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**BULLETIN #3531**  
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## Discipline

### Discipline Penalties Imposed on Union Securities Ltd. and John P. Thompson; Violation of By-law 29.1.

Person Disciplined A Hearing Panel of the Investment Dealers Association of Canada (the Association) appointed pursuant to Association By-law 20 has imposed discipline penalties on Union Securities Ltd. (Union), a Member of the Association, and Union's Ultimate Designated Person (UDP) John P. Thompson (Thompson).

By-laws, Regulations, Policies Violated After a Settlement Hearing on April 18, 2006 in Vancouver, British Columbia, a Hearing Panel considered, reviewed, and accepted a Settlement Agreement negotiated between Union, Thompson, and Staff of the Enforcement Department of the Association (Staff). Pursuant to the Settlement Agreement, Union and Thompson (the Respondents) admitted that they failed to develop and implement adequate compliance systems to ensure effective supervision of activity at the firm to the required standards of the Association, and thereby acted contrary to Association By-law 29.1.

Penalty Assessed The penalties imposed against the Respondents are as follows:

- a) Union will pay a global fine inclusive of costs in the amount of one million dollars (\$1,000,000);
- b) Thompson is permanently prohibited from acting as UDP for Union or any other Member firm; and

The Respondents are also bound by the following undertakings provided to Staff:

- a) over the next three year period, Union will retain the services of a qualified external compliance consultant acceptable to Staff to review and test its compliance systems and policies;

- b) Union will add at least one external independent Director to its Board of Directors;
- c) Union will refrain from operating any accounts for corporations for which the purpose of incorporation is to circumvent registration requirements; and
- d) Union will ensure that it creates and maintains an audit trail including documentation of its “locate” of securities for any short sales and acknowledges that the threshold limits set out in Regulation SHO under the *Securities Exchange Act* of 1934 (SHO) apply to it and will ensure that all such short sales are not in violation of the threshold rules referred to in SHO.

Staff and the Respondents acknowledged and agreed that the penalty would have been significantly higher except for the following mitigating factors:

- a) the Respondents fully cooperated with the Compliance Monitor which was appointed by an Association Hearing Panel on July 25, 2005 and consented to the extension of the Compliance Monitor’s term;
- b) by agreeing to an early resolution of these matters, the Respondents enabled Staff to devote resources to other matters;
- c) with the exception of the failure to provide the Preserved Records (paragraphs 53-57 of the Settlement Agreement), the Respondents fully cooperated with Staff in their investigation of the matters giving rise to the Settlement Agreement;
- d) in total Union has and/or will spend \$500,000 for the services of the Compliance Monitor and for the services of the external compliance consultant that it has undertaken to retain for the next three years pursuant to paragraph 80(c)(i) of the Settlement Agreement; and
- e) Thompson has no prior disciplinary history.

Summary  
of Facts

**Factual Background**

Union was founded in 1963 and has been a Member of the Association since February 28, 1997. Union’s head office is in Vancouver, British Columbia.

Thompson is the chief executive officer of Union. He has been registered in a number of capacities from 1983 to the present. From July 2001 to February 2005 he was Union’s Chief Compliance Officer and since January 2002 he has been Union’s UDP.

The Settlement Agreement resolved all outstanding enforcement matters during the relevant period. These enforcement matters resulted from the Respondents’ failure to develop and implement compliance systems to the required standards of the Association.

Examples of these failures are set out under the headings that follow.

### **Sales Compliance Reviews**

The Association's draft 2005 Sales Compliance Review (SCR) report described in detail instances of problems in many areas of the sales compliance function at Union. Many of the adverse findings in the draft report, including many characterized as "significant" and/or "repeat items", had also been cited in previous SCR reports.

In particular, the draft 2005 SCR report described instances of problems in the following subject areas:

- a) deficiencies related to supervision of client account activity to the required standards of the Association;
- b) deficiencies related to supervision of branch offices to the required standards of the Association;
- c) deficient internal controls to detect or restrict certain registrant or account activities;
- d) inadequate account documentation;
- e) operating accounts in the United States (US) without registration or applicable exemptions from registration requirements;
- f) inadequate account verification procedures;
- g) deficiencies related to supervision of futures trading; and
- h) a failure to update Union's compliance manual to reflect regulatory changes implemented by the Association since the previous SCR.

The failure by the Respondents to prevent or correct the sales compliance shortcomings noted in the SCRs was detrimental to the public interest, and was therefore a contravention of By-Law 29.1.

### **Accounts For US Residents Through Yukon Holding Companies**

In 2001, the Association released Member Regulation Notice 114 (MR 114) which warned Member firms that if they were not registered in the US jurisdiction where a client resided and were not eligible for exemption with that jurisdiction they must close the account by March 1, 2002.

After the release of MR 114 Union closed accounts held by US residents and, as a result of client inquiries, sought and received an opinion from US counsel that US residents could operate accounts at Union through Yukon holding corporations without Union being registered in the state in which the US resident lived, provided the corporation was organized under Yukon law and the principal place of business was the Yukon. At the time Yukon was unique in that there was no residency requirement for the directors of a Yukon corporation.

With this opinion, Union advised its Registered Representatives (RRs) who in turn advised their US resident clients that if the client chose to establish Yukon holding

companies, Union would open an account for the Yukon holding company. Union RRs referred most of the US resident clients to the same Yukon law firm to transact all of the required corporate paper work

Some US resident clients chose to incorporate a Yukon corporation in order to open an account at Union. The US residents had no connection to the Yukon. Yukon was simply a Canadian jurisdiction that allowed sole non-resident directors to incorporate a company.

None of the US residents had any personal or business connection with Yukon. The purpose of most of the Yukon holding companies was to operate investment accounts at Union. The same US resident was the beneficial owner and was contacted at the same telephone number in the US. All investment decisions were made by the US resident in the US. Three different RRs at Union estimated that their commission revenue derived from Yukon holding companies represented over 50% of their gross commissions in 2002, 2003, and 2004.

By informing and allowing US residents to open these accounts Union acted contrary to By-law 29.1.

### **Short Selling US Securities**

“Naked” short selling generally refers to selling short without having borrowed the securities to make delivery. As a result, the seller fails to deliver securities to the buyer when delivery is due. This is known as a “failure to deliver” or a “fail.”

On December 2, 2004, the Association published Member Regulation Notice MR0320 which advised Member firms that the US Securities and Exchange Commission (SEC) had adopted SHO. Members trading directly or indirectly on US markets were advised to adjust their trading practices to comply with this rule and that failure to comply with this rule may be considered to be a violation of IDA By-law 29.1.

One of the goals of SHO was to establish uniform “locate” and “close-out” requirements in order to address problems associated with fails, including potentially abusive “naked” short selling, such as purposely driving down the price of a security.

After reviewing fail data for threshold securities from January 10, 2005 through to June 30, 2005 (the Short Selling Period), Staff identified a number of securities at Union that were not properly located by Union and consequently the firm was not able to deliver. In certain stocks, the failures by Union to “locate” were continuous.

During the Short Selling Period, Union executed short sales for certain OTCBB companies without proper locate procedures being done. In each instance Union relied on the US market maker to perform the “locate” and relied on the US market maker to document the locate. By relying on the US market maker, Union failed to properly perform and document the “locate”. In certain instances Union continued to short threshold securities with fails outstanding for a period of 13 or more consecutive settlement days without pre-borrowing.

Although Union obtained advice from US counsel that market makers could perform and document the locate function on Union’s behalf, Union acknowledged that it failed to adequately implement proper controls and procedures with respect to short selling US stocks in accordance to SHO and Association MR0320 and therefore violated

Association By-law 29.1. Union acknowledged it is responsible for having evidence that the “locate” has been done; and for compliance with the threshold requirements set out in SHO.

### **Supervision Of F**

F is a RR who commenced working at Union’s Toronto branch office in August 2001. Since October 1999 F has been under strict supervision due to the fact that garnishee orders have been obtained against him and prior to joining Union he had been named as a defendant in a number of civil litigation matters.

Between August 2001 and January 2002, F executed transactions in the D Account on instructions provided by D’s brother-in-law, who did not have trading authority on the account. Further, without D’s authorization F gave cheques that were issued to D, to D’s brother in law.

By virtue of F being under strict supervision, Union was required to approve and document each trade ticket that F completed. While most trade tickets were approved and documented as required, on certain trade tickets there is no evidence of pre-approval.

These failures of supervision were detrimental to the public interest, and therefore collectively constituted a violation of Association By-Law 29.1.

### **Failure To Cooperate**

On October 14, 2004, Staff wrote to Union and to F to inform each of them of Staff’s investigation into F’s conduct and into Union’s supervision of F’s activities. On November 3, 2004, Staff wrote to Union to, among other things, request unfettered access to F’s computers for the investigation.

Discussions ensued between Staff and counsel for Union. As a result, the computer hard-drives were preserved, secured and held by counsel for Union (the Preserved Records). Much relevant information was provided to the Staff. However, Union refused to provide Staff with free access to the Preserved Records. Union contended that some of the information in the Preserved Records was personal to F and was, therefore, irrelevant. Union also took the position that some of the material was covered by solicitor-client privilege claimed by F.

On June 6, 2005, a Hearing Panel found that Union failed to comply with By-law 19.6 when it failed to provide free access to the Preserved Records, other than those over which solicitor-client privilege was claimed.

Union requested a hearing and review of the decision of the Hearing Panel. In the Settlement Agreement, Union withdrew its request for a hearing and review of the decision and agreed to fully comply with the decision of the Hearing Panel.

### **Supervision Of L**

L was a RR and a Registered Options Representative (ROR) in the Calgary branch office of Union.

While still under the mandatory 90 day close supervision period for a newly registered

RR, L commenced a trading strategy in the accounts of two clients which primarily involved the trading of S&P Index options and options in technology companies. Neither client had any past experience with options. As a result of this trading strategy, both clients suffered significant losses.

The Respondents failed to take steps early enough to effectively prevent the activity in the accounts of the two clients. These failures of supervision were detrimental to the public interest, and therefore collectively constituted a violation of Association By-law 29.1.

#### **Appointment Of A Monitor**

Due to a number of matters, including those set out above, on July 22, 2005 without notice to Union, Staff made an application to a Hearing Panel for the appointment of a Monitor (the Compliance Monitor) for Union.

On July 25, 2005 the Hearing Panel granted Staff's application and appointed a Compliance Monitor for a 90 day term.

On August 10, 2005 Union indicated that it intended to request a review of that decision. In the Settlement Agreement, Union withdrew its request for a review.

Kenneth A. Nason  
*Association Secretary*