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Discipline

Discipline Penalties Imposed on Union Securities Limited; Violation of By-law 17.2A and Policy 3.

Person Disciplined A Hearing Panel appointed pursuant to IDA By-law 20 has imposed discipline penalties on Union Securities Limited (“Union”), at all material times a Member of the IDA.

By-laws, Regulations, Policies Violated In a written decision released on April 8, 2005, which followed a disciplinary hearing held on January 13 and 14, 2005, in Vancouver, BC, a Hearing Panel found that, between November 2000 and January 2001 inclusive, Union violated By-law 17.A and Policy 3 in that it failed to establish internal controls with respect to enforcing the use by employees at Union of foreign exchange rates.

The panel dismissed two other allegations, the first of which related to an allegation that Union failed to properly supervise the trading activity in a client’s accounts, contrary to Regulation 1300.2 and Policy 2. The second allegation related to Union’s failure to disclose on a UTN, in respect of a Registered Representative (“RR”), the fact that the RR had engaged in manipulation of foreign exchange rates in order to disguise losses incurred as a result of his trading activity, when it knew or ought to have known that the said conduct was a reason for the RR’s termination, contrary to By-law 29.1.

Penalty Assessed The Hearing Panel imposed a fine of \$25,000 against Union. The parties will make written submissions with respect to the issue of costs and a decision in that regard will be released at a later date.

Summary of Facts *Failure to Establish Internal Controls*
The facts, which were agreed upon by both the Association and Union were that Ramon Albert Porcellato (“Porcellato”) worked in the White Rock sub-branch office of Union. Although he was licensed as an investment advisor, he worked as an assistant to another broker, Martin Browne (“Browne”).

In or about November 2000, Porcellato conducted day-trading activities for himself, and in so doing, sustained a large loss. Porcellato was concerned that, if this loss appeared in his own account, Union would terminate his employment.

DP was a high net-worth client of Browne's who had both Canadian and US dollar accounts at Union. Porcellato and DP were friends, so Porcellato asked DP if he could contract Porcellato's day-trades to DP's Canadian Dollar account, to which DP agreed. DP conducted his trading primarily in DP's US Dollar account, so Porcellato wanted to use DP's Canadian dollar account in order to keep his trading separate from DP's trading activity.

On November 22, 2000, Porcellato contracted his day-trades, which consisted mainly of stocks listed in the NASDAQ exchange, to DP's Canadian Dollar account where he continued to effect his day-trading until January 10, 2001 (the "Trading Period"). During this period, Porcellato effected 530 trades of US stocks in DP's Canadian Dollar account with the knowledge and consent of DP, but without the knowledge and consent of Union. DP never complained to Union about any of the trades conducted by Porcellato in his Canadian Dollar account. During the Trading Period, the daily balance in DP's Canadian Dollar account varied between a debit of \$535,874.96 to a credit of \$52,607.32. The total effect of all Porcellato's trades in DP's account, including commission, but excluding the exchange rate, was a loss of US \$162,890.06. At the time that Porcellato parked his trades in DP's Canadian Dollar account, Union's computer system automatically set the foreign exchange rate used to settle US trades in CDN dollar accounts. Union also had an unwritten policy that permitted brokers to enter a more favourable foreign exchange rate than the 1.5 cent spread onto trade tickets which were then inputted into Union's computer system. The unwritten policy was designed to allow consideration to clients in appropriate circumstances.

In order to hide the trading losses resulting from his parking his trades in DP's Canadian Dollar account, Porcellato entered false exchange rates on various trade tickets throughout the Trading Period (outside the ambit of the unwritten policy). Typically, Porcellato achieved this by using a higher exchange rate on the sell transactions than on the buy transactions.

As a result of Porcellato's conduct, Union suffered a loss of CDN \$259,468.05.

At the time that Porcellato entered false exchange rates, Union was not monitoring the foreign exchange rates used to settle trades.

Porcellato's misconduct came to light when Union, through monthly reviews of its foreign exchange account conducted by the finance department, discovered that Union's foreign exchange revenue was negative. The finance department traced that loss directly to DP's Canadian Dollar account.

In March 2000, Union cancelled all the trades that Porcellato had effected in DP's Canadian Dollar account from that account and reinstated them to DP's US Dollar account and on March 22, 2001, Union credited DP's US Dollar account with US \$152,048.00. Consequently, no client was harmed by Porcellato's conduct.

Counts 2 and 3 Not Made Out

An allegation contained in the Notice of Hearing was that Union failed to properly supervise the trading activity in DP's accounts, contrary to Regulation 1300.2 and Policy 2. The crux of this allegation was that the combination of the increased trading activity in the Trading Period and the fact that it occurred principally in US securities contracted through DP's Canadian Dollar account (when DP also had a US Dollar account) represented "red flags" or should have aroused the concern of Union and should have led it to make inquiries.

The Hearing Panel, however, found that Union did not commit this contravention. They considered the circumstances in light of the fact that the Trading Period occurred during an unusually active time in the market, at a time when “day trading” strategies became increasingly prevalent and that the pattern was not inconsistent with DP’s recent trading history.

The final allegation in the Notice of Hearing relates to the UTN that Union filed in respect of Porcellato. It was alleged that Union failed to disclose to the Association that Porcellato had engaged in manipulation of foreign exchange rates in order to disguise losses incurred as a result of his trading activity, when it knew that the conduct was the reason for Porcellato’s termination. The UTN indicated that Porcellato had conducted unauthorized discretionary trades in DP’s account. The UTN outlined the losses of \$259,468.05 and that the client’s account had been restored to its original state. Porcellato also signed a promissory note in respect of the losses. The allegation suggested that the omission of the reference to the foreign exchange rate issue was deliberate.

The Hearing Panel found that, while unauthorized discretionary trading is a serious matter they could not think of any understanding of the expressions “unauthorized trading” and “discretionary trading” which made those terms apt as descriptions of what Porcellato did. They also did not accept the characterization by Union of parking and foreign exchange manipulation aspects of the matter as merely collateral or incidental, or as “facts underpinning the breach”.

The Hearing Panel was puzzled by Union’s evidence that it did not focus on the significance of the foreign exchange aspect of the matter, given that it credited DP’s US Dollar account with US \$152,048, i.e. assumed the burden of the loss in DP’s account; and more or less concurrently with the filing of the UTN had secured a promissory note from Porcellato for the liability. They found it difficult to understand, how, in the circumstances this aspect of the matter could have been overlooked.

With respect to UTNs in general, the Hearing Panel found that the requirements for completing same are not difficult to understand. The information provided on the UTN must be provided “fulsomely and without fudging.”

However, the Hearing Panel found that evidence did not establish that Union deliberately set out to mislead the Association, and accordingly, the count was not made out.

Although the Hearing Panel did not think that Union set out deliberately to deceive the Association, they thought that, whether through faulty analysis or inattention, Union failed to provide the Association with the information requested in the UTN “fulsomely and without fudging.”

Please see Bulletin # 3160 for the disciplinary action taken against Porcellato.

Kenneth A. Nason
Association Secretary