporate convertible debentures the Respondent purchased for her various client's accounts. Without further information, a proper assessment of the suitability of a specific debt or bond instrument would be impossible.

It is clear from a review of Statements provided by the Respondent's clients that she provided them with little, if any, information concerning US corporate convertible debentures and did not provide them with any information with respect to actual bond ratings or other information with respect to the attributes of the securities or the companies that she was investing their money in. Some did not even know what a convertible debenture was.

The Respondent's contention that the US corporate debt securities and, in particular, the US corporate convertible debentures complained of were, in fact, suitable investments, being within the risk tolerance indicated by each of the clients, is not borne out by the evidence and materials presented at the Hearing.

With one exception, all of the complaining clients were unsophisticated investors, and while expressing "some" acceptance of risk in a small portion of their portfolio, were generally risk adverse and more concerned with capital preservation and income generation as investment objectives. A review of the US corporate convertible debentures traded in these client's accounts satisfies us that in most cases the securities involved were well outside the risk tolerance indicated by the Respondent's clients.

The evidence presented established that the majority of the US corporate convertible debentures purchased by the Respondent for these clients fell into a category of speculative investments suitable for aggressive investors with a high risk tolerance. An analysis of the holdings of the US corporate debt securities traded by the Respondent in each of the complainant's accounts shows that at the time the securities were purchased, they were rated "B" or lower according to S & P's Credit Rating Bulletins. Standard and Poors describes these types of securities as "less than investment grade" and as having significant speculative characteristics. While these securities would likely have some quality in protective characteristics, they may be outweighed by large uncertainties or major exposure due to adverse conditions. As pointed out by the Association's counsel, the term "junk bond" is a more irreverent expression for this category of corporate debt. The Respondent's characterization of these securities, both to her clients and then to the Association's investigators, as "low risk", is completely unsupportable.

The Respondents contention in her Written Reply of November 7, 2002, that all of her client's losses were due to a completely unforeseeable series of events resulting in "the entire convertible market being effected, resulting in an inability for corporations to access the capital markets in a normal fashion, which led to a highly unusual number of defaults, in Chapter 11 bankruptcies" with almost total illiquidity in the types of corporate convertible debentures she was trading in, provide little, if any, assistance to her. It was to avoid the risks associated with the type of economic conditions the Respondent describes that these clients retained the Respondent.

The Respondent's contention that she relied to a "greater extent" on the ratings provided by her employer, Nesbitt Burns, with respect to the US corporate convertible debentures in question, is unsupported by any evidence. There was no evidence presented that would indicate that any material or ratings of the impugned securities that would differ from the readily available ratings material supplied by Standard and Poors even existed, let alone was relied upon by the Respondent.

The Respondent's purported reliance on the supervisory capacity of her employer is somewhat more problematic. Her then employer, Nesbitt Burns, has itself admitted violations related to their lack of supervision of the Respondent and, as earlier referenced, have been fined a total of $450,000.00, plus $50,000.00 in costs, related to those violations. However, it is also clear that, when faced with the contentious issue of the prices to be attributed to these US corporate convertible debentures for use on client's month-end statements, the Respondent vigorously maintained that her knowledge with respect to these securities, in particular proper pricing, was superior to that of others within Nesbitt Burns, including her supervisors. While it is clear that there was a failure to supervise by her employer, there is no evidence that the Respondent ever relied on her employer for supervision and, in fact, vigorously objected on those occasions when any supervision was attempted.

In the result, we are satisfied that, with respect to each allegation, the Respondent did fail to ensure recommendations and trading appropriate for the client and in keeping with the client's investment objectives.

3. Engaging in business conduct or practice which was unbecoming or detrimental to the public interest by submitting price lists for certain securities which were materially incorrect contrary to By-Law 29.1.

By-Law 29.1 provides, in part:

> "Members . . .
>
> (ii) Shall not engage in any business, conduct or practice which is unbecoming or detrimental to the public interest."

Sometime between 1996 and 1998 the Respondent began to provide to Nesbitt's Risk Management Department lists of what she claimed where the fair market values of certain US corporate convertible debentures for the purposes of client month-end statements. At the time Nesbitt had no written policies dealing with verification of prices of US corporate convertible debentures for the purpose of month-end statements. However, Nesbitt's general policy was that all prices for month-end statements had to be obtained through, or verified by, an external source. The practice was that prices of convertible debentures that could not be obtained directly by computer would be obtained or confirmed by Nesbitt's trading desk, with sources in New York.

As the market deteriorated for the US corporate convertible debentures that Respondent was trading in, the evidence presented by the Association's counsel indicates that the Respondent took issue with the prices Nesbitt was attributing to the securities. As a result of the Respondent's complaints, Nesbitt's Risk Management Department accepted the Respondent's lists of "month-end priced" for the months September, October and November, 1998, without confirming them with their own trading desk. Nesbitt's Risk Management Department was aware of, and acquiesced in, this circumvention of internal policies.

The prices submitted by the Respondent to Nesbitt for a number of US corporate convertible debentures were materially incorrect, as there was a substantial gap between the prices listed by the Respondent and the fair market value of the securities at the material time, according to readily obtainable, independent published sources. It should be noted that the gaps between the prices submitted by the Respondent and the actual fair market value were, in some cases, well in excess of 100% of actual fair market value. Nesbitt's Risk Management Department participation in this activity is lamentable, but does not absolve the Respondent. The Respondent does not deny that she knew that Nesbitt would rely on her price submissions and her failure to exercise due diligence in verifying the accuracy of her submissions either through Nesbitt's trading desk or through external sources, amounted to conduct unbecoming a registered representative and was clearly detrimental to the public interest.

4. Failure to learn the essential facts relative to the client contrary to Regulation 1300.1(a)

Regulation 1300.1(a) provides:

Each member shall use due diligence:

(a) To learn the essential facts relative to every customer and to every order or account accepted;

The two alleged violations of Regulation 1300.1(a) were not subject to direct comment by the Respondent in her Reply dated November 7, 2002. As such, we accept the facts and reasoning of the Association's counsel with respect to the allegations in counts 1 and 10 which are briefly summarized as follows:

Count 1 - Between March, 1996 and August, 1996, L.C. opened a margin account, an RRSP account and a locked in retirement account at Nesbitt's Olds, Alberta branch office. The New Client Application Forms ("NCAF'S") were not prepared by the Respondent but rather by John Harvie, another registered representative employed by Nesbitt at it's Olds, Alberta branch. However, the NCAF's were ultimately signed by the Respondent without her ever meeting the client or discussing the client's investment objectives or risk tolerance to confirm the information set out in the NCAF's. In the NCAF's completed by L.C., each account had stated investment objectives of at least 50% income, 25% moderate growth and 25% aggressive trading. Beginning in December, 1996, the Respondent began to purchase for L.C.'s accounts certain US corporate convertible debentures that were medium to high risk in nature. Both the types of securities purchased and the concentration of these securities within each of L.C.'s accounts, exposed L.C. to a level of risk that did not accord with the client's stated risk tolerance and further, did not accord with documented investment objectives. It is also clear from the uncontradicted facts that the Respondent had never met L.C. or discussed his investment objectives or risk tolerance subsequent to the NCAF's being prepared by another Nesbitt member.

Count 10 - The Respondent had been responsible for her client W.J's margin account from 1995 onwards. In 1997 an updated NCAF was completed by W.J. which confirmed investment objectives of 25% income, 50% moderate growth and 25% aggressive trading. During the entire period of the Respondent's responsibility for W.J.'s margin account, that account remained 100% invested in one security, Canadian Crude Separators Inc. Consequently, it can be inferred that the Respondent failed to accurately set out the client's investment objectives or failed to properly update the New Client Application Form for this account to allow for that concentrated position, thereby contravening Regulation 1300.1(a).

II. PENALTIES IMPOSED

In imposing penalties, it is important to recognize that the securities industry is primarily self regulated. In order for the industry to maintain that status and continue to enjoy the confidence of the public in the standards of conduct it requires and supports, it is essential that the penalties imposed adequately reflect the gravity of the misconduct alleged. In this case we consider there to be a number of aggravating factors to be considered.

Most important is the scope of the Respondent's misconduct. This was not an isolated incident or conduct involving a limited number of transactions over a limited period of time. The Respondent's misconduct involved a large number of clients, hundreds of transactions and extended over a period of four years. While the wrong doing with

respect to the ten complainant clients in the Notice of Hearing involved a loss to those clients of approximately $2 million, the Association's counsel has also put before us further information with respect to similar conduct involving over 100 additional complaints by the Respondent's clients. In excess of 150 additional complaints were received with respect to the Respondent's conduct and as a result, her former employer, Nesbitt Burns, has settled in excess of 130 of those complaints for a total cost to that firm of over $10 million Canadian.

While for the most part it is difficult to extend the characterization of the Respondents activities from a level of gross negligence to that involving deception or fraud, it is difficult to characterize the Respondent's activities with respect to the mispricing of the securities in question on client's statements as anything but deliberately deceptive. We consider this an aggravating feature of the Respondent's conduct.

It is also significant that the Respondent benefited significantly from the misconduct in question. We are told that her commission participation in the transactions complained of over the period of five years amounted to $241,000.00.

Additionally, while initially the Respondent attended as requested and provided some information to the Association's investigators, she thereafter ceased any participation or co-operation in the investigation. With very few exceptions, she has continued to deny any wrong doing or responsibility for the very significant losses suffered by her clients and her then employer. While denying responsibility, she has not appeared on either Hearing date or provided any expression of remorse for her conduct. She has not participated in any form of restitution to either clients or her former employer.

We consider that there are two mitigating factors that we should take into consideration in imposing penalty. The first is that having spent 18 years as a registered representative, there is no prior history of misconduct or disciplinary proceedings with respect to the Respondent. The second factor we consider is the Respondent's initial participation and co-operation in the Association's investigation. However, given her subsequent withdrawal from the process, we accord her initial participation, little weight.

We do not consider that the Respondent's former employer's regrettable lack of supervision over her as either a mitigating or aggravating circumstance. As a result of their failure to supervise the Respondent in a number of material respects, BMO Nesbitt Burns Inc. has been the subject of disciplinary proceeding by the Association, resulting in a Settlement Agreement requiring Nesbitt to pay a fine in the amount of $450,000.00, pay costs in the sum of $50,000.00 and to enact and submit to the Association for review and approval, its internal policies and procedures relative to the pricing of corporate securities for sale to its clients. Additionally, as previously referenced, Nesbitt has also paid in excess of $10 million to former clients of the Respondent as a result of her trading activities. This Settlement Agreement was entered into July 23, 2002.

We have also reviewed the Association's Disciplinary Sanction Guidelines dated January, 2003 and also a number of District Council decisions presented by the Association's counsel including the following:

1. Re: Cumming (Pacific District Counsel, December 15, 1997);
2. Re: Milewski (Ontario District Counsel, July 28, 1999);
3. Re: Hrynyk (Ontario District Counsel, November 23, 2000);
4. Re: McLaughlin (Atlantic District Counsel, February 9, 1999);
5. Re: Andersen (Alberta District Counsel, April 7, 2000);
6. Re: Armstrong (Alberta District Counsel, October 25, 1999); and
7. Re: Robb (Pacific District Counsel, December 4, 2001).

Considering all of the factors referred to above, we conclude first and foremost that the Respondent should be expelled from the Association with a lifetime prohibition respecting approval in any capacity with the Association. It is the District Council's wish to impose on the Respondent a permanent bar from any form of registration within the securities industry.

In addition, we further order the Respondent to disgorge and pay to the Association the sum of $241,000.00 representing commissions earned by the Respondent with respect to the activities determined to be in violation of the Association's Regulations and By-Laws.

With respect to the individual accounts as contained in the Amend Notice of Hearing, attached as Tab A, we order as follows:

1. With respect to Counts 3 and 7 where the losses suffered by the Respondent's clients exceeded $1 million as a result of the contravention of regulation 1300.1(c), we impose fines of $15,000.00 on each count.

2. With respect to Counts 2, 4, 5, 6, 8, 9, 11, 12 and 13 respecting contraventions of Regulation 1300.1(c), we impose fines of $10,000.00 per count.

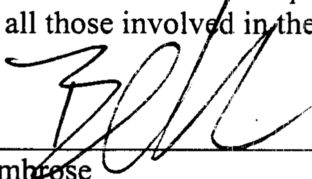
3. With respect to Counts 1 and 10 involving contraventions of Regulation 1300.1(a), we impose fines of $10,000.00 per count.

4. With respect to Count 14 for failing to use due diligence to ensure that the price list submitted by her to her Member firm for purposes of pricing certain US corporate debt securities were materially correct thereby engaging in business conduct or practice which was unbecoming or detrimental to the public interest contrary to By-Law 29.1, we impose a fine of $50,000.00.

5. With respect to Count 15 for failing or refusing to comply with requests from the Association to attend and give information in relation to the investigation contrary to By-Law 19.5, we impose a fine of $15,000.00.

Additionally, we are satisfied in the basis of information presented by the Association's counsel that the investigative costs of the Association arising out of the Respondent's misconduct are in excess of $130,000.00 to date. The Respondent's employer, Nesbitt, has paid $50,000.00 towards those costs as a result of the Settlement Agreement of July 23, 2002. We impose a like sum of $50,000.00 as against this Respondent, as costs of these proceedings.

We conclude by thanking the Association's counsel and the investigators involved for their diligence and professionalism throughout. The thoroughness of the investigation, together with the manner of its presentation sets a standard that can, and should be followed by all those involved in the regulation of the Canadian securities industry.



Bruce W. Ambrose

T. Martin Davies

John D. James

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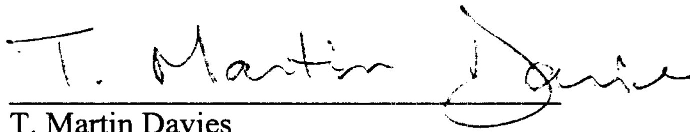

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