



INVESTMENT DEALERS
ASSOCIATION OF CANADA

bulletin



ASSOCIATION CANADIENNE DES
COURTIERS EN VALEURS MOBILIÈRES

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For distribution to relevant parties within your firm

BULLETIN # 3396
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Discipline

Discipline Penalties Imposed on Timber Hill Canada Company; Violations of By-laws 17.1 and 17.2 and By-law 29.1

Person Disciplined	A Hearing Panel appointed pursuant to IDA By-law 20 has imposed discipline penalties on Respondent Name, at all material times a Member of the IDA.
By-laws, Regulations, Policies Violated	Following a settlement hearing held on December 2, 2004, in Montreal, Quebec, a Hearing Panel reviewed and accepted a Settlement Agreement negotiated between Timber Hill Canada Company (“Timber Hill”) and the Association Staff.

Pursuant to the Settlement, Timber Hill admitted that:

1. During the period from September of 2002 through November of 2002 inclusively, it failed to ensure that its Risk Adjusted Capital was calculated in accordance with the rules prescribed by the Association and, consequently, reported inaccurate financial information in its Monthly Financial Reports filed to the Association, contrary to By-law 17.2.
2. As at October 31, 2002, it failed to maintain its Risk Adjusted Capital at a level greater than zero, and was capital deficient by \$2,058,000.00, contrary to By-law 17.1.
3. During the period from January 20, 2003 to June 27, 2003, while designated in the Early Warning System, it engaged in conduct unbecoming a Member, contrary to By-law 29.1:
 - a) by paying \$17,000.00 in bonuses to its officers, while restricted from doing it by the Association according to By-law 30; and

- b) by failing to comply in a timely manner with the Association's request of being provided with evidence of risk management policies and procedures implemented and maintained by the Respondent according to Policy No.3.

Penalty
Assessed

The discipline penalty assessed against Timber Hill is a fine in the amount of \$40,000.00.

In addition, Timber Hill is required to pay costs of the Association in the sum of \$3,500.00

Summary
of Facts

By letter dated December 11, 2002, the Association notified Timber Hill of its designation in the Early One Warning Category as at October 31, 2002, based on the review performed by the Financial Compliance Department of the Association of the October 31, 2002 Monthly Financial Report (MFR) of Timber Hill, and notified the Member of the applicable restrictions.

Notably the Member was advised that it could not directly or indirectly make any payment by way of bonus to any officer without the prior written consent of the Association and that the restrictions were to be applicable while Timber Hill remained designated to be in the Early Warning System. The Member acknowledged in writing its designation and of being submitted to the applicable restrictions.

Timber Hill remained designated in the Early Warning System for several months and the restrictions imposed upon its activities were not lifted until July 7, 2003.

On January 13, 2003, following an on-site examination of the September 30, 2002 MFR of Timber Hill, errors were noted in the Member's margin calculation on securities owned and sold short.

First, some positions were omitted from the margin calculation. The Member confirmed that certain options were excluded from the margin calculation due to an inadvertent computer programming error and indicated that it would be corrected and that a new calculation would be prepared for the Association.

Second, errors were noted in the margin calculation due to the incorrect interpretation of IDA Regulation 100 as it relates to options margining. The Respondent was under the impression that negative margins were permitted against the margin requirements of the options strategies to which they were applied, as they were permitted for other specific options strategies. While its interpretation was made in good faith, it was incorrect and resulted in significant negative margins which were improperly applied against the margin requirements of other positions and as a result reduced the total margin requirement of the firm. The margin requirement on securities owned and sold short was thereby significantly understated.

The examination also disclosed that the Respondent did not set any trading limits on the position taken for the firm's inventory positions.

On January 17, 2003, the Association obtained from Timber Hill the amended Risk Adjust Capital (RAC) calculation for the months of September, October and November 2002. Based on this information, the RAC was overstated by \$2,010,190 as at October 31, 2002 and the recalculation resulted in a capital deficiency for the month of October 2002 in the amount of \$1,281,000. It was determined that the capital deficiency was resolved due to many large options position held by the Member which expired in December 2002. The recalculation also disclosed that the RAC was overstated by \$1,814,000 as at September 30, 2002 and by \$86,000 as at November 29, 2002 but these adjustments did not cause capital deficiencies as of these dates.

By letter dated January 27, 2003, the Association confirmed the capital deficiency as at October 31, 2002 and notified Timber Hill of the restrictions remaining imposed upon its financial activities and other additional requirements. Notably, the Member was required to implement the necessary controls that would ensure the minimization of financial exposure of the firm. More specifically, the Member was reminded that monitoring must be put in place in order to address the identified issue of the absence of set trading limits on the position taken for the firm's inventory positions.

On January 28, 2003, the Association obtained from Timber Hill its updated calculation of the RAC as at October 31, 2002. This new calculation reflected all the programming changes in order to correct the programming error. As a result of the incorrect interpretation regarding use of negative margins, the Respondent overstated its RAC for the month of October 2002 by \$3,654,000. As a result of the omissions of positions due to its programming error, the Respondent overstated it another \$2,787,000. Therefore, Timber Hill was capital deficient as at October 31, 2002 in the amount of \$2,058,000.

Inquiries made by the Association in the information stated in the Monthly Financial Report filed by Timber Hill as at January 31, 2003 disclosed that while designated in the Early Warning System and prohibited from doing so as per the Association's letters of December 11, 2002, January 27, 2003 and January 31, 2003, the Respondent paid bonuses totalling \$17,000 to its two officers at the end of January 2003. These payments were not the result of an intentional violation of the Early Warning restrictions.

Timber Hill did not provide the Association until June 27, 2003 with a confirmation of the risk management system in place and applied to minimize its financial exposure due to the proprietary trading, as requested in Association's letter dated January 27, 2003, while reminded of this request by letter on January 31, 2003 and on February 18, 2003 and despite of its undertaking to have this completed in March 2003.

The violations did not put any client at risk because Timber Hill is not doing business with the investing public but only trading its own inventory. Timber Hill is a subsidiary of a well capitalized holding company, which would have added the required capital to the Member had it been aware of the need to do so at the time.

Kenneth A. Nason
Association Secretary