2006 BCSECCOM 532

Pacific International Securities Inc.

and

Max Meier, Lawrence Hugh McQuid, Jean-Paul Philippe Bachellerie, Robert Herbert Blades, John Todd Eymann, Alberto John Quattrociocchi, and Martin J. Reynolds

Section 161 of the *Securities Act*, RSBC 1996, c. 418

Hearing

Panel	Adrienne Salvail-Lopez	Vice Chair
	John K. Graf	Commissioner
	Roy Wares	Commissioner

Dates of Hearing

2002
January 14, 15
July 24, August 27
October 7, 8, 9, 10, 21, 23, 28, 29, 30, 31
November 4, 5, 6, 12, 13, 14, 15, 20, 21
December 16, 17, 18, 19

2003
January 13, 14, 16, 20, 21, 22, 23
March 4, 10, 11, 12, 20, 24, 25, 26, 27, 28, 31
April 1, 3, 4, 9, 11, 14, 15, 16, 22, 23, 24, 28, 29, 30
May 1, 29, June 2, 3, 4, 6, 10, 12, 13
July 14, 15, 16, 24, 25, 28, 29, 30, 31
August 1, 5, 6
Oct 16, 17, 20, 21, 22, 23, 24, 28, 29
Nov 4, 17, 18, 19, 20, 21, 24
Dec 1, 2, 8, 10, 11, 12, 15, 17

2004
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Date of Majority Decision	September 1, 2006
Date of Dissenting Findings	September 12, 2006

Appearing

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DECISION OF COMMISSIONERS GRAF AND WARES

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I. DECISION

¶ 1 This decision relates to a hearing under section 161 of the *Securities Act,* RSBC 1996, c. 418. It is the decision of Commissioners Graf and Wares.

¶ 2 The hearing lasted 124 days, over a period of almost three years, had some 20,000 pages of evidence and over 15,000 pages of transcripts.

¶ 3 The Executive Director issued the notice of hearing on July 20, 2001 [2001 BCSECCOM 720] and alleged that the Respondents contravened the know your client rule (section 48 of the *Securities Rules*, BC Reg 194/97), the business procedures rule (section 44 of the Rules) and acted contrary to the public interest.

¶ 4 **Except as noted below, we have found that the Executive Director did not prove any of the allegations in the notice of hearing.**

¶ 5 The exceptions are the Screening Deficiencies that we deal with under the heading Compliance with Applicable Laws. These regulatory contraventions were insignificant and we concluded we would impose no sanctions.

¶ 6 At the outset of this case, the Executive Director told us that Pacific International was a haven for unsavoury characters conducting illicit transactions and the Pacific International's directors, driven by "greed", "hid their heads in the sand". The Executive Director proved none of this.

¶ 7 This case appears to be based on a theory that US clients trading in US markets at a Canadian brokerage equals illegal activity. The Executive Director argued that Pacific International ought to have ceased doing business with all its non-resident experienced market participant clients who traded on the Bulletin Board, by March 24, 1997 (see the discussion under the heading The Red Flag Argument). In our view, there is simply no basis for this argument.

¶ 8 Considering that Bulletin Board trading was an issue for the whole British Columbia capital market, we think the Executive Director could have pursued regulatory solutions other than an enforcement hearing.

II. THE ALLEGATIONS

¶ 9 The Executive Director made allegations against Pacific International Securities Inc., Max Meier, Lawrence Hugh McQuid, Jean-Paul Philippe Bachellerie, Robert Herbert Blades, Germain Carriere, John Todd Eymann, Alberto John Quattrociocchi, Martin J. Reynolds and Theresa Mary Sheehan. Subsequently, the Executive Director settled with Germain Carriere and elected not to proceed with the allegations against Theresa Mary Sheehan. The others are referred to in this decision as the "Respondents".

¶ 10 In final submissions, the Executive Director asked the panel to reach the following conclusions:

- Pacific International failed to make enquiries to learn the essential facts and reputation for dealing with certain types of clients contrary to Rule 48. (NOH paragraph 27.1)

- Pacific International failed to establish and apply written prudent business procedures for dealing with certain types of clients contrary to Rule 44. (NOH Paragraph 27.3)

- The Respondents acted contrary to the public interest. (NOH Paragraph 28)

- The Directors failed to exercise the care, diligence and skill of a reasonably prudent person contrary to sections 118 and 135 of the Company Act. (NOH Paragraph 29)

- The Directors failed to ensure that Pacific International complied with the securities regulatory requirements. (NOH Paragraph 30)

- The Respondents failed to fulfil their roles as Gatekeepers in the securities industry. (NOH Paragraph 31)

- Mr. McQuid failed to ensure PDO approval of certain accounts contrary to CDNX Rule F.1.01.3 and IDA Regulation 1300.2. (NOH Paragraph 21.3)

III. BACKGROUND

A. The Firm

¶ 11 Pacific International is a full service brokerage firm headquartered in Vancouver. It was founded in 1982 by Meier, Eymann and others. Until about 1990, Pacific International specialized in trading junior stocks on the Vancouver Stock Exchange. At that time it employed about 50 investment advisors. In 1990, Pacific International commenced a diversification program that saw it add corporate finance, institutional trading and research to its business. It later added mutual fund and fixed income trading and started to develop its wealth management business by seeking out new clients who were longer term investors, rather than speculative traders.

¶ 12 During the time of the conduct under review, (the period from July 1, 1995 to at least December 31, 1999 was defined in the NOH as the "Material Time"), Pacific International employed 120 to 170 employees. Approximately 70 new investment advisors were hired during the Material Time. A significant portion of Pacific International's revenue was generated from dealing with non-resident clients and, in large measure, is a reflection of explosive growth in US markets. Pacific International's commission revenue from US trading was 24% of total commission revenue in its 1995 fiscal year and 66% in 1999. This is consistent with the growth in the value of trading on US venture markets (NASDAQ and the National Association of Securities Dealers Over-the-Counter Bulletin Board), which increased dramatically from US$3.3 trillion in 1996 to US$10.8 trillion in 1999.

¶ 13 During the period from April 1996 to December 1999 Pacific International executed an average of 1055 trades per day, had 4900 US clients and maintained about 33,000 accounts, 7200 of which were US dollar accounts.

¶ 14 In May, 1998, National Bank Financial purchased 35% of Pacific International. National Bank Financial is the brokerage and investment banking arm of Canada's sixth largest bank.

¶ 15 Except as noted, all matters referred to in this decision took place during the Material Time.

B. The Respondents

¶ 16 Except as noted below, at all relevant times, each of the individual Respondents was an officer and a director of the firm and a member of the Executive Committee of the board. Meier was President and Chief Executive Officer.

McQuid was, at varying times during this period, Chief Financial Officer, Chief Operating Officer and the designated Compliance Officer. Except for Martin Reynolds, the others held various executive positions with Pacific International. Reynolds was the Chairman, a director and a member of the Executive Committee of Pacific International from June, 1994. He resigned as Chairman, and as a member of the Executive Committee, in October, 1998, and as a director in March, 1999. Bachellerie joined Pacific International in 1995, and became an officer, director and a member of the Executive Committee in August, 1997.

¶ 17 Meier has worked in the securities industry since 1980. He was a member of the Vancouver Stock Exchange Board of Governors from 1987 to 1997 and was Vice Chair of the VSE for four years. He also chaired various committees at the VSE. He is an investment advisor who has never had a client complaint.

¶ 18 McQuid is a former RCMP officer and former Manager of Compliance at the VSE. He is an active volunteer contributor of his time to various industry bodies and self regulatory organizations and is highly regarded by his peers.

C. The Business

¶ 19 In the period leading up to the Material Time, an important part of Pacific International's business was trading small capitalization, venture oriented, stocks listed on the VSE. Due in part to bad publicity arising from the scandal involving Bre-X (which traded on the Toronto Stock Exchange), trading in junior mining stocks on the VSE declined materially in the mid-1990s. Stricter supervision of issuers and promoters by the VSE also contributed to the decline in VSE trading. Much of the former VSE trading migrated to the Bulletin Board, a loosely regulated United States quotation system.

¶ 20 With the explosive growth in the US venture capital markets, Pacific International attracted significant numbers of new clients from the United States. Many of these clients were "experienced market participants", such as insiders, control persons, promoters or persons engaged in investor relations. As it turned out, some had criminal or regulatory histories.

D. The Seminal Events

¶ 21 On February 10, 1999, the VSE released a decision in which a Pacific International investment advisor, J.C. Hauchecorne, was fined and permanently banned from being an investment advisor, for taking unauthorized instructions from disreputable persons and for assisting in the unauthorized transfer of funds from an account.

¶ 22 On June 15, 16 and 18, 1999, three indictments were issued in the United States, naming Pacific International's clients in matters involving securities trading. Pacific International's name was mentioned in each of these indictments, but no allegations were made against Pacific International.

¶ 23 On June 29, 1999, two of Pacific International's investment advisors, Messrs. Rachfall and Patterson, were arrested in the United States for their part in a fraud perpetrated in the United States by two Pacific International clients. This fraud was the subject of the June 16, 1999 indictment referred to above.

¶ 24 As a result of this confluence of events, Pacific International took steps to protect its reputation by preventing a recurrence of the negative publicity associated with events such as these.

E. Responses to the Events

¶ 25 Pacific International engaged CMC Capital Consulting Corp in mid-July, 1999. The principal officer of that firm, Dean Holley, is a former broker and options trader in the industry and a former supervisor of market surveillance at the VSE. Following his employment at the VSE, he was employed by this commission, first as a compliance officer, then as director of enforcement and finally as executive director, the chief administrative officer of the commission. His firm's clients have included several Canadian securities commissions (including this commission), the Investment Dealers Association, the Toronto Stock Exchange, the US justice department, a number of dealers and legal counsel for litigation support. At various times, Holley has been qualified as an expert witness on securities regulation and industry practice and has lectured on these topics.

¶ 26 Holley's engagement included the following matters:

1. An assessment of the currency and adequacy of the internal compliance and supervision policies of Pacific International.

2. A review of the firm's organizational structure, particularly in relation to the compliance function generally, new account opening, account documentation, account supervision, securities trading and complaint handling.

3. A review of the qualifications, experience and responsibilities of the firm's compliance and supervisory staff.

4. An examination of the procedures and practices of the firm for the documentation, review and approval of new client applications, with

particular emphasis on the procedures and practices followed for the accounts of clients who are not resident in British Columbia.

5. An examination of the procedures and practices followed by registered salespersons, PDOs and supervisory staff in satisfying the regulatory 'know your client' and 'suitability' requirements.

6. An examination of the procedures, skills and knowledge of the firm's trading and supervisory staff in relation to the detection and prevention of unfair or abusive trades or trading practices, with particular emphasis on trading in US OTC Bulletin Board securities.

7. An examination of the procedures, skills and knowledge applied by the firm's supervisory staff in the post-trade review of client account activity (including daily and monthly review procedures).

8. An examination of the procedures and practices of the firm's sales supervisory staff in satisfying regulatory requirements for the prevention and detection of money laundering activity and in the detection and prevention of other inappropriate financial transactions.

¶ 27 Holley engaged KPMG Investigation and Security Inc. to review compliance procedures in areas relating to money laundering and proceeds of crime legislation. Their recommendations are included in Holley's report.

¶ 28 Following is an extract from Holley's report:

> Pacific International has a well-defined program for establishing compliance procedures. Its compliance and operations staff are capable and experienced. The firm's compliance programs are designed to meet regulatory requirements and to protect the firm from civil or regulatory liability. Systems are in place to ensure that client activity is reviewed on a daily and monthly basis in accordance with industry standards.
>
> Pacific International is well ahead of many of its competitors in the development and application of compliance information systems and databases. The firm has established written policies that reflect regulatory requirements and those policies, rigorously applied, would generally meet or exceed the firm's obligations under SRO rules and provincial securities legislation.

¶ 29 In the report, Holley made a number of recommendations, virtually all of which Pacific International followed. These recommendations were made primarily to

protect Pacific International's reputation, and were not considered necessary for compliance with regulatory requirements. Holley's testimony about this was:

> Q You were asked a question as to whether compliance now balances risk to the firm with benefits to the client. Is it your evidence that such balancing was done even before your retainer by the firm?
> A Well, I didn't -- in, in those terms, Mr. Skwarok, I didn't see, in the course of our review, that the interests of the clients were sacrificed. I think the primary change in the system at Pacific International is to put a considerably higher emphasis on potential risks to the firm and its reputation, not the firm from a financial perspective. The financial risk management, I think, has always -- had always been sound. But there was a much greater emphasis put on protecting any potential risks to the firm's reputation.
> Q I believe your evidence was that the procedures that were in place generally even before your retainer were, these are my words and correct me if I'm wrong, first rate?
> A I thought they either met or exceeded the industry standards and peer standards in virtually every area, yes.

The Executive Director did not challenge this testimony.

¶ 30 Pacific International also closed all the client accounts of five investment advisors who were active in US markets, regardless of whether the client had a regulatory history (ie., sanctioned by a securities regulator) and regardless of whether the client had been problematic to Pacific International. Pacific International already had a policy of not dealing with anyone who it knew had a criminal record and this practice was continued.

¶ 31 Pacific International made other policy changes at this time that, together with the implementation of the Holley recommendations, discouraged US experienced market participants from future dealings with Pacific International.

¶ 32 After Pacific International implemented these changes, about 20 investment advisors moved to other local firms.

¶ 33 In this decision, when we refer to Pacific International's evidence or Pacific International's testimony, the person introducing the evidence could be the individual Respondents, or it could be Richard Thomas, who was Manager of Compliance at Pacific International from July, 1997. Thomas and each of the individual Respondents testified and we found them to be credible witnesses. Their testimony was clear, unevasive and forthcoming. Further, some were testifying over long periods during the hearing and all of them were testifying in

2003 about events that occurred during the period from July, 1995 to December, 1999. In most cases we have not distinguished among them when reciting the evidence.

IV. THE RED FLAG ARGUMENT

¶ 34 Apart from a brief argument on the business procedures rule, the Executive Director's only argument for all the remaining allegations was what we call the Red Flag Argument. This argument was based on a theory that was not at all evident from reading the NOH.

¶ 35 Indeed, it appears the Respondents had difficulty understanding the allegations. Following is an exchange that occurred in July, 2003, when Mr. Zolnay asked Mr. Thomas if he understood an allegation. This was the Executive Director's comment about that question:

> Madam Chair, this is the problem with counsel for a witness trying to decipher what the allegations are that are made by other parties. It's not appropriate. Mr. Zolnay will hear what staff's allegations are at the closing of this matter. [It's] simply inappropriate for Mr. Zolnay to be asking Mr. Thomas to understand what staff's allegations are.

¶ 36 The principal allegations in the NOH were that Pacific International and its directors contravened section 48 of the *Securities Rules*, BC Reg 194/97, "the know your client rule", and section 44 of the Rules, "the business procedures rule". The news release accompanying the NOH had the same focus.

¶ 37 In a lengthy opening statement, the Executive Director expanded upon the know your client obligation and said that the "fundamental failure", the one "which led to every other failure", was Pacific International's failure to question the motivation of US residents coming to Vancouver to trade in US markets.

¶ 38 In final submissions, however, the Executive Director made the Red Flag Argument. These are a few examples of the more than 20 variations of this argument:

> Had the Directors responded properly to the … red flags Pacific International could have removed their non-resident experienced market participant OTCBB business no later than March 24, 1997 thereby reducing or eliminating the ensuing damage to Pacific International's reputation and the integrity of the British Columbia market that commenced in the summer of 1999.

> Staff are alleging that a series of red flags should have caused the directors of Pacific International to realize much sooner than they did, and certainly no later than March 24, 1997, that Pacific International could not continue with their non-resident experienced market participant OTCBB clients without damaging their own and British Columbia's reputation.
>
> The steps Pacific International took in the summer of 1999 to remove the non-resident experienced market participant OTCBB segment of their business should have been taken no later than March 24, 1997.
>
> Staff submit that the Respondents knew or should have known that a significant portion of their business was extremely risky and this should have caused them to realize much sooner than they did that they could not effectively supervise this business.

¶ 39 The Executive Director argued that the Red Flag Argument related to paragraphs 16 to 24 and 27 to 33 of the NOH; in other words, all the allegations.

¶ 40 In our opinion, the Red Flag Argument does not prove any of the allegations.

¶ 41 When the Executive Director alleges contravention of the legislation, the Executive Director must produce evidence that is intended to be used to prove the contravention. The next step the Executive Director must take is to show, in argument, how the evidence constitutes proof of the contravention. The Respondents argued that:

> The events referred to by Staff appear to be unrelated and, more significantly, they do not appear to constitute proof of any of Staff's allegations or of any regulatory breach.

We agree.

¶ 42 The Executive Director argued that Pacific International ought to have ceased doing business with all its non-resident experienced market participant clients who traded on the Bulletin Board, by March 24, 1997. In our view, there is simply no basis for this argument. The know your client rule does not prohibit Pacific International from dealing with clients.

V. FINDINGS

¶ 43 In final submissions, the Executive Director made no arguments that related the evidence produced to the allegations that the Respondents contravened sections 48 and 44 of the Rules and contravened the public interest. Since the Respondents

were faced with the allegations in the NOH, we review these allegations and briefly set out the reasons for finding that the Executive Director did not prove them.

A. Know Your Client

¶ 44 The know your client rule in section 48 of the Rules is one of the cornerstones of securities regulation.

¶ 45 Following is the text of the relevant portions of the rule:

> (1) A registrant … must make enquiries concerning each client
>
> > (a) to learn the essential facts relative to every client, including the identity and, if applicable, credit worthiness of the client and the reputation of the client if information known to the registrant causes doubt as to whether the client is of good business or financial reputation …

¶ 46 Under section 48 of the Rules, a registrant must learn about a client's reputation if the registrant knows something that causes doubt as to whether the client has a good reputation. In our view, the registrant must act reasonably, first in determining whether the information should cause it to doubt the client's reputation and second in the action it takes if the information causes it to doubt the client's reputation. Generally, we would expect the registrant to do this on a client by client basis.

¶ 47 In paragraph 27.1 of the NOH, the Executive Director alleged that:

> Pacific International failed to learn and the Directors failed to cause it to learn, the essential facts about Pacific International's clients holding Accounts, including especially, but not exclusively, their identity, reputation, and reasons for retaining Pacific International, when the Respondents knew, or ought to have known, information that caused, or ought to have caused, doubt whether certain of Pacific International's clients were of good business or financial reputation, contrary to section 48 of the *Rules* or section 43 of B.C. Reg. 270/86, VSE Rules F.1.04, F.1.01, VSE By-law 5.01(2) and IDA Regulation 1300.1(a)

¶ 48 The information the Respondents are said to have known or ought to have known included items defined in the NOH as Activity, Distributions, Indictments, Complaints, Demands, Screening Deficiencies, the issue of a VSE citation against J.C. Hauchecorne and reviews conducted by Pacific International's compliance

staff. These items are listed in NOH paragraphs 27.2.1 to 27.2.6 and are described in paragraphs 16 to 24 of the NOH.

¶ 49 In the next few sections we deal with each of these items.

1. Activity

¶ 50 In paragraph 20 of the NOH, the Executive Director alleged:

> Throughout the Material Time, certain of the Accounts displayed activities and characteristics (the "Activity") that would have caused a reasonable registrant to investigate the owners and operations of the Accounts, because each Activity, alone or in combination, is potentially a symptom of illegal conduct or conduct contrary to the public interest, including money laundering and share manipulation.

¶ 51 In summary, the Executive Director alleged that the Respondents should have investigated its clients further because they knew, or ought to have known, things about Pacific International's clients that should have caused them to doubt their clients' reputations. There are seven activities that the Executive Director alleged ought to have raised concerns with the Respondents:

- US residents trading in Canada
- Criminal and regulatory histories
- Significant debit balances
- Receipts and transfers of large blocks of securities
- Third party transfers
- Early settlement fees
- Cash transfers with little or no intervening trading activity

We deal with each of these in the following paragraphs.

US Residents Trading in Canada

¶ 52 In paragraph 20.1 of the NOH, the Executive Director alleged:

> Some Accounts were owned or operated by non-residents and residents of Canada who were experienced market participants, such as insiders, control persons, promoters, or persons engaged in investor relations activities. Others were persons registered or formerly registered to trade in securities in the United States or elsewhere. The trading of foreign stocks

in British Columbia by non-residents should have prompted Pacific International to question the motivation of those clients.

¶ 53 Pacific International testified it was not unusual for US clients to want to trade with them and with other Canadian brokers. This is especially true for experienced market participants who tend to participate in the small cap markets in which Pacific International did a significant amount of its business.

¶ 54 Pacific International did not solicit business in the United States, so it attracted clients who were sophisticated and would know about the more generous Canadian settlement and short selling rules and would also be aware of the need for strong execution skills. The trading skills of Vancouver brokers in small cap stocks were well known.

¶ 55 Pacific International also testified that, when it discovered a person was an experienced market participant, it treated them differently than other clients by monitoring their trading more closely. Pacific International viewed them as higher risk clients, but did not automatically assume they were of questionable reputation.

¶ 56 Pacific International did not follow the practice of asking each non-resident client why they chose to trade at Pacific International.

¶ 57 In our view, making inquiries of clients as to why they were dealing with Pacific International would not, in and of itself, be fruitful. A client who wants to hide something isn't likely to answer truthfully. Among other things, Pacific International closely monitored trading and conducted targeted searches of its non-resident clients' backgrounds (see the discussion under the next heading Criminal and Regulatory Histories). In our view, these procedures, together with Pacific International's understanding of why US clients might want to trade US stocks in Canada, was more likely to produce relevant information than were inquiries of clients, questioning their motivation.

¶ 58 **We find that the Executive Director did not prove that Pacific International's responses to dealing with non-resident clients who traded foreign stocks were unreasonable.**

Criminal and Regulatory Histories

¶ 59 For convenience, in this section we deal with the Executive Director's allegations in paragraph 20.2 and also in paragraph 19.

¶ 60 In paragraph 20.2 of the NOH, the Executive Director alleged that some accounts were owned, operated by, or associated with persons with criminal or regulatory histories.

¶ 61 In paragraph 19 of the NOH, the Executive Director also alleged:

> 19. Pacific International knew or ought to have known of some or all of the Indictments, the Complaints, the citation, and some or all of the behaviour which led to them. This information ought to have led Pacific International to conduct internal reviews of the trading in US markets and account opening activities and to address the compliance deficiencies which those reviews should have revealed. This did not happen and the compliance deficiencies continued.

¶ 62 In paragraph 19, the Executive Director refers to Indictments and Complaints. These are described in paragraphs 16 and 17 of the NOH:

> 16. On March 28, 1997, May 21, 1998, June 15, 1999, and June 18, 1999, the United States Department of Justice filed Indictments naming clients of Pacific International, citing their trading through certain of the Accounts, and alleging breaches of American securities laws.
>
> 17. During the Material Time, the United States Securities and Exchange Commission (the "SEC") named Accounts or clients of Pacific International in civil complaints (the "Complaints").

¶ 63 We first deal with the allegations in paragraph 19.

¶ 64 The Respondents argued that the Executive Director produced no evidence to prove the allegations in paragraph 19. The Executive Director included an evidence match in final argument to link the evidence with the allegations. Nothing was shown for paragraph 19.

¶ 65 We note that indictments were issued on June 15, 16 and 18, 1999. The Executive Director alleged in paragraph 19 that Pacific International failed to do certain things after the indictments were issued. It was precisely these indictments, however, that led to the hiring of Dean Holley and to the subsequent policy changes made by Pacific International to address the negative publicity it was receiving. While these indictments alleged illegal activity, they are not, as the Executive Director alleged, evidence of Pacific International failing to react to their existence.

¶ 66 Pacific International testified there were no transactions in the accounts involved in the indictments that could reasonably have alerted compliance staff to the fraudulent and illegal activity alleged in the indictments. This testimony was not challenged by the Executive Director.

¶ 67 In the case of the June 16, 1999 indictment against John Manion, for example, Pacific International testified that the alleged transactions at Pacific International were not remarkable or suspicious. The two transactions involving shares were insignificant in relation to the company's issued capital and most of the funds that were wired out of the Pacific International accounts were sent to the client, not to third parties.

¶ 68 Pacific International testified that, in each indictment and complaint, the alleged improper conduct occurred outside of Pacific International. Typically, the conduct involved running pump and dump schemes at US brokerages and bribing or coercing US brokers into selling manipulated stocks. None of this alleged improper conduct could have been detected by Pacific International.

¶ 69 The fraud alleged in the Manion indictment, for example, relates to the payment of undisclosed cash kickbacks to brokers and unlicenced cold callers at four US NASD member firms, and the use of false and misleading statements by persons at these firms to sell stock to their clients. Pacific International testified that none of this fraudulent misconduct was alleged to have occurred at Pacific International and could not have been detected by Pacific International's compliance staff.

¶ 70 Now, we consider paragraph 20.2 of the NOH.

¶ 71 Pacific International's regulatory obligation, which it said it followed, was to make further inquiries if something raised a concern about a client's reputation.

¶ 72 The VSE offered a background search service. The Executive Director's witness, Ms. MacIntosh, a former employee of the VSE, testified that Pacific International was more active in conducting background information searches about its clients than any other brokerage firm in Vancouver.

¶ 73 In April 1997, Pacific International adopted what amounted to a risk based approach to conducting background searches. This policy, recommended to McQuid by compliance staff, provided for doing background searches of all actively trading US experienced market participant clients. From time to time Pacific International also conducted background searches of accounts that had other attributes that might have interested them at the time. For example, during the period from April 1997 to February 1998, Pacific International also searched

all the accounts of Hauchecorne, when they became concerned about who he was dealing with.

¶ 74 The Executive Director argued that, commencing no later than March 24, 1997, Pacific International ought to have conducted background searches of virtually all of its non-resident clients who traded on the Bulletin Board.

¶ 75 Even if Pacific International had further investigated all of its clients, and discovered that some had criminal or regulatory histories:

- there is no regulatory requirement that says a firm cannot deal with clients who are not of good business or financial reputation.
- Pacific International testified that they had a policy of not dealing with clients who they knew to have a criminal record of any kind.
- Pacific International had a reasoned process for deciding on whether to retain clients who had a regulatory history.
- Pacific International testified that they closely monitored the trading in all active accounts, regardless of the reputation or residence of the client.

¶ 76 This commission has found that a convicted cocaine dealer was entitled to have a brokerage account and trade securities [*Re William F. Robertson* [1988] BCSC Weekly Summary 78]. In that decision the commission said:

> The Commission is of the view that this type of individual criminal activity does indeed single an individual out for very close scrutiny in an application of this nature. Nevertheless conviction of a criminal offence unrelated to securities would not normally be considered grounds to prevent an individual from exercising his statutory right to trade in securities, although it may well disqualify him from being a registrant or becoming a director or officer of a public company.

¶ 77 The Holley report said this about background searches:

> As part of the know-your-client requirements, registrants are obliged to make inquiries concerning the 'business and financial reputation' of potential clients in many circumstances. The regulations, however, do not set out specific criteria about how a dealer is to exercise judgment in determining whether or not a client is 'acceptable'. Dealers must establish their own guidelines regarding the acceptance of clients based on their assessment of risk and on their ability to effectively supervise account activity.

¶ 78 Holley testified that, in each case where Pacific International retained an account with a known regulatory history, the decision to do so was made on a reasoned basis. Pacific International testified that, when it discovered such a client, various factors were considered, including, the nature and seriousness of the infraction, whether the conduct giving rise to the infraction could be repeated in a brokerage account at Pacific International, the age of the infraction, and the client's history at Pacific International, being the nature of the activity in the account and the age of the account. If Pacific International decided, after reviewing all these factors, to keep the account, it would be subjected to heightened supervision.

¶ 79 What firms must do when they discover a client has a questionable reputation is decide if the person is likely to conduct inappropriate transactions in their accounts at the firm. If not, and the person is accepted or retained as a client, the firm must monitor the trading. Pacific International's evidence, as stated above, was that they closely monitored trading in all active accounts, regardless of the residence or reputation of the client and followed a practice of not dealing with any person it knew to have a criminal record.

¶ 80 There was no evidence that any of the persons identified by the Executive Director as being problematic to Pacific International were suspended from trading in any jurisdiction at any time while they were Pacific International clients.

¶ 81 We also note this commission's practice of allowing sanctioned persons to continue to trade securities so long as the contravention giving rise to the sanction did not involve securities trading such as insider trading or manipulation.

¶ 82 The Executive Director built much of the case against the Respondents on the premise that Pacific International was a haven for unsavoury characters, many of whom were alleged to be members of the Mafia. That proved not to be true.

¶ 83 None of the other searches performed by Pacific International identified any clients who were Mafia members. Holley testified that, during his review, he found no indication of clients who were Mafia members, other than allegations made in the indictments.

¶ 84 The Executive Director named 42 persons who were alleged to fit into the unsavoury character category. Of these, seven were neither clients of Pacific International nor authorized on any Pacific International accounts, leaving 35 clients. For 10 clients, the regulatory history occurred after the client's account was closed. Of the remaining 25 clients, only eight were clients who Pacific International decided to keep after learning of their regulatory history. Of these, only three were later alleged to have engaged in improper or illegal conduct. Two

of these were David Houge and John Manion (who it turns out acted in concert in their alleged misconduct) and the third was a person we call Mr. G.

¶ 85 In addition to the 35 clients with histories, we have evidence that Pacific International discovered a further five clients with histories during one of its targeted background searches in July, 1997. The searches involved 29 clients not already included in the list of 35 clients. The search criteria identified clients who were the most likely to be problematic, because they were active traders, or they traded heavily in Bulletin Board stocks or in stocks traded on another US quotation system, the "Pink Sheets" (which is virtually unregulated) and their occupation was investment banking, investments, public relations, or consulting. Some of these five accounts were closed and others were placed under heightened supervision. There is no evidence that any of these five clients were later subject to criminal or regulatory proceedings.

¶ 86 A background search of Houge was conducted in July 1997. It disclosed that Houge had entered into a settlement with the SEC in 1986 that resulted in Houge being permanently enjoined from violating US securities laws, but did not prohibit him from trading. Pacific International attempted to obtain further details of the injunction from the VSE, but were told they had everything the VSE could find. McQuid and Rachfall telephoned Houge in August 1997 to discuss the settlement with him. Houge told them it related to misstated financial reports filed by a public company and that he had signed the statements as a director of the company. He neither admitted nor denied being complicit in the misstatement. Houge had been a client since December 1996, without incident.

¶ 87 McQuid testified that:

> … when we became aware of it, … we certainly considered it and … we looked … at the age that it had been outstanding, some 11 years … at that time, with no other search material returned, … by the VSE. So we took from that that Mr. Houge had been of good behaviour, if you will, since 1986 to 1997. We also looked at the … activity … in his account and we also spoke to Mr. Houge … about the circumstances … of this matter, because we couldn't get any other information than … what was appearing here.

¶ 88 In May 1998, Houge was indicted in the United States for the conduct later described in the June 16, 1999 indictment against Manion and others. On learning of the Houge indictment in June 1998, Pacific International froze Houge's accounts at Pacific International. Pacific International testified that, on June 3, 1998, they received a copy of a June 1, 1998 restraining order against Houge but it did not disclose the name of the stock involved and did not mention John Manion.

Pacific International also discussed this information with the RCMP, who did not disclose the stock involved and did not mention John Manion. The Houge indictment was later withdrawn and Houge settled a civil complaint with the SEC.

¶ 89 Manion became a client in 1993. A September 1997 background search of Manion disclosed a 1996 civil settlement with the SEC. The terms of the settlement permanently enjoined Manion from violating US securities laws, but did not prohibit him from trading. The nature of the conduct giving rise to the settlement was a failure to disclose full details of compensation received from an issuer for investor relations services. The disclosure made said only that compensation may have been received, but did not disclose, as was required, the amount of compensation actually received.

¶ 90 In October 1998, the State of Florida made allegations against Manion and others involving the sale of promissory notes. Pacific International was unaware of the allegations, which did not include a reference to Pacific International.

¶ 91 McQuid and Thomas both testified that they did not recall seeing the Manion history and could not recall the reasons for keeping him as a client.

¶ 92 When the Houge and Manion indictments were issued, Pacific International reviewed the trading in their accounts and found nothing remarkable. Nevertheless, McQuid testified that, with the benefit of hindsight, he regrets having made the decision to retain Houge and Manion as clients. On this point, however, we note that the bulk of the transactions cited in the June 16, 1999 indictment took place prior to Pacific International learning of Houge's and Manion's regulatory history. It appears inevitable that the indictment would still have named Pacific International, even if Pacific International had ceased doing business with Houge and Manion as soon as they learned of their histories.

¶ 93 In 1997, Pacific International conducted a background search of a client, Mr. G, and discovered he had a regulatory history. G had owned his own brokerage firm and had been sanctioned in 1992 by the NASD for charging clients excessive markups on stock purchases. G's firm was closed and G was banned from the brokerage industry for a specified period of time, which had expired by the time Pacific International became aware of his history. He was also fined, and ordered to pay restitution should he try to re-enter the business. He was not banned from trading.

¶ 94 Pacific International testified that G's history, upon discovery, would have been considered using the same analysis described above. The history was approximately five years old, it involved sales practices at a brokerage firm, and not something he could do in his account at Pacific International. The trading in

his Pacific International account was reviewed and found to be unremarkable. Of note is the fact that the VSE audit of September 1998 also included a review of this account but raised no issues about it. G's account at Pacific International, following the discovery of his history, was subject to continuous heightened supervision. After his account was closed by Pacific International in 1999, as part of the mass closure of accounts of five investment advisors, G was indicted in the United States for actions unrelated to his accounts at Pacific International. He was later acquitted.

¶ 95 Much was made by the Executive Director of two other individuals, named Mazzeo and Weiss, who were neither clients of Pacific International, nor authorized on any Pacific International accounts, nor were they alleged by the Executive Director to have given any instructions on any Pacific International accounts.

¶ 96 In July 1998, one of the Pacific International compliance staff members noticed that an individual named Mazzeo had referred four accounts to Pacific International. The staff member had read a magazine article referring to Mazzeo as having worked for a brokerage with "ties to several New York Mafia families" and recalled seeing the name Mazzeo as a referral for clients. As a result of this discovery, Pacific International did background searches on the referred clients, all of which produced no negative information. At least one of the accounts was subject to heightened supervision. All four (two of whom were married to each other) client accounts were retained, after reviewing their trading, on the basis that the reputation of a client should not be impugned merely because they knew someone who may have had a questionable reputation.

¶ 97 The Executive Director says that Pacific International should have regarded the referred clients as having the same reputation as Mazzeo. Thomas testified that doing so was "a slippery slope", and pointed out that he had read an article in which it was alleged Mazzeo was a business associate of a member of the Quebec Securities Commission. Similarly, Eric Wynn, who is referred to under the heading Hauchecorne Citation, was also alleged in a media article to have attended "coffee parties" at the White House, with US President Clinton. Pacific International's counsel also mentioned the example of Wayne Gretsky being a friend of convicted felon Bruce McNall. We agree with Thomas.

¶ 98 The other individual, Sholam or Shalom Weiss, was referred to in the opening statement of counsel for the Executive Director as follows:

> That's quite a stable [of] clients. The last one is Shalom Weiss, who was convicted of racketeering and money laundering in November 1999,

> having been indicted in April of 1988. And he was sentenced to 845 years in prison.

¶ 99 Counsel was wrong. Weiss was not a client and was not authorized on any Pacific International accounts. Weiss' alleged connection to Pacific International was that he might have been the brother-in-law of a Pacific International client and might have referred one Pacific International account. Pacific International testified that they didn't know of the existence of Weiss before the NOH was issued.

¶ 100 The burden is on the Executive Director to show that what Pacific International did was not reasonable. We heard no argument that what Pacific International did was unreasonable. The Executive Director must do more than say that Pacific International ought to have done something different. The test is reasonableness.

¶ 101 In our view, a detailed review of compliance procedures and activity at virtually any dealer will inevitably uncover instances where procedures have broken down. Perfection is not the standard. The standard is reasonableness. About this, Holley said:

> … there isn't a compliance system that's ever foolproof.

¶ 102 **We find that the Executive Director did not prove the allegations in paragraph 19 of the NOH.**

¶ 103 **We find that the Executive Director did not prove that Pacific International's responses to dealing with clients having criminal or regulatory histories were unreasonable.**

Significant Debit Balances

¶ 104 We note that, in connection with the next five activities, beginning with Significant Debit Balances and ending with Cash Transfers With Little or No Intervening Trading Activity, the Executive Director did not argue that the actions Pacific International took with respect to each of them were unreasonable.

¶ 105 Paragraph 23 of the NOH states:

> Some accounts were cash accounts that ran significant debit balances.

¶ 106 The Executive Director alleged that significant debit balances are inherently suspicious because they are potentially symptomatic of illegal conduct or conduct contrary to the public interest, including money laundering or share manipulation.

¶ 107 In support of this allegation, the Executive Director argued only that each debit balance "… although not in contravention of the cash account rule, was in and of itself suspicious".

¶ 108 The Executive Director quoted from IDA Bulletin #2537, dated November 26, 1998, stating, in part, that:

> Members should be vigilant in ensuring that related customers or customers otherwise acting in concert are not using accounts to trade small cap issues included on the OTC Bulletin Board, or in any other markets inside or outside Canada, to create a false appearance of trading activity or otherwise engage in manipulative activity. U.S. regulators have expressed concern that, in some cases, cash account rules may have been inappropriately utilized to extend credit in order to facilitate such transactions.

¶ 109 This bulletin deals with the conduct of related customers or customers otherwise acting in concert. The Executive Director did not introduce any evidence to show that any accounts met these criteria.

¶ 110 There is no regulatory prohibition against cash accounts having debit balances, significant or otherwise. The Executive Director offered no evidence of breaches of regulatory requirements with regard to these balances.

¶ 111 Pacific International testified that this was a common practice in its accounts, both with residents and non-residents, and that it followed all the regulatory requirements for the operation of cash accounts.

¶ 112 Pacific International's credit department monitored debit balances. Trading in accounts that maintained balances was closely supervised to ensure that neither regulatory rules nor Pacific International's credit policies were breached.

¶ 113 Pacific International further testified that the debit balances were ordinary in the brokerage business and not inherently suspicious. We agree with that, unless the firm has other information that suggests conduct described in IDA Bulletin #2537 or that causes doubt as to the client's reputation. As we have pointed out, there was no evidence this was the case for any client account.

¶ 114 **We find that the Executive Director did not prove that Pacific International's responses to debit balances were unreasonable.**

Receipts and Transfers of Large Blocks of Securities

¶ 115 Paragraph 20.4 of the NOH states:

> Some accounts consistently received in or transferred out, or both, by physical or electronic delivery, large blocks of stocks traded on the National Association of Securities Dealers Over-the-Counter Bulletin Board …

¶ 116 The Executive Director alleged that the transfers themselves might be potentially a symptom of illegal conduct or conduct contrary to the public interest, including money laundering or share manipulation.

¶ 117 The Executive Director argued that deposits and transfers of large blocks of securities were inherently suspicious. No explanation was given as to why this activity was suspicious, other that to say:

> The activity is inherently suspicious. There is no elaboration to be given beyond what is set out in the Notice of Hearing. Registrants are expected to exercise judgment and have common sense.

¶ 118 There is no regulatory prohibition against this practice.

¶ 119 Pacific International's evidence was that there is no other way of introducing securities into the system for trading without at some point delivering a certificate. Moreover, it was common for clients, both resident and non-resident, to transfer stock to accounts of other clients with whom they have business dealings. Pacific International further testified that the Activity was ordinary in the brokerage business and not inherently suspicious, particularly if it involved a single transfer to an unrelated account.

¶ 120 To the extent such transfers might be indicative of potential money laundering, Pacific International's practice was to ensure that a readily identifiable audit trail existed in its accounts so that all transactions could be readily traced.

¶ 121 Holley testified that during his review he noted nothing that stood out as money laundering.

¶ 122 To the extent a regulatory concern might arise from transfers out suggesting that the client did not own the securities that were transferred out, Pacific International's procedures for accepting deposits of stock were such that ownership had to be attested to when the stock was deposited.

¶ 123 Pacific International also prepared a daily report of stock and funds movements that was reviewed by compliance staff for unusual items.

¶ 124 McQuid testified that VSE staff recommended prohibiting acceptance of physical certificates of Bulletin Board stock, but their recommendation was not accepted by the VSE Board of Governors. He said the VSE concern at the time was primarily driven by financial risk to member firms arising from weaknesses in the US clearing system where share certificates are frequently rejected by transfer agents. Pacific International avoided this risk by always ensuring that a certificate was transferred into Pacific International's name before it could be sold by a client.

¶ 125 The Executive Director offered no criteria for defining a "large" block. Further, the Executive Director used the number of shares as a basis for identifying "large" blocks. The Respondents argued that it was more appropriate to use the market value of the block or the size of the block in relation to the amount of the authorized capital of the issuer as the criteria. We agree.

¶ 126 **We find that the Executive Director did not prove that Pacific International's responses to the receipts and transfers of large blocks of securities were unreasonable.**

Third Party Transfers

¶ 127 Paragraph 20.5 of the NOH states:

> Sale proceeds from some accounts were frequently distributed to third parties.

¶ 128 The Executive Director alleged that the transfers are potentially a symptom of illegal conduct or conduct contrary to the public interest, including money laundering or share manipulation.

¶ 129 Pacific International testified that it was not logical to take the position that a client using their own money to make a payment was, by itself, improper or unusual. Moreover, for actual money laundering to exist, there must first be a crime. It isn't reasonable, therefore, to assume that, absent other considerations, all third party transfers are potentially money laundering and in need of investigation.

¶ 130 Pacific International testified that its clients often use their brokerage accounts as bank accounts, making deposits and paying bills. Included in the type of transactions that Pacific International described were purchases of shares or warrants in a private placement and the exercise of options, all of which would be common for clients who were experienced market participants.

¶ 131 To place these transactions in context, Pacific International testified that, during the period from December 1996 to March 2000, Pacific International conducted 86,598 banking transactions, aggregating over $10 billion.

¶ 132 Pacific International reviewed all large cheques and wire transfers before they were sent out. Pacific International's compliance department also reviewed third party transfers when they appeared to be unusual.

¶ 133 Pacific International also prepared a daily report of stock and funds movements that was reviewed by compliance staff for unusual items.

¶ 134 Pacific International testified that, to the extent there might be a concern about this practice as a possible money laundering activity, it was Pacific International's practice to always ensure that an appropriate audit trail existed in Pacific International's accounts so that all transactions could be readily traced.

¶ 135 Holley testified that during his review he noted nothing that stood out as money laundering.

¶ 136 Pacific International further testified that third party transfers were ordinary in the brokerage business and not inherently suspicious, particularly if it involved a single transfer to an unrelated account. Holley confirmed the fact these transactions were common in the industry. He also testified that "Patterns of activity [in an account] are usually the most telling indicators of … potential problems. … I thought that compliance staff were quite astute and were appropriately suspicious or skeptical about patterns of activity …"

¶ 137 **We find that the Executive Director did not prove that Pacific International's responses to third party transfers were unreasonable.**

Early Settlement Fees

¶ 138 Paragraph 20.6 of the NOH states:

> Some clients frequently paid significant fees so that they could receive cash from securities sales before the settlement date.

¶ 139 The Executive Director alleged that the payment of these fees is potentially a symptom of illegal conduct or conduct contrary to the public interest, including money laundering or share manipulation.

¶ 140 There is no regulatory prohibition against this practice.

¶ 141 Pacific International testified that the activity was ordinary in the brokerage business for at least 20 years and not inherently suspicious. Holley said that most dealers charge early settlement fees.

¶ 142 **We find that the Executive Director did not prove that Pacific International's receipt of early settlement fees was potentially a symptom of illegal conduct or conduct contrary to the public interest.**

Cash Transfers With Little or No Intervening Trading Activity

¶ 143 Paragraph 20.7 of the NOH states:

> Cash was transferred in and out of some accounts with little or no intervening trading activity between the receipt and transfer of cash.

¶ 144 The Executive Director alleged that the transfers are potentially a symptom of illegal conduct or conduct contrary to the public interest, including money laundering or share manipulation.

¶ 145 There is no regulatory prohibition against making such transfers.

¶ 146 Pacific International testified that its clients often make cash transfers. Pacific International also testified that this often happens when clients deposit cash in their account and then use the cash to acquire stock directly from an issuer in a private placement.

¶ 147 Pacific International testified that, in the case of the list of accounts provided by the Executive Director as evidence of the transfers, there was actually a significant amount of intervening trading activity in the accounts in question. Many of the transfers referred to by the Executive Director were to other accounts of the same client or to other accounts on which the client is authorized, such as the client's corporate account. Pacific International also testified transfers of funds between cash accounts and margin accounts are common, in order to properly manage margin deficiencies and excesses.

¶ 148 Pacific International reviewed all large cheques and wire transfers before they were sent out.

¶ 149 Pacific International also prepared a daily report of stock and funds movements that was reviewed by compliance staff for unusual items.

¶ 150 Pacific International also testified that, to the extent there might be a concern about this practice as a possible money laundering activity, it was Pacific International's practice to always ensure that an appropriate audit trail existed in Pacific International's accounts so that all transactions could be readily traced.

¶ 151 Pacific International further testified that the transfers were ordinary in the brokerage business and not inherently suspicious.

¶ 152 **We find that the Executive Director did not prove that Pacific International's responses to transfers with little or no intervening trading activity were unreasonable.**

Findings on Activity

¶ 153 No rules exist to prohibit any Activity described in paragraphs 20.3 to 20.7 of the NOH.

¶ 154 The VSE audit reports disclosed no concern on their part arising from any Activity.

¶ 155 The Executive Director did not produce evidence to show that there was unusual or illegal trading in any client account.

¶ 156 **We have found that, for each Activity, the Executive Director did not prove that Pacific International's responses to the Activity were unreasonable or that the Activity was potentially a symptom of illegal conduct.**

2. Distributions

¶ 157 In paragraph 22 of the NOH, the Executive Director alleged:

> Clients received into their Accounts securities that were ostensibly issued under American registration exemptions and then disposed of those securities into U.S. markets. Pacific International failed to make reasonable inquiries to determine whether its clients were not illegally distributing those securities …

¶ 158 The Executive Director alleged that Pacific International failed to make reasonable inquiries to determine if these distributions were illegal, but did not offer any evidence of how Pacific International failed to do so.

¶ 159 The Executive Director did not produce evidence that any trading constituted illegal distributions but, more importantly, nor was any evidence produced to

show that there was something about the trading in any account that ought to have attracted Pacific International's attention.

¶ 160 Pacific International testified that it engaged US counsel to design the system used by them to monitor distributions and implemented what it believed to be a robust system for ensuring that appropriate exemptions from US laws existed for dispositions in these circumstances. A review of the procedures was conducted by US counsel in 1998.

¶ 161 Pacific International testified that its detailed procedures monitored all deposits of US stock. These procedures were intended to ensure that it made reasonable inquiry to determine if securities were being illegally distributed. The procedures, which included filing a form with the SEC, were intended to comply with the provisions of SEC Rule 144.

¶ 162 Pacific International had to be particularly cautious in this area, as US laws can hold a broker/dealer responsible for illegal distributions if they fail to make reasonable inquiries.

¶ 163 **We find that the Executive Director did not prove that Pacific International failed to make reasonable inquiries to determine whether its clients were not illegally making Distributions.**

¶ 164 In our view, the Executive Director should not allege that a dealer is contravening American laws unless a competent authority in the United States has found that to be the case. If the American authority makes that finding, it is appropriate to use that as the basis for an allegation.

3. Indictments and Complaints

¶ 165 Paragraph 27.2.3 of the NOH lists Indictments, Complaints and Demands as containing relevant information in connection with the know your client rule. We have already dealt with Indictments and Complaints under the heading Criminal and Regulatory Histories. The discussion on Demands follows.

4. Demands for Production

¶ 166 In paragraph 23 of the NOH, the Executive Director alleged:

> Pacific International received numerous requests during the Material Time for production of information from Commission Staff and the Vancouver Stock Exchange relating to the Accounts …

¶ 167 The Executive Director alleged that the Demands should have caused Pacific International to doubt whether certain of its clients were of good business or financial reputation. The Executive Director did not make any argument that Pacific International's responses to the Demands were unreasonable.

¶ 168 Pacific International said this about Demands:

> … it's really very hard to take anything from these demands. We don't know whether the demand relates to a victim of the investigation. We don't know whether the regulators are just looking for information relating to the trading. We don't know whether they're looking for information which will tell them who traded the security. It's very, very difficult to make anything out of any specific information request.

¶ 169 Pacific International testified that receipt of Demands was commonplace, particularly with respect to junior market securities. When received, there was seldom, if ever, any context given by the regulator to assist Pacific International in understanding the reason for the request, thus enabling Pacific International to conduct due diligence on its own. Moreover, it was Pacific International's experience that the Demands seldom led to any regulatory actions. They were usually unremarkable. Nevertheless, Pacific International established a system for making the compliance department aware of them, so that they could supervise the accounts with that knowledge in mind.

¶ 170 Pacific International testified that the majority of the Demands that staff said it should have taken notice of were either requests for a record of all trading in a particular stock or asking whether a particular person had an account at Pacific International. In the first instance, no clients are identified and, in the second, no securities are identified, leaving a firm short of potentially useful information.

¶ 171 Pacific International also testified that it received far more demands for information about trading in Canadian stocks that it did for US stocks. In 1998 alone, in addition to demands about US securities, Pacific International received 124 demands about Canadian securities. This contrasts with the 113 demands that the Executive Director says Pacific International received about US securities during the entire Material Time.

¶ 172 **We find that the Executive Director did not prove that Pacific International's responses to Demands were unreasonable.**

5. Screening Deficiencies

¶ 173 In paragraph 21 of the NOH, the Executive Director alleged:

> Pacific International failed to fulfil the requirements of various rules and statutes to ensure it had proper client information as follows:
>
> 21.1 Client verification procedures in the Accounts frequently did not satisfy the requirements of the *Proceeds of Crime (Money Laundering) Act*, S.C. 1991, c. 26, P-24.5, and the *Proceeds of Crime (Money Laundering) Regulations* SOR 93-75.
>
> 21.2 Some Account opening documents lacked certain information, such as proper client identification or other essential facts.
>
> 21.3 Trading and other activity occurred in some Accounts before a designated partner, director, or officer approved the opening of the Account, as required by CDNX Rule F.1.01.3 (formerly VSE Rule F.1.01.c) and IDA Regulation 1300.2.

¶ 174 These were defined in the NOH as Screening Deficiencies.

¶ 175 The Executive Director alleged that Pacific International failed to learn essential facts about its clients because the existence of Screening Deficiencies should have caused doubt whether its non-resident experienced market participant clients who traded on the Bulletin Board were of good business or financial reputation.

¶ 176 We don't see any connection between the Screening Deficiencies and the allegation, except with respect to paragraph 21.2 of the NOH. As far as that allegation is concerned, we are not prepared to find that Pacific International contravened the know your client rule. We deal with this and the other Screening Deficiencies below, under the heading Compliance with Applicable Laws.

¶ 177 **Based on the above, we find that the Executive Director did not prove that the Screening Deficiencies ought to have caused doubt whether Pacific International's non-resident experienced market participant clients who traded on the Bulletin Board were of good business or financial reputation.**

6. Hauchecorne Citation

¶ 178 Paragraph 18 of the NOH states:

> On July 11, 1998, the Vancouver Stock Exchange issued a citation against J.C. Hauchecorne, a registered representative of Pacific International, involving activity related to the indictments.

¶ 179 The Executive Director alleged that Pacific International failed to learn essential facts about its clients because the citation ought to have caused doubt whether its non-resident experienced market participant clients who traded on the Bulletin Board were of good business or financial reputation.

¶ 180 By the time the citation was issued, in our view, Pacific International had no further obligation under the know your client rule regarding the accounts involved. In the rest of this section, we review the events giving rise to the citation in detail, and Pacific International's responses to them. This review will explain why we reached this conclusion.

¶ 181 Hauchecorne joined Pacific International in April 1995, from another Vancouver brokerage firm. Meier and McQuid conducted due diligence about him before he was hired and received no negative information about him. Hauchecorne was Swiss and dealt mainly with European clients. In October 1995, Hauchecorne opened, and transferred to, a new Pacific International office in Calgary.

¶ 182 One of Hauchecorne's clients, Ubiquity Holdings, was a company based in the Bahamas. Ubiquity Holdings followed Hauchecorne when he moved to Pacific International from another Vancouver broker firm. At Pacific International, the Ubiquity Holdings account traded primarily NASDAQ senior board stocks.

¶ 183 On April 10, 12 and 18, 1996, pursuant to three separate fax instructions received by Hauchecorne, and vetted by compliance staff, Pacific International sent three wire transfers of money totaling USD $1.748 million to an account in Hong Kong. In each case, the signature on the letter of instruction appeared to be that of a Mr. Pindling, an authorized person on the account. The recipient of the wires was named Ubiquity Holdings.

¶ 184 On April 15, 1996, McQuid received a telephone call from a Phillip Gurian, asking for account information on the Ubiquity Holdings account. He told McQuid that he was a person who gave instructions on the account and that there was unauthorized trading in the account that he wanted to investigate. McQuid told Gurian that Pacific International had no written authorization on file for Gurian to give instructions and refused Gurian's request.

¶ 185 McQuid approached Hauchecorne about the call, and Hauchecorne told him that any instructions from Gurian were always verified with Pindling. McQuid told Hauchecorne not to take any instructions from Gurian without Gurian being properly authorized on the account. In July 1996, Hauchecorne's assistant confirmed what Hauchecorne told McQuid but, in 1998, in testimony before the VSE panel hearing the Hauchecorne citation, said otherwise.

¶ 186 The last trade in the Ubiquity Holdings account occurred on April 15, 1996.

¶ 187 In early May, 1996, Pacific International's credit manager received a telephone call from Gurian, again requesting account information and accusing Hauchecorne of stealing USD $1.5 million from the Ubiquity account. The credit manager gave him no information, as Gurian was not authorized on the account.

¶ 188 On May 8, 1996, Pacific International received the results of a background search ordered on April 4, 1996 under the name Metzer. The last trades in the Metzer account at Pacific International were on April 4, 1996. The search disclosed no negative information.

¶ 189 On May 23, 1996, McQuid received a telephone call from Gurian, in which he accused Hauchecorne of stealing USD $1.5 million from the Ubiquity account. McQuid gave him no information as he was still not authorized on the account. Some time before this call, McQuid had sent account information to Pindling. Pindling did not query anything on the statements nor did he indicate there was anything wrong with the statements. McQuid also checked the signatures on the fax instructions for wiring the funds and confirmed what his staff had earlier concluded, that nothing appeared untoward (later, in the Hauchecorne hearing, the VSE panel found that Pindling's signature was forged). He also made some inquiries about Gurian and concluded that his credibility was low.

¶ 190 At this time, McQuid noticed that the signature of one of the authorized persons on the account had changed over time. McQuid said he felt that Gurian had likely been involved in the change. By this time, the account was effectively closed. All trading activity had ceased and the funds had been transferred out. McQuid did not yet know that Hauchecorne had been taking unauthorized trading instructions.

¶ 191 Around June 21, 1996, McQuid placed Hauchecorne on informal (ie., not imposed by a regulatory body) strict supervision. At the same time, the Ubiquity Holdings account was restricted by Pacific International so that no transactions could be conducted without McQuid's approval.

¶ 192 It was not until June 27 or 28, 1996 that Hauchecorne told Pacific International (Meier and McQuid) about an incident in a New York hotel. On or about May 24, 1996, Hauchecorne had met a client in New York, at the client's request. When the client came to Hauchecorne's hotel room, he was accompanied by three other people. Hauchecorne was roughed up and accused of stealing the funds transferred from the Ubiquity Holdings account. The lives of Hauchecorne and his family were threatened. A gun and a lead pipe wrapped in a towel were visible to Hauchecorne.

¶ 193 One of the men present, Phillip Abramo, was Hauchecorne's client, but had opened his account under the alias Louis Metzer. Pacific International's earlier identity check on Metzer conformed to federal money laundering legislation requirements and they also conducted a background search under that name without discovering any negative information.

¶ 194 Another of the men in the room was Gurian. Hauchecorne knew Gurian because, as was later found by the VSE in the Hauchecorne hearing, Gurian was indeed giving Hauchecorne unauthorized trading instructions for the Ubiquity Holdings account. Hauchecorne referred to the men in the hotel room as "mob types".

¶ 195 The rest of the members of the Executive Committee were given details of the incident shortly after this conversation. McQuid also reported the incident to the police and to the VSE and the Alberta Stock Exchange.

¶ 196 On July 18, 1996, Pacific International received the results of a background search on Gurian and discovered he had a regulatory history but no criminal history. There was no reference to any "mob" connections.

¶ 197 In December 1996 and March 1997, it was reported in media articles that Abramo was a purported member of the Mafia and that Gurian and Wynn were "associates" of Abramo. The March 24, 1997 article also contained details of the Hauchecorne hotel room incident, although neither Hauchecorne's nor Pacific International's names were mentioned in the article.

¶ 198 Apart from discovering, from media articles, that Metzer was an alleged Mafia member, in none of the background searches conducted by Pacific International did it discover any Mafia members who were clients. Holley testified that during the course of his review he saw no indication of any Mafia clients, other than as alleged in the indictments.

¶ 199 In March 1997, most of the Ubiquity Holdings funds were recovered and paid to the appropriate parties.

¶ 200 In April 1997, in consequence of the Hauchecorne incident, and media articles about Abramo and Gurian, McQuid asked compliance staff to devise a due diligence procedure to deal with US clients who actively trade in American markets. Compliance staff recommended doing a background search on each client who fit this profile and Pacific International followed this recommendation. Details of the new search procedures are discussed under the heading Criminal and Regulatory Histories. Pacific International also amended their wire transfer procedures to require that faxed instructions be orally verified with the client before they were acted upon.

¶ 201 On July 18, 1998, the VSE imposed strict supervision on Hauchecorne, when it issued the citation.

¶ 202 In September 1998, at the Hauchecorne hearing at the VSE, Hauchecorne's assistant testified that Hauchecorne had also been taking unauthorized trading instructions from Eric Wynn and that almost none of the unauthorized trading was confirmed by Pindling. Wynn had both a criminal and a regulatory history and was alleged in media articles to have been associated with members of the Mafia.

¶ 203 The Executive Director argued, in final submissions, that, after the media articles reported that Hauchecorne was involved with alleged mob people, Pacific International ought to have immediately ordered background searches on all Hauchecorne's non-resident clients. In fact, Pacific International did just that, by February 1998, and did not discover any other clients with any criminal or regulatory histories.

¶ 204 One of Hauchecorne's clients later developed a regulatory history, but a year after the closure of his account and beyond the Material Time. The allegations against the client had nothing to do with transactions in his account at Pacific International.

¶ 205 The Executive Director also argued that each director ought to have been given every detail of the hotel room incident and that the directors should have demanded they be informed of all future connections that Pacific International had with "disreputable persons".

¶ 206 Pacific International testified that, throughout the course of the Hauchecorne matter, the Executive Committee was briefed on all salient facts. Each of the directors testified that they learned enough about the incident to know that it was a very serious matter. They did not feel they had to know each minute detail in order to appreciate the significance of it. Nor did they feel they needed to know about all future connections with disreputable persons. They said they generally relied upon McQuid and his compliance group to deal with issues as they arose and to inform the directors of serious matters, particularly those involving wrongdoing in the accounts of the firm.

¶ 207 The Ubiquity Holdings matter was not about Bulletin Board trading. It was about an apparent theft of money and about an investment advisor who took instructions from unauthorized parties, without telling the firm and without the firm having a reasonable ability to discover it. There appears to be little connection between this incident and any of the securities related incidents cited by the Executive Director.

¶ 208 This matter, together with the Rachfall and Patterson issue discussed below, under the heading Business Procedures, demonstrates the difficulty that firms have in dealing with "rogue" brokers, who can hide taking unauthorized instructions, should they so choose. Hauchecorne had been an investment advisor for a long time, without any regulatory history, and, according to what his former employer told Pacific International when Hauchecorne moved to Pacific International, had no compliance problems. Pacific International had no reason to suspect that Hauchecorne might be taking these unauthorized instructions.

¶ 209 **We find that the Executive Director did not prove Pacific International's responses to the Hauchecorne incident were unreasonable and that the incident should have caused Pacific International to doubt whether its non-resident experienced market participant clients who traded on the Bulletin Board were of good business or financial reputation.**

7. Compliance Staff Reviews

¶ 210 Paragraph 24.1 of the NOH states:

> Pacific International's compliance and operations staff identified and documented some or all of the Activity, the Screening Deficiencies, and the Distributions.

¶ 211 The Executive Director argued:

> [The respondents] argued that it would be inappropriate to use the e-mails and other communications from compliance as "evidence of a non-functioning compliance department. For the most part, Staff have not attempted to use these documents in that fashion. Staff have used these documents to prove that many important facts were known to Pacific International and were not passed on to the directors …"

¶ 212 The information identified by compliance staff was dealt with above under the headings Activity, Screening Deficiencies and Distributions.

¶ 213 We have also dealt with this information in considering whether the directors fulfilled their duties under the *Company Act*, under the heading *Company Act* Requirements.

¶ 214 **In light of this we make no finding with respect to this allegation.**

8. Findings on Know Your Client Rule

¶ 215 The know your client rule placed an obligation on Pacific International to make inquiry if it received information that raised doubt about a client's business or financial reputation. Pacific International recognized this obligation and responded to the information it received.

¶ 216 **Based on the findings made above, we find the Executive Director did not prove that Pacific International contravened the know your client rule contained in section 48 of the Rules.**

B. Business Procedures

¶ 217 In paragraph 27.3 of the NOH, the Executive Director alleged:

> The Respondents failed to establish and apply written prudent business procedures for dealing with clients, particularly those holding Accounts, including supervising the registered representatives or the investment advisors employed by Pacific International, in compliance with the *Act* and the regulations, contrary to s. 44 of the *Rules* and section 40 of B.C. Reg. 270/86, VSE Rule F.2.01, and IDA Regulation 1300.1(b).

¶ 218 Section 44(1) of the Rules says:

> A dealer, portfolio manager or investment counsel must establish and apply written prudent business procedures for dealing with clients in compliance with the Act and the regulations.

¶ 219 Pacific International's written procedures were contained in a sales procedure manual and were continually updated by "Compliance Bulletins", as new issues arose. The procedures manual was in process of being updated in 1998, when Pacific International engaged a consultant to assist in bringing its manuals up to date. Holley completed the update in 1999.

¶ 220 About business procedures, and compliance generally, the Holley report says:

> Pacific International has a well-defined program for establishing compliance procedures. Its compliance and operations systems are designed to meet regulatory requirements and to protect the firm from civil or regulatory liability. Systems are in place to ensure that client activity is reviewed on a daily and monthly basis in accordance with industry standards.
>
> Pacific International is well ahead of many of its competitors in the development and application of compliance information systems and

> databases. The firm has established written policies that reflect regulatory requirements and those polices, rigorously applied, would generally meet or exceed the firm's obligations under SRO rules and provincial securities legislation.

¶ 221 The two areas that the Holley report identified where procedures were not "rigorously applied" are areas where Pacific International admitted it failed to comply with regulatory requirements. These are discussed under the headings Screening Deficiencies and Compliance With Applicable Laws. According to Holley, Pacific International's written procedures reflected conformity with regulatory requirements, but in these two admitted problem areas, the procedures were not followed.

¶ 222 Holley testified that Pacific International procedures "met or exceeded the industry standards and peer standards in virtually every area".

¶ 223 The Executive Director did not identify how Pacific International's procedures were deficient. The Executive Director adopted an interpretation of Holley's report and testimony that purports to show that Pacific International contravened section 44 of the Rules. We have read the report and considered Holley's testimony and find no basis for the Executive Director's interpretation.

¶ 224 We accept Holley's report and his testimony that the written procedures met regulatory requirements. That, however, is not the end of it.

¶ 225 Section 44 of the Rules requires not only that adequate written business procedures exist, but also that they be followed. In the case at hand, however, the instances where procedures were not followed are the Screening Deficiencies. For the reasons expressed in our discussion under the heading Compliance with Applicable Laws, we are not prepared to find here that Pacific International contravened section 44 of the Rules as a result of the Screening Deficiencies.

¶ 226 The Executive Director did not present an argument to show that Pacific International's procedures for supervising its investment advisors were inadequate. We take the opportunity here to deal with some of the anecdotal evidence we saw on supervision of investment advisors.

¶ 227 Many of the clients about which evidence was led by the Executive Director were clients of Hauchecorne, Rachfall and Patterson, Blades and Meier.

¶ 228 Hauchecorne was under strict supervision (informal and formal) for much of his tenure at Pacific International. The Meier client and the Blades client that were held out by the Executive Director as being problem clients were continuously

under intense scrutiny by compliance staff and there were regular communications with Meier and Blades about them.

¶ 229 Hauchecorne's significant breaches of regulatory requirements involved taking instructions from people not authorized to give them and being complicit in the theft of money from an account. Pacific International could not be expected to know that since Hauchecorne deliberately hid it from them.

¶ 230 McQuid testified that Rachfall and Patterson had no disciplinary history and had a long history of being compliant investment advisors who typically brought compliance issues to the attention of the compliance department, rather than vice versa.

¶ 231 The circumstances that led to the arrest and imprisonment of Rachfall and Patterson were likewise unusual. The Rachfall and Patterson clients who were at the root of the issue, Houge and Manion, gained control of virtually all the free trading shares of a US issuer. Having achieved control, they then, using US brokerage firms, manipulated the share price and sold the stock at higher prices. Rachfall's and Patterson's part in the affair was assisting in assembling the control position, which they did in concert with other brokerage firms. Pacific International could not be expected to know what Rachfall and Patterson were doing in these circumstances.

¶ 232 Thomas testified that he subsequently reviewed the trading at Pacific International in the stock that was involved in the Rachfall and Patterson conviction. He found the trading was unremarkable. Nothing stood out as something that ought to have been detected.

¶ 233 In each case, the conduct alleged in the indictments and complaints referred to in this decision took place outside Pacific International. It included conduct such as making misrepresentations to potential investors, bribing or coercing US brokers and failure to disclose compensation for investor relations services. Where conduct occurred outside Pacific International without its knowledge, it cannot be shown that Pacific International failed in its duty to supervise the trading in its accounts.

¶ 234 The evidence showed that Pacific International closely monitored trading in all its active accounts, regardless of who the investment advisor was.

¶ 235 Holley testified that Pacific International's compliance systems were much more sophisticated, more rigorously documented and, in many cases, more effectively applied, than those of its competitors.

¶ 236 Holley also said the resources devoted to compliance at Pacific International were "probably above industry standards" and that Pacific International's systems, many of which were developed internally and used regularly, were more advanced than its competitors.

¶ 237 **We find that the Executive Director did not prove that Pacific International contravened section 44 of the Rules.**

C. Conduct Contrary to the Public Interest

¶ 238 In paragraph 28 of the NOH, the Executive Director alleged:

> The Respondents acted contrary to the public interest by the following:
>
> 28.1 failing to establish and apply adequate procedures to identify, investigate, halt, and prevent, where appropriate, the Activity, Screening Deficiencies, and the American Dispositions;
>
> 28.2 failing to supervise properly or at all the conduct of its investment advisors and registered representatives;
>
> 28.3 failing to ensure that it was not assisting its clients to dispose of restricted securities into American securities markets; and
>
> 28.4 failing to become a member of the NASD for better scrutiny of its U.S. business.

1. Failing to Establish and Apply Procedures

¶ 239 The Executive Director alleged that the Respondents acted contrary to the public interest by "failing to establish and apply adequate procedures to identify, investigate, halt and prevent, where appropriate, the Activity, Screening Deficiencies, and the American Dispositions".

¶ 240 In our view, all requirements for establishing and applying business procedures fall within section 44 of the Rules. Under the heading Business Procedures, we have found that the Respondents did not contravene section 44 of the Rules.

¶ 241 Further, where the Executive Director has alleged contravention of our legislation, in our view, it is not necessary for the Executive Director to also allege, for the same conduct, that a person has acted contrary to the public interest.

¶ 242 We note that this paragraph of the NOH makes allegations with respect to "American Dispositions". This term is not defined anywhere in the NOH, nor did the Executive Director use this term in final argument.

2. Failing to Supervise

¶ 243 In paragraph 28.2 of the NOH, the Executive Director alleged that the Respondents failed "… to supervise properly or at all the conduct of its investment advisors and registered representatives".

¶ 244 In our view, all requirements for supervising fall within section 44 of the Rules. We have already found that the Respondents did not contravene section 44 of the Rules, under the heading Business Procedures.

¶ 245 We repeat our earlier comment that, where the Executive Director has alleged contravention of our legislation, in our view, it is not necessary for the Executive Director to also allege, for the same conduct, that a person has acted contrary to the public interest.

3. Illegal Distributions

¶ 246 In paragraph 28.3 of the NOH, the Executive Director alleged that the Respondents acted contrary to the public interest by "failing to ensure that they were not assisting clients in disposing of restricted securities into American securities markets".

¶ 247 We have discussed this allegation under the heading Distributions.

¶ 248 **After taking into account the factors described under Distributions, we find that the Executive Director did not prove that the Respondents failed to ensure that Pacific International was not assisting its clients to dispose of restricted securities into US securities markets. Indeed, from the evidence we saw, there was no basis for the Executive Director to make this allegation.**

4. NASD Membership

¶ 249 In paragraph 28.4 of the NOH, the Executive Director alleged that the Respondents acted contrary to the public interest by "failing to become a member of the NASD for better scrutiny of its U.S. business".

¶ 250 The VSE, in February 1994, published a notice that suggested member firms would "likely" have to register in a state in the United States if they dealt with clients there. The notice also said that members were urged to comply with federal

and state laws in the United States. A later notice, published in March 1994, said the VSE "… continues to urge Members to seek competent legal advice in this area." As suggested by the VSE, Pacific International had obtained legal advice and it confirmed Pacific International was not required to register in the US since it did not solicit clients there and its trades were through market makers.

¶ 251 Pacific International also took steps to ensure that it was not subject to state laws. It stopped doing business with clients in some states that attempted to aggressively enforce their laws and also stopped doing business with some types of clients.

¶ 252 The Executive Director argued, in opening submissions, that Pacific International was required to be registered, "That Pacific International knew the requirements. It just chose to ignore them."

¶ 253 The Executive Director made this argument, even though there was no allegation in the NOH that Pacific International needed to be registered in the United States.

¶ 254 In closing submissions, the Executive Director stated:

> It would appear that on the evidence of this case (non solicitation only and Market Maker only) that Pacific International likely qualified for federal and state exemptions from broker dealer and security registration.

¶ 255 However, the Executive Director continued to argue that Pacific International should have become a member of the NASD for better scrutiny of its business.

¶ 256 There was no requirement in the United States for Pacific International to join the NASD. Nor was there a requirement in Canada for Pacific International to join the NASD. In our view, it is not appropriate, in these circumstances, for the Executive Director to ask the commission to find that Pacific International acted contrary to the public interest.

¶ 257 **We dismiss the allegation.**

5. *Company Act* Requirements

¶ 258 In paragraph 29 of the NOH, the Executive Director alleged that:

> The Directors failed to … exercise the care, diligence and skill of a reasonably prudent person, contrary to sections 118 and 135 the *Company Act*, R.S.B.C. 1996, c. 62.

¶ 259 The relevant sections of the *Company Act* are:

> 118 (1) Every director of a company, in exercising the director's powers and performing the director's functions, must
>
> …
>
> (b) exercise the care, diligence and skill of a reasonably prudent person.
>
> (2) The provisions of this section are in addition to, and not in derogation of, any enactment or rule of law or equity relating to the duties or liabilities of directors of a company.
>
> 135 The provisions of sections 118 … apply to every officer of a company.

¶ 260 The Executive Director argued that, after the Hauchecorne hotel room incident, the Pacific International directors ought to have realized there were serious compliance problems and that they needed to involve themselves in the management of the compliance function. The substantive actions argued to be required of the directors by March 24, 1997, as cited by the Executive Director, were:

- The directors ought to have, at the time of learning of the hotel room incident, instructed McQuid to tell them every detail of the incident, to keep them informed of any past or future connection between Pacific International and disreputable persons and to search all of Hauchecorne's non-resident clients.

- The issue of a criminal complaint against three clients in October 1996 ought to have also caused the directors to instruct McQuid to search all of the clients of Rachfall and Patterson.

- The failure of all the directors to read and make themselves fully aware of the March 24, 1997 media article alleging mob involvement in the Bulletin Board, and the Hauchecorne incident, was a failure of their statutory duty to exercise the care, diligence and skill of a reasonably prudent director.

- After having read the article they ought then to have instructed McQuid to do background searches of all the non-resident Bulletin Board trading clients of the nine investment advisors who produced most of the commissions from trading Bulletin Board stocks.

¶ 261 Failure to do all this by March 24, 1997 was argued to be a breach of their statutory duty.

¶ 262 The reader is also referred to the discussions under the headings The Red Flag Argument, Hauchecorne Citation and Gatekeeper Responsibilities.

¶ 263 McQuid and Meier testified that the Executive Committee was briefed on the Hauchecorne incident and related followup. The directors each acknowledged that they knew enough about it to regard the matter as a serious one. None of them, however, believed that this one incident was indicative of a systemic problem in compliance activities at the firm and that it should have led to the procedures suggested by the Executive Director. As indicated earlier, the backgrounds of all Hauchecorne's clients were in fact searched, albeit not by March 24, 1997.

¶ 264 The Hauchecorne incident had nothing to do with trading shares on the Bulletin Board. The accounts in question traded NASDAQ senior board issuers. The Hauchecorne incident had nothing to do with trading. It was about an investment advisor being accused of being complicit in the theft of money from an account. The Hauchecorne incident was unique and could not have stood out to Pacific International as foreshadowing later events associated with clients who traded predominately on the Bulletin Board.

¶ 265 That said, the Hauchecorne incident was responded to by Pacific International in a number of ways. Hauchecorne was placed on informal strict supervision. The accounts in question were restricted. Pacific International informed the police, the VSE and the Alberta Stock Exchange of the incident. Over the course of the period starting from the incident and ending in February 1998, all of Hauchecorne's accounts were subjected to background searches to see if any other unsavoury clients were identified, and none were. Wire transfer procedures were changed to require fax instructions to be orally verified with the client. A more in-depth, risk based, approach was adopted with respect to client background searches.

¶ 266 Most of the directors didn't know of the 1996 criminal complaint. The complaint involved three clients who allegedly bribed US brokers to assist in a pump and dump scheme. One of them was also accused of misrepresentation. One of them had a 16 year old criminal history that Pacific International was unaware at the time. In October, 1996, when the criminal complaint was made public, two of them had been clients of Pacific International for just over two years and one of them was a client for just over two months. Pacific International was not mentioned in the complaint and there were no allegations made, either in the complaint or by the Executive Director, that any of the transactions referred to in the complaint had occurred in Pacific International accounts.

¶ 267 The three clients named in the complaint were Rachfall and Patterson clients. There was no evidence of any prior cases indicating that Rachfall and Patterson

might have dealt with undesirable clients. McQuid testified that, in the 11 years leading up to late 1996 that he had known Rachfall and Patterson, he had no compliance problems or issues with them. He said they had been supportive of him and would bring compliance issues to him.

¶ 268 The three clients' accounts were restricted immediately upon Pacific International learning of the complaint, one or two days after it was issued.

¶ 269 The Executive Director alleged that the directors should have been told about the October, 1996 complaint and Pacific International should have conducted background searches of all Rachfall and Patterson clients. The directors all said they didn't need to know about complaints unless the trading involved Pacific International. McQuid said there was no thought at the time to search all the accounts because nothing had come to his attention to suggest there were systemic problems with Rachfall's and Patterson's client base. The Executive Director said the prior experience with Hauchecorne should have led Pacific International to conclude they could have a substantial problem with their entire client base. McQuid said there was no reason to connect the Hauchecorne matter with this incident. The Hauchecorne incident was unique. We agree with McQuid.

¶ 270 Much was made by the Executive Director of the December, 1996 and March 24, 1997 media articles. The Executive Director argued that the article ought to have shown the Respondents that the Mafia controlled the Bulletin Board and ought to have caused them to question why they dealt with clients who traded on the Bulletin Board.

¶ 271 Not only were the allegations in the article never proved, but also the primary aspect of mob control that the articles dealt with was alleged mob control of brokerage firms and alleged bribery and coercion of US brokers. It did not allege that individual retail traders on the Bulletin Board were dominated by Mafia members.

¶ 272 The directors accepted the media article for what it was, an unproven story.

¶ 273 None of the searches performed by Pacific International identified any clients who were Mafia members. Holley testified that, during his review, he found no indication of clients who were Mafia members, other than allegations made in the indictments.

¶ 274 The Executive Director connected a number of unrelated events as a basis for saying that the Respondents ought to have known Pacific International would ultimately receive bad publicity as a result of its clients' activities.

¶ 275 The Executive Director argued that all the so-called red flags can be connected because each was "... connected to one element of a common theme of non-resident, and/or experienced market participant, and/or OTCBB accounts". We prefer to suggest that the Executive Director is making these connections using hindsight.

¶ 276 Even if the directors knew of all the red flags the Executive Director sets out in argument, in our view, the Executive Director makes no compelling argument that the directors acted unreasonably in managing the business and affairs of Pacific International and, as a result, breached their *Company Act* duties.

¶ 277 McQuid testified that he attended committee and board meetings at the VSE where discussions were held about the VSE potentially banning trading on the Bulletin Board by local firms and/or banning the physical acceptance of share certificates. After consideration, the bans were never imposed. McQuid also said that he informed the members of the Executive Committee of these VSE discussions. The decision by the VSE not to impose these bans lends credibility to Pacific International's continuing to deal with clients who were active on the Bulletin Board and to Pacific International's practice of accepting physical delivery of securities.

¶ 278 The individual Respondents were all actively involved in the business. Except as we have noted, they were all members of an Executive Committee that met weekly, except in summer and at Christmas, when it met every three weeks.

¶ 279 Executive Committee meetings were formally structured, with written agendas. Minutes of the meetings were kept.

¶ 280 Extensive written reports from each department head were supplied to the Executive Committee in advance of its meetings. These reports were expected to cover all significant matters occurring in the departments.

¶ 281 The directors received copies of all audit reports of the VSE and the firm's external auditors. There were no significant deficiencies noted in any of these reports. Pacific International testified that the 1999 VSE report, that covered work done in September 1998, included the following: "During the course of our fieldwork, our review of compliance with VSE rules, regulations, and by-laws did not identify any reportable deficiencies."

¶ 282 Pacific International was not named in the VSE citation against Hauchecorne.

¶ 283 In 1998, Pacific International's compliance practices were reviewed by National Bank Financial when they conducted their due diligence in connection with their

acquisition of 35% of Pacific International shares. Nothing was said to the directors about any deficiencies.

¶ 284 Holley testified that, before the events of mid-1999, Pacific International had demonstrated an appropriate commitment of resources to compliance, had employed competent staff and had an appropriate compliance infrastructure in place. This testimony confirms what the directors believed to be the case.

¶ 285 The directors approved the hiring of McQuid as, among other things, its chief compliance officer. They knew McQuid's history and his reputation.

¶ 286 Meier testified that Pacific International used a system of corporate governance modelled after one put in place by Meier and others at the VSE, with the assistance of a consultant who is recognized as an expert in corporate governance.

¶ 287 A number of the directors were also investment advisors and had regular contact with the compliance department.

¶ 288 The directors had a broad range of complementary skills.

¶ 289 The directors had regular contact with each other on a daily basis.

¶ 290 The directors were obligated to take reasonable steps to ensure that an adequate system of compliance was in place. If they saw something that called the system into question, they were obligated to investigate it. The Pacific International directors did establish an appropriate system of compliance. In each case, they testified that, with minor exceptions, they received all the information they needed to fulfil their duties and they believed they reacted appropriately to that information.

¶ 291 The Executive Director must meet a very high threshold to show that directors acted unreasonably. In our view, the Executive Director fell short of that threshold. Generally, regulators should be slow to interfere with decisions made by directors in managing their company's business and affairs.

¶ 292 This is particularly so when:

- the Executive Director did not prove that Pacific International contravened any laws (other than the Screening Deficiencies).

- the Executive Director did not prove that Pacific International should have been put on notice and made inquiries because of trading in a client account.

- Pacific International had well developed governance and compliance structures.

- Pacific International had competent and well respected compliance staff.

¶ 293 **We find that the Executive Director did not prove that the Pacific International directors acted unreasonably in fulfilling their duties and, therefore, the directors did not fail to fulfil their duties under the *Company Act*.**

6. Compliance With Applicable Laws

¶ 294 In paragraph 30 of the NOH, the Executive Director alleged that "The Directors failed to ensure that Pacific International's conduct, business and affairs complied with all applicable laws, regulations, rules, and by-laws".

¶ 295 We deal with two matters here.

¶ 296 Under the heading Business Procedures, we referred to Pacific International's admissions that it failed to comply with regulatory requirements. Under the heading Screening Deficiencies, we referred to the Executive Director's allegation that Pacific International failed to comply with the know your client rule for three Hauchecorne accounts.

¶ 297 Paragraph 21 of the NOH defined these matters as Screening Deficiencies and alleged:

> Pacific International failed to fulfil the requirements of various rules and statutes to ensure it had proper client information as follows:
>
> 21.1 Client verification procedures in the Accounts frequently did not satisfy the requirements of the *Proceeds of Crime (Money Laundering) Act*, S.C. 1991, c. 26, P-24.5, and the *Proceeds of Crime (Money Laundering) Regulations* SOR 93-75.
>
> 21.2 Some Account opening documents lacked certain information, such as proper client identification or other essential facts.
>
> 21.3 Trading and other activity occurred in some Accounts before a designated partner, director, or officer approved the opening of the

> Account, as required by CDNX Rule F.1.01.3 (formerly VSE Rule F.1.01.c) and IDA Regulation 1300.2.

¶ 298 Pacific International admitted the contravention of money laundering legislation described in paragraph 21.1, and the contravention of VSE and IDA rules on account opening described in paragraph 21.3. In 1999 and 2000, this commission found, in two other hearings, that Hauchecorne contravened the know your client rule with respect to the accounts involved in paragraph 21.2.

¶ 299 In all three matters, however, there are other factors to consider.

¶ 300 With respect to money laundering legislation, properly identifying clients was a problem faced by the entire brokerage industry in Canada and failure to satisfy these requirements was commonplace at the time. The IDA and the VSE knew the industry was not in compliance. Pacific International took a number of steps on its own to try and solve the problem. It also discussed the problem at industry meetings, with a view to establishing industry wide procedures. It is somewhat ironic that this still appears to be a continuing problem for the industry.

¶ 301 With respect to the deficiencies in account opening documents of the three clients, the accounts in question were located offshore. Account opening procedures and documentation for offshore accounts during the Material Time, and for some time thereafter, were an industry wide issue. In *Re Jean-Claude Hauchecorne* [2000] 30 BCSC Weekly Summary 11, the commission did not prescribe any procedures to deal with offshore accounts, but, in recognition of the industry wide issue involving offshore accounts, left it to the industry to resolve. The commission said:

> Neither of the Commission hearings [on this matter] was for the purpose of establishing general standards for registrants when opening corporate accounts. This is particularly so given that the industry is now undertaking a consultation involving registrants and regulators on a national basis. It is far preferable that the ultimate policy determination flow out of that process, which will afford all interested parties the opportunity to participate in a full debate on the issue.

In light of this decision, we have not found that Pacific International contravened the know your client rule with respect to these three Hauchecorne accounts (see Findings Under Know Your Client Rule).

¶ 302 With respect to account opening approval, Pacific International followed a procedure that, while not in strict compliance with regulatory requirements, was, in Pacific International's opinion, at least as robust as was prescribed. The result

of the procedure, however, was that the required partner, director or officer approval was not always obtained until after the mandatory 24 hour time limit, even though senior compliance staff had reviewed the material and "signed off" on it within the 24 hour requirement. We regard this matter as form over substance.

¶ 303 None of these three contraventions was identified by the VSE in their audits. Nor has the federal department responsible for enforcing money laundering legislation alleged that Pacific International failed to obey applicable laws.

¶ 304 The admitted contraventions were rectified almost two years before the NOH was issued.

¶ 305 **After considering all these factors, we are not prepared to sanction the Respondents for the admitted contraventions.**

¶ 306 We recognize that firms must comply with all applicable laws and that directors are supposed to ensure that takes place. In these unique circumstances, however, we are not prepared to find that the directors acted inappropriately. It was appropriate for the Pacific International directors to let McQuid deal with the two industry wide matters. The remaining matter was procedural and we have already decided it was a case of form over substance.

¶ 307 We are surprised to see these allegations in the NOH. Two of these contraventions were well known industry wide problems at the time. The other is a procedural matter where Pacific International could readily have complied on a technical basis. In our view, these matters would have been better dealt with at a compliance level and not at a hearing before the commission.

¶ 308 The only laws, regulations, rules and by-laws that fall within this allegation are SRO rules dealing with conduct already reviewed under sections 44 and 48 of the Rules, federal money laundering legislation and the PDO rule. We have already made findings on the federal money laundering legislation and the PDO rule.

¶ 309 Where the Executive Director alleged non-compliance with the Act or Rules (in this case sections 44 and 48 of the Rules), it is not necessary for the Executive Director to repeat the allegation for SRO rules that deal with the same requirements. **We therefore make no findings on these SRO rules.**

¶ 310 In final argument, the Executive Director alleged that McQuid failed to ensure PDO approval. In the NOH, this was stated to be a Pacific International responsibility.

¶ 311 This allegation was not made against McQuid in the NOH. The Executive Director argued that all allegations against the directors in the NOH were against the directors as a group and not against an individual director. Therefore, there is no basis for the Executive Director to argue that we should make a finding against McQuid. Pacific International admitted to this failure and we have dealt with it on that basis.

7. Gatekeeper Responsibilities

¶ 312 In paragraph 31 of the NOH, the Executive Director alleged that the Respondents acted contrary to the public interest when they "failed to fulfil their roles as gatekeepers in the securities industry".

¶ 313 The Executive Director argued that Pacific International failed in its role in the following way:

> The Respondents' Gatekeeper duty required that they effectively supervise their clients in order to protect the integrity of the securities market. If they could not effectively supervise their clients, they should not have been doing business with them.
> …
>
> Their Gatekeeper duty requires that they decide whether they can effectively supervise their clients. If they cannot, they should not open accounts for them.

¶ 314 The Executive Director further argued that:

> Staff's common sense proposition [is] that if Pacific International could not effectively supervise its non-resident experienced market participant OTCBB business that they should have got out of that business.

¶ 315 In summary, the Executive Director used the gatekeeper role as the premise for arguing that Pacific International should have stopped doing business with all its non-resident experienced market participant clients who traded on the Bulletin Board. Indeed, Pacific International did this, voluntarily, in the summer of 1999, but the Executive Director says it should have been done in the spring of 1997.

¶ 316 The gatekeeper role is not defined or mandated in the Act. The role comes from a series of VSE Notices, and a notice issued by this commission. The notices focus on the public interest obligations of investment advisors and dealers to be alert to potential illegal trading and to advise the regulators. The notices also remind

dealers of their obligations under the know your client rule and the business procedures rule.

¶ 317 Following are extracts from VSE Notice to Members #96/97, issued in 1997:

> … it is the duty of RR's to act in the best interests of their clients. However, the RR's must also act in the best interests of their employers and through them the whole Securities Industry. From this it follows that if the RR becomes aware, through knowledge of the client or otherwise, that the intention or effect of the trading by a client would be in breach of the Securities Act or impugn the integrity of the market place, then it is incumbent on the RR in the capacity of "Gatekeeper" within the Securities Industry, to draw the matter to the attention of Management of the firm and the Member shall draw this to the attention of the Exchange. Further, wilful blindness on the part of RR's, may equally be construed as failure to meet their responsibilities.
>
> Particular attention is drawn to Rules F.2.17.1(5) which address the areas of deceptive and manipulative trading and market corners.
>
> It is, in this regard, important for each RR to be aware of potential signs of market manipulation.

¶ 318 The VSE's gatekeeper notice was essentially copied by this commission when it issued its own notice.

¶ 319 In our view, the gatekeeper notices provide the industry with guidance on how to comply with the know your client rule. It also provides the industry with guidance on their public interest obligation to report potential illegal activity. Also, in our view, that illegal activity would include not only market manipulation, as is suggested in the notices, but also activity such as insider trading and money laundering.

¶ 320 The know your client and public interest obligations do not, as the Executive Director argued, extend to activities of a client outside of their account at the firm, unless the firm has knowledge of those activities. In that case, we say the registrant would have an obligation to make inquiries of the client under the know your client rule, if those activities cause doubt as to the business or financial reputation of the client.

¶ 321 Every firm has an obligation to assess the risk of dealing with a client and to properly supervise the activity in the client's account. This obligation comes from

the know your client rule, which does not include a prohibition against dealing with a client.

¶ 322 We again note that the Executive Director has not introduced any evidence to prove that money laundering or manipulative trading occurred in Pacific International's client accounts. We have found that Pacific International did not contravene the know your client rule. The Executive Director did not produce evidence to show that the Respondents acted contrary to the public interest by failing to report potential illegal activity.

¶ 323 **We find the Executive Director did not prove that the Respondents acted unreasonably in fulfilling their gatekeeper responsibilities.**

¶ 324 September 1, 2006

¶ 325 **For the Commission**

John K. Graf
Commissioner

Roy Wares
Commissioner

2006 BCSECCOM 532

FINDINGS OF VICE CHAIR SALVAIL-LOPEZ

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I. INTRODUCTION

¶ 326 I have read the decision of Commissioners Graf and Wares. While they were writing their decision, I gave them drafts of my findings. I do not concur with their decision.

¶ 327 The principal allegations in the notice of hearing are that:

1. Pacific International failed to learn the essential facts about certain clients, contrary to section 48 of the Securities Rules, and acted contrary to the public interest by failing to fulfil its role as a gatekeeper of the capital market;
2. Pacific International failed to establish and apply written prudent business procedures for dealing with clients, contrary to section 44 of the Securities Rules; and
3. the directors acted contrary to the public interest by failing to exercise the care, diligence and skill of a reasonably prudent person, contrary to section 118 of the Company Act.

II. KNOW YOUR CLIENT

¶ 328 Section 48 of the Securities Rules, BC Reg 194/97, provided:

> 48 (1) A registrant, except an underwriter or a securities adviser, must make enquiries concerning each client
>
> (a) to learn the essential facts relative to every client, including the identity and, if applicable, credit worthiness of the client and the reputation of the client if information known to the registrant causes doubt as to whether the client is of good business or financial reputation, and
>
> (b) to determine the general investment needs and objectives of the client, the appropriateness of a recommendation made to that client and the suitability of a proposed purchase or sale for that client.

¶ 329 The Commission reviewed the general obligations on registrants, including the know your client rule, in *Re Hauchecorne* [1999] 51 BCSC Weekly Summary 69. In *Hauchecorne*, the Commission upheld the decision of a Vancouver Stock Exchange hearing panel that Jean-Claude Hauchecorne had contravened the know your client rule in respect of the Ubiquity accounts at Pacific International. The Commission said:

> A registrant occupies a special and privileged place in the securities market. Securities dealers and the employees acting on their behalf must be registered under the Act and must meet stringent qualifications to obtain and maintain registration. They are also subject to extensive rules of conduct under both the Act and the by-laws and rules of self regulatory organizations like the Exchange. These rules of conduct are intended to protect investors and to ensure the integrity of the securities market.
>
> The "know your client" rule plays a central role in this scheme of regulation…

¶ 330 Like the other rules of registrant conduct, the know your client rule is designed to protect both the client and the integrity of the capital market. To protect the client, a registrant is expected to determine the suitability of all proposed trades for the client. To protect the integrity of the capital market, a registrant is expected to act as a gatekeeper for the market.

¶ 331 Both the VSE and the Commission provided guidance to registrants regarding their gatekeeper responsibilities. The VSE issued a notice in 1989 and updated notices in 1994 and 1997. The 1994 gatekeeper notice described the basic gatekeeper responsibilities, before providing more detailed guidance:

> The world wide attention that has been placed on the Securities Industries in many jurisdictions makes it appropriate to review and restate the guidelines under which RR's and other industry participants should operate. In particular, the role of the Member and its employees in upholding the integrity of the market place (the role of "Gatekeeper") continues to be of major importance.
>
> The Know Your Client rule is one of the fundamental rules of the Securities Industry. It is incumbent upon any RR to have as full a knowledge as possible of the personal circumstances and investment objectives of all clients, both on an initial and an ongoing basis. It follows that it is the duty of RR's to act in the best interests of their clients.
>
> However, the RR's must also act in the best interests of their employers and through them the whole Securities Industry. From this it follows that if the RR becomes aware, through knowledge of the client or otherwise, that the intention or effect of the trading by a client would be in breach of the Securities Act or impugn the integrity of the market place, then it is incumbent on the RR in the capacity of "Gatekeeper" within the Securities Industry, to draw the matter to the attention of Management of the firm and the Member shall draw this to the attention of the Exchange. Further, willful blindness on the part of RR's, may equally be construed as failure to meet their responsibilities.

¶ 332 The Superintendent of Brokers of the Commission issued a notice in 1995 that provided further guidance. The notice reminded market participants that public participation in the capital market depends greatly on public confidence in the fairness and integrity of the market. The fair trading notice described the responsibility of registrants in that regard:

> Registrants have a responsibility to stock exchanges, to their clients and to the market place generally to ensure that their activities are carried out responsibly and in compliance with the letter and spirit of the legislation and exchange rules and by-laws. The following are examples of some of the activities that are expressly prohibited by exchanges and do not comply with the principles of fair trading:
>
> (a) making a fictitious transaction;
>
> (b) giving or accepting an order which a person knows or ought to know does not involve a change of ownership of the securities in question;

(c) purchasing, selling, or offering to purchase or sell securities where the person knows or ought to know that the effect of such a purchase or sale would be to unduly disturb the normal position of the market or to create an abnormal market condition in which market prices do not fairly reflect current market values, or being a party to any plan or scheme to do so;

(d) confirming a transaction when no trade has been executed;

(e) indiscriminate or improper solicitation of orders either by telephone or otherwise;

(f) high pressure or other trading tactics of a character considered undesirable;

(g) using or participating in the use of any manipulative or deceptive method of trading where the person knows or ought to know the nature of the method; and

(h) violation of any statute applicable to trading in securities.

Even if a registrant is not directly involved in an unfair or inequitable activity, the registrant is expected to be inquisitive and pro-active in dealing with such activities that are carried on by others and of which the registrant is or should be aware. Registrants should refuse to accept instructions from clients who, in the registrants' judgment, are engaged in illegal, unfair or abusive trading activities. All such instructions or orders should be reported immediately to the registrant's senior management. Senior management are expected to bring matters concerning serious misconduct in the markets to the attention of the stock exchange or the Compliance and Enforcement Division of the Commission.

¶ 333 A registrant's know your client responsibilities begin at the time the client opens an account. In *Hauchecorne*, the Commission focussed on the importance of learning the essential facts about a client at the time the account is opened. The Commission's decision included an excerpt from the Conduct and Practices Handbook. The Handbook is an industry manual that governs the conduct of registrants. The Commission said:

> The Handbook refers to the "know your client" rule as the "Cardinal Rule". After stating the rule at page 38, the Handbook discusses the importance of the new client application form, as follows:

The first step towards compliance with this regulation is made by means of a New Client Application Form which must be completed when opening each account. To assist the client in fulfilling his or her investment objectives and to assess whether proposed securities trading activity is in keeping with industry rules, the RR [registered representative] must maintain a continued awareness of the client's personal and financial circumstances.

Accurate and complete information on the form provides data necessary to fulfil three basic requirements set by regulatory authorities:

(i) The firm must obtain the information necessary to judge the risk involved in accepting the account.

(ii) The RR must obtain background information about the client and the client's family in order to advise on the initial purchase and in building a portfolio in line with the account's developing investment objectives.

(iii) The RR and the firm must obtain sufficient information to determine what special industry rules will apply to the opening and trading of the account.

At page 43, the Handbook discusses the opening of accounts in two special circumstances where the new client application form specifies that additional documentation is required:

Full information must be detailed as to any person(s) having authority to instruct the RR to carry out any securities transaction, to withdraw, deposit or transfer assets, etc. In addition, full disclosure must be made of any person(s) having a beneficial interest in the account and/or future profits or losses in the account. Nominee and joint accounts are two examples of accounts which fall into this category and require the identification of all parties having control or financial interest in the account.

… In the event that the account is opened for a corporation, partnership, or other business interest, the same care in assessing its financial stability should be taken as for an individual unless the company's financial capability and business character are obvious because of its size, listing on an Exchange, etc. In the case of smaller companies, the true owner and officers of the company and persons entering orders must be identified. Names of nominees

> may not be substituted unless they are separately identified and the firm has appropriate documentation.

¶ 334 The first of the three basic requirements referred to in the Handbook is particularly relevant to this case. Pacific International, like any dealer, must obtain the information necessary to judge the risk involved in accepting an account. This risk assessment allows the dealer to make two critical decisions.

¶ 335 The first is to define the supervisory regime that would be appropriate for the account. Two of the factors the dealer would consider in defining that supervisory regime would be the nature of the client and of the client's proposed activity. Another factor would be any special industry rules applicable to the account, as noted to in requirement three.

¶ 336 The second critical decision is whether to accept the account. Unless the dealer is satisfied that it can establish and effectively apply the appropriate supervisory regime, it should not accept the account.

¶ 337 The need for careful assessment at the time a dealer opens an account was also emphasized in the Holley Report. Dean Holley was retained by Pacific International on July 16, 1999, to conduct a review of its compliance and supervisory policies and practices. Holley submitted his report to Pacific International on August 13, 1999. The report said:

> In our view, the standards of account supervision expected of dealers will generally increase whenever the dealer is trading in risky securities (particularly in securities of non-reporting issuers and OTC BB [Over the Counter Bulletin Board] securities), trading for non-resident clients about whom less information may be available, and trading for 'market participants' (registrants, promoters, investor relations personnel, insiders and control persons).
>
> As part of the know-your-client requirements, registrants are obliged to make inquiries concerning the 'business and financial reputation' of potential clients in many circumstances. The regulations, however, do not set out specific criteria about how a dealer is to exercise judgment in determining whether or not a client is 'acceptable'. Dealers must establish their own guidelines regarding the acceptance of clients based on their assessment of risk and on their ability to effectively supervise account activity.

> As a general principal, we believe that the firm can best protect itself by concentrating its supervisory efforts on the careful assessment of clients at the time they first come to the firm.

¶ 338 When Pacific International opened the Ubiquity accounts – Ubiquity Holdings Ltd., First Nassau Ltd., Roddy Di Primo S.A. and Louis Metzer – it did not know the identity or creditworthiness of the corporate clients. The only information Pacific International had about each of the three companies was a name, a phone number and an address that was a post office box in the Bahamas. Pacific International had no information about the business of the companies. It had no information about the beneficial owners of the accounts. It had no information about three of the four authorized persons on the accounts; only Obafemi Pindling's personal information form had been completed and even it lacked his date of birth.

¶ 339 Pacific International failed to make inquiries to learn the essential facts about the Ubiquity clients at the time Pacific International opened their accounts. This made it impossible for Pacific International to assess the risks associated with the accounts. Without that risk assessment, Pacific International was unable to define an appropriate supervisory regime for the accounts or to determine whether it was able to effectively implement that regime. In the absence of that risk assessment and analysis, Pacific International should not have accepted the Ubiquity accounts.

¶ 340 A registrant's know your client responsibilities are ongoing. They do not end when the registrant decides to accept the account.

¶ 341 The supervisory regime applied to the account will generate information for the registrant. The registrant must monitor, analyze and, if indicated, act on that information. Action could take many forms, from making further inquiries and gathering more information (from inside or outside the firm) to closing the account.

¶ 342 Different departments in the firm play different roles in this process. The investment advisor has direct contact with the client and is on the front line. Credit, Operations and Trading each receive different types of client information. Research is a source of a variety of information from outside the firm. Compliance, however, plays a critical role in the know your client process. Compliance is essentially the firm's investigations unit, a role that was recognized by Holley in his testimony:

> A What you expect compliance people to do, at least what I expect compliance people to do is look for potential problems, to exercise,

> demonstrate some understanding exactly what the problem might be, and take appropriate supervisory steps. Whether that's conducting an investigation, to concluding that they saw a problem in trading pattern, to raising concerns about a client, you expect the investigators, and compliance officers are similar in most respects to investigators, you expect compliance officers to look for dirt and to take appropriate steps and to come to some fairly forceful conclusions about what they think they found.

¶ 343 In order to determine whether Pacific International met its ongoing know your client responsibilities, I looked at five groups of accounts.

1. Ubiquity

¶ 344 Pacific International decided to accept the Ubiquity accounts. The corporate accounts were opened in May 1995 and the Metzer account in August 1995. The investment advisor for the accounts was Hauchecorne. In late March and early April 1996, Pacific International received three requests to wire a total of over $1.7 million (all amounts are in US dollars unless otherwise noted) out of the Ubiquity account to an account in the name of Ubiquity at a bank in Hong Kong.

¶ 345 On April 15, one day before Pacific International received the third wire request, Lawrence McQuid received a call from Philip Gurian. Gurian had been the referral on the Roddy Di Primo and Metzer accounts, but was not an authorized person on any of the accounts. Gurian told McQuid that he had been entering orders on the Ubiquity account and wanted information about the account, particularly about certain trades of which he had been unaware. McQuid told Gurian that he could not have the information because he was not authorized on the account.

¶ 346 After Gurian's call, McQuid talked to Hauchecorne. Hauchecorne told him that Hauchecorne took instructions from Gurian from time to time, but always confirmed those instructions with an authorized person. McQuid told Hauchecorne to discuss with his client getting Gurian authorized on the account, if Gurian was going to continue to provide instructions.

¶ 347 McQuid said that he probably reviewed the Ubiquity file after Gurian's call. He recalled seeing the first two wires, which totalled $1 million, and thinking that they were consistent with a dissatisfied client, who had accused his investment advisor of discretionary trading, removing his funds from the firm to prevent further discretionary trading:

> A I recall seeing that [the first two wires], and I recall thinking that that was consistent with a dissatisfied client, so that if his concern was on trading then the very first thing that he's doing is making sure that the account or the funds are removed from the firm. He was consistent with my -- I haven't had anything like this in my previous experience, but my previous experience is it that if a client is dissatisfied with their account, if the allegation is that the salesman is doing discretionary orders on the account, then they will often get the account out of the firm so it isn't ongoing.

¶ 348 McQuid said that he was not concerned about this situation, but kept a closer eye on the trading in the Ubiquity accounts after Gurian's call. However, McQuid said that he did not want to be made aware of any requests to transfer funds out of the accounts because Gurian had talked only about trading; he had said nothing about funds being improperly removed from the account.

¶ 349 The third wire was sent on April 18. McQuid was not sure whether he knew of the request before the wire was sent.

¶ 350 Gurian began calling again in early May. In a call to Jay MacFarlane (Credit) around that time, Gurian alleged for the first time that $1.5 million had been wired out of one of the accounts without authorization. Gurian claimed that Hauchecorne and one of Hauchecorne's associates had stolen the money. MacFarlane told McQuid of this call shortly afterwards. Gurian called McQuid for the second time on May 23. Gurian said that he was the agent for the Ubiquity accounts and that Hauchecorne had stolen $1.5 million from those accounts. He would not say from which account and again demanded account statements. McQuid refused to send them.

¶ 351 McQuid took some action in response to Gurian's second call. McQuid again talked to Hauchecorne, who again assured him that Pindling had authorized all transactions and that there was nothing improper on the Ubiquity account. McQuid tried to call Pindling at the number in the new client application form, but no one ever answered. McQuid had Operations summarize "relevant" information about each account, including recent monthly statements and wire requests, and reviewed the summary.

¶ 352 McQuid said that Gurian accused Hauchecorne of theft in order to get the account statements:

> Q So, I take it you agree with me that that is something that is out of the ordinary, an allegation of a theft of $1.5 million by one of your brokers, correct?

A It, it most certainly is out of the ordinary, but it would be more, more startling if it hadn't been in the context of him calling several times looking for account statements. When he doesn't get what he wants, then he appears to be escalating it so that we will give him what it is that he is calling for.

¶ 353 In the end, McQuid concluded that nothing more needed to be done. He noted in his memo to file regarding Gurian's second call:

> No further inquiries or action will be taken unless requested by one or more of the clients or unless there are other facts to support making such inquiries.

¶ 354 There were other facts to support making further inquires:

- Gurian's first call to McQuid in April had raised a concern that Hauchecorne had been taking instructions from an unauthorized person. That call, combined with the $1 million that had just been wired out of the account, raised a second concern – that Hauchecorne had been making discretionary trades. Now there was a third concern; Hauchecorne had been accused of stealing $1.5 million from an account. All three concerns involved serious allegations against Hauchecorne.
- The Ubiquity accounts were very important to Hauchecorne. They generated approximately $250,000 in gross annual commissions and accounted for two thirds of Hauchecorne's US business. US business accounted for almost half of Hauchecorne's total business in 1995.
- There were credit concerns with the accounts. By January 1996, Pacific International was loaning the accounts over CDN$2 million against Cellstar stock that had been purchased on margin. By the end of March, that amount was CDN$1.67 million, but rising again. As well, by late March, the Roddy Di Primo account was short 95,000 Osicom shares, with a market value of over $825,000. McQuid and the rest of Executive Committee knew of these concerns and McQuid was taking some steps to deal with them. He had told Hauchecorne to reduce both amounts. He had instructed Compliance to do searches through the VSE of Roddy Simon, the authorized person on the Roddy Di Primo account, and Metzer (neither search revealed any information). He had instructed Research to do an assessment of Cellstar.
- The account opening documentation for the Ubiquity accounts was incomplete. The address for each of the clients was a post office box in the Bahamas. There was no information about the business or beneficial owners of the three corporate clients. There was no information about the persons authorized on the accounts, other than Pindling.

- The identity of the authorized persons on the Ubiquity account was ambiguous. The original authorized persons had been Pindling and Joy Cartwright. In March 1996, Ubiquity delivered in a share certificate with a power of attorney signed by Lisa Gibson. Operations checked with Hauchecorne, who said that he did not know but that he would have an agent for Ubiquity call them. Gurian told Operations that Cartwright and Gibson were authorized on the account. Acting on Gurian's instructions, Operations requested a letter of resignation from Pindling and Cartwright, and sent out a package of new account documentation for signature by Cartwright and Gibson. At least some of the documents, signed by Cartwright and Gibson, were returned to Pacific International.
- Operations noted that Cartwright's signature had changed. The signature on the new account documents was different from the signature on the original account documents. When McQuid learned of this, in May or June, he did not ask either Hauchecorne or the client for an explanation.
- The three wire requests had ostensibly been signed by Pindling. Despite the size and destination of the wires, and the ambiguity as to Pindling's authority over the account, Operations had acted on the wire requests after doing nothing more than verifying that the signature on the faxed requests appeared to be the same as the Pindling signature they had on file.
- Hauchecorne's assistant also had information about the Ubiquity accounts. If asked, she could have told McQuid, as she told Pacific International's lawyer that July, that Gurian's involvement in the Ubiquity accounts extended far beyond giving instructions from time to time. She said that Gurian gave very detailed instructions on an almost daily basis. She said that, when Hauchecorne called Pindling to confirm those instructions, Hauchecorne would say: "I just want you to be aware that …". She said that it was obvious that "Pacific International was one of many brokers that Gurian used" as he sometimes became confused about which accounts he had where.

¶ 355 All of this information was within Pacific International and either known by or available to McQuid.

¶ 356 The calls from Gurian to McQuid and Pacific International staff should have caused doubt as to whether the four Ubiquity clients were of good business or financial reputation. They also should have raised concerns about the identity of the clients and the purposes for which the accounts were being used. These doubts and concerns should have caused Compliance to make further inquiries about the clients.

¶ 357 On May 24, the day after McQuid's second call from Gurian, Hauchecorne was assaulted in his New York hotel room by Gurian, Metzer and two others. McQuid

and the rest of the Executive Committee did not learn of this incident until late June, when they brought Hauchecorne to Vancouver. Hauchecorne was summoned to explain the letter Pacific International had just received from Ubiquity's lawyer demanding the return of the $1.7 million that had been wired out of the Ubiquity account.

¶ 358 It was that letter that finally caused McQuid to take some real action. He gave instructions that nothing was to occur on the Ubiquity accounts without his authorization. He told Compliance to apply heightened supervision to Hauchecorne and his clients. He told Hauchecorne to put his non-computerized trades through the trade desk. Finally, after a discussion at their meeting on June 25, the Executive Committee summoned Hauchecorne to Vancouver to "discuss this matter".

¶ 359 From July onward, McQuid spent a great deal of time trying to discover exactly what Hauchecorne knew, seeking out other information, and liaising with regulatory and law enforcement agencies. His primary purpose in all of this was to recover the $1.7 million. Had Pacific International devoted the same diligence to knowing these clients at the time the accounts were opened, and on an ongoing basis, Pacific International might never have been involved in the events that led to the June 1999 indictment against Gurian and Metzer.

¶ 360 That indictment charged Gurian, Metzer and three others with securities fraud, wire fraud, mail fraud, money laundering, and RICO violations. The indictment alleged:

- Metzer was an alias of Philip Abramo, a capo, or captain, of the DeCavalcante family of Cosa Nostra.
- Gurian had a hidden interest in, and controlled the trading decisions and operations of, Sovereign Equity Management Corporation (a US broker dealer) and Falcon Trading Group Inc. (a US hedge fund).
- The defendants obtained discounted shares in three financially troubled issuers, including SC&T International Inc.
- The shares were deposited into accounts of nominee Bahamian companies that were controlled by the defendants.
- The defendants caused the issuance of false news releases about the financial affairs and prospects of the three issuers, in order to raise the price of their shares.
- The Sovereign brokers sold the shares to their retail clients. The defendants offered the brokers extra commissions, or juice payments, to sell the shares. The defendants also ordered the brokers not to permit Sovereign's clients to sell the shares while the defendants were still selling theirs.

- Once the defendants had sold their shares, they ordered the Sovereign brokers to stop supporting the share prices. The defendants then sold short the shares of the three issuers. The short sales were done through Falcon and through nominee Bahamian companies with accounts in Vancouver, Canada and elsewhere.
- In order to obtain shares to cover their short positions, the defendants engaged in extortion of other brokers. They used their stated relationship to the mafia and threatened the brokers with bodily harm.
- When a nominee of one of the Bahamian companies authorized money to be wired from the company's account, the nominee was murdered and the broker who transferred the money was threatened with death.
- By participating in this scheme, the defendants made tens of millions of dollars in profits.
- The defendants also bankrupted the three issuers and left Sovereign's clients with worthless shares.

The indictment referred to Hauchecorne and to the Ubiquity, Roddy Di Primo and Metzer accounts at Pacific International. It described certain deposits of money and shares into the Ubiquity account and a trade in the account. It also described the $1.7 million wire transfers from the Ubiquity account and the New York hotel incident.

¶ 361 I have concluded that Pacific International failed to make inquiries to learn the essential facts about the Ubiquity clients at the time it opened their accounts. I also conclude that Pacific International failed to make inquiries to learn the essential facts about these clients during April and May 1996, when Operations received the three wire requests and McQuid, and other Pacific International staff, received the calls from Gurian.

2. Globus

¶ 362 Pacific International opened an account for Marvin Kowalski on February 14, 1996. Kowalski had an address in New York and described himself as self-employed in investments. His new client application form stated that he deposited 50,000 shares of Globus Group Inc. at the time he opened the account. Globus shares were quoted on the OTC BB.

¶ 363 Pacific International opened an account for Della Limited on February 28. Della's address was a post office box in Antigua, West Indies. Its business was "investers corp". The authorized persons on the account were Edward Vertsman and Albert Khayut. The new client application form stated that the company deposited 50,000 shares of Globus at the time it opened the account.

¶ 364 Pacific International opened accounts for Virgo Bay Limited and Leeward Cove Holdings Ltd. on May 6. Both companies had the same address, which was a post office box in the Bahamas. There was no description of either company's business. The authorized person on both accounts was Nancy Lake.

¶ 365 The investment advisor for all four accounts was Leigh Ivancoe.

¶ 366 On June 19, the VSE requested Pacific International to produce documents on the Virgo Bay account. The request originated with the National Association of Securities Dealers and part of it referred specifically to account activity in June.

¶ 367 Sometime in November, a person from the FBI called Pacific International and spoke with McQuid. The FBI wanted to know which clients at Pacific International had been trading an OTC BB stock called Globus. McQuid understood from the call that the FBI was in the very early stages of an investigation into the trading in Globus through an American broker dealer called Hillcrest. During the call, McQuid advised the caller how to obtain the documents he was looking for, namely by going through the Commission, the VSE or the RCMP. McQuid also told the caller that Pacific International would start preparing the documents in anticipation of receiving a request from one of those agencies.

¶ 368 After the call, McQuid determined that the Kowalski, Della, Virgo Bay and Leeward Cove accounts had traded Globus shares. He did not recall if any other account had traded the stock.

¶ 369 McQuid acknowledged that he did not often receive calls from the FBI and that he knew that the FBI dealt with serious national or international matters. He described his level of concern at the time:

> A As I remember my thought process at that time was that, yes I was concerned to get a call from the FBI, and I told them how to get the information it was that they were looking for, and I looked myself to see which accounts not knowing if anything had happened in the -- in the accounts that was going to be of interest to them. My concern was more of if we were going to continue trading the security, and I remembered thinking at the time that there was very little security left at the firm, we hadn't traded it for some time prior to the -- to the call, so I was thinking, I think, more on an ongoing supervisory basis.
>
> Q Okay. But doesn't it -- let's say that you looked in these accounts and they had been trading the stock in question, Globus, but the

Globus stock had all gone out, and there is nothing more, don't you still have a concern, although the stock's gone out, you still have the clients who were now trading in something else, but the client hasn't changed; correct?

A That's true, yes.

Q And if the FBI is looking at their trading in one stock, doesn't it concern you that where there's smoke there might be fire?

A I don't remember thinking that at the time. I think when I look back on it hindsight the answer to that would be yes.

¶ 370 McQuid said that, when he looked to see which accounts had traded Globus shares, he did not know "if anything had happened in the – in the accounts that was going to be of interest to them". If McQuid had looked at the account documentation for these four accounts, he would have seen the following:

- All four accounts had been opened within a three month period beginning in mid-February. One account was for a US resident who was self-employed in investments. Each of the three corporate accounts had an offshore post office box as an address, one in the West Indies and two in the Bahamas. One of the companies described its business as "investers corp"; neither of the other two described its business at all.
- Ivancoe was the investment advisor on all four accounts
- Between February and May, 640,000 Globus shares had been delivered into the four accounts.
- Between February and September, all four accounts had traded Globus shares. There had been over 90 trades in the Della account and over 60 trades in the Kowalski account. With very few exceptions, neither account traded any other security. The Virgo Bay and Leeward Cove accounts traded smaller numbers of Globus shares.
- Between February and September, the price of Globus shares rose and fell sharply. The first sale from the Kowalski account was on February 16; the price was $5.375. By August 20, the price was $8.00. The price on September 30 was $2.00.
- Between February and October, Kowalski wired $2,730,108 out of his account:
  - $556,436 to the client;
  - $1,346,459 to other Pacific International clients, including Virgo Bay and Leeward Cove;
  - $481,737 to Globus; and
  - $345,476 to other third parties.
- By November, as McQuid had noted, "there was very little security left at the firm".

¶ 371 This information should have raised a very serious concern as to whether these four accounts had participated in a manipulation of the market for Globus shares. In order to resolve that concern, Compliance needed to make further inquiries. For example, had Compliance looked at market information for Globus shares since the beginning of the year, they would have learned more disturbing information. According to a press release issued by the US Attorney in April 1997, the price of Globus shares had been $.25 in January 1996, reached $8.00 by September, and fallen to less than $.40 in October.

¶ 372 McQuid was asked whether the deposit of the Globus shares into the four accounts was unusual or suspicious:

> Q At the time did you consider it to be unusual or suspicious that these shares were deposited into several different Pacific International accounts?
> A Well, the receipt of either warrants or share certificates by firms is the normal course of business, that's how -- that's how shares that companies issue get into the -- into the brokerage and the clearing system. In fact, to my knowledge that's the only way that they could get into the system. So it's not unusual. You deal in certificates every day.
> Q How significant is the number 640,000 shares in the context of Globus?
> A It's not. As I recall it these -- these deposits trickled in over a period of time, and for the most part they were small deposits of 30,000 or 50,000, and I think I said the other day that the deposits were under a hundred, but on subsequently re-checking there were I think two for 101,000 and change.
> Q So aside from those two deliveries in of a hundred thousand shares, the others were in the 50,000 or less range?
> A They were in you small quantities, yes.
> Q And again, the significance of those numbers is what?
> A There is no significance to them. They are small quantities of shares that would -- would probably go unnoticed unless there was some intervening matter that brought them to someone's attention.
> Q And did such an event transpire?
> A No.

¶ 373 The trickling in of those 640,000 Globus shares, along with all of the other activity in the four accounts, should not have gone unnoticed. Holley addressed these types of activity in his report:

Trading and Activity in Securities of OTC Bulletin Board Issuers

The delivery and the subsequent resale of OTC BB securities by U.S.-resident clients was an element of more than one of the recent U.S. indictments. The receipt by Pacific International of significant amounts of stock in the Bulletin Board issuers, either as physical certificates or IMM [inter-member movement] transfers, has not been uncommon and is a significant area of activity for Operations Department staff.

There is obviously no regulatory prohibition to the receipt and sale of securities by an investment dealer, but past experience has highlighted the unique risks of concentrated activity in the Bulletin Board market. In an effort to address those risks Pacific International has adopted a requirement for a Securities Deposit Letter for deposits beyond a threshold number of shares (currently 300,000) that is designed to obtain assurance that subsequent resale of the security would not violate U.S. securities laws. The firm has also established procedures for the immediate forwarding of U.S. certificates to an authorized transfer agent for re-registration and confirmation.

Client activity in Bulletin Board securities appears to be largely concentrated in the accounts of relatively experienced U.S.-resident clients for whom suitability has not been a major issue. The risks associated with Bulletin Board trading appear not so much risks to Pacific International's clients as risks to Pacific International and its reputation. While the supervision of Bulletin Board trading activity is central to the issues currently being faced by the firm, this is not a matter that lends itself to clear or simple business and regulatory solutions.

Ultimately, the nature and extent of firm's involvement in OTC Bulletin Board securities must be decided on the basis of the firm's willingness to accept the risk to its reputation and the firm's ability to devote the resources necessary to effectively supervise this activity. We understand that the firm is actively considering a number of business decisions aimed at addressing both business and regulatory concerns about Bulletin Board activity.

To the extent that the firm plans to accommodate client activity in OTC BB securities in the future, we have set out a number of recommendations for supervision.

Recommendation 30

We recommend that the firm seek legal advice with respect to potential resale considerations for securities of non-reporting issuers deposited by both Canadian and non-resident clients.

Recommendation 31

Current procedures do not effectively prevent clients from avoiding the Securities Deposit Letter by 'trickling in' securities in smaller amounts. We recommend that the threshold for requiring Securities Deposit Letters be reduced to 100,000 shares and that Operations staff involved in monthly statement reviews be instructed to alert 'trickle in' deposits.

Recommendation 32

We recommend that consideration be given to the proposal that no securities of Bulletin Board issuers be accepted for deposit and resale, either in physical certificate form or a transfer from another intermediary.

Recommendation 33 [A]

We recommend that the firm prohibit wires, cheques or journals to third parties when securities are deposited and sold under a Securities Deposit Letter that says the securities were to be sold for the sole benefit of the client.

¶ 374 On December 2, Pacific International received a subpoena from the Assistant US Attorney in New York. The subpoena required Pacific International to produce trading blotters respecting trading in Globus shares. McQuid advised the Assistant US Attorney that Pacific International was prepared to cooperate, but required an order from a court or the Commission. The Commission issued an order on December 23 requiring Pacific International to produce trading blotters for all transactions in Globus shares from January 1 to December 20, 1996. The Commission issued another order for production on February 7, 1997. That order required Pacific International to produce account opening documents for the Kowalski, Della, Virgo Bay and Leeward Cove accounts, plus one other account. The order also required Pacific International to produce monthly statements for 1996 for those five accounts, plus five others.

¶ 375 In March 1997, the RCMP executed a search warrant at Pacific International regarding Globus. McQuid said that he did not recall the RCMP coming in, but that Pacific International's typical process would have been that Operations would have prepared the material required by the warrant.

¶ 376 The Globus indictment was filed on March 28. Vertsman was one of the defendants. Pacific International did not know of this at the time.

¶ 377 On April 21, the VSE sent a letter to McQuid advising that the VSE had initiated an investigation into the conduct of Ivancoe as it related to trading in Globus shares. The letter also advised that the VSE's review would consider the conduct of Pacific International as it related to the supervision of Ivancoe. The letter was signed by the Investigator, Debra Haggarty.

¶ 378 On receiving the letter, McQuid said he called Jim Hurkett at the VSE. McQuid said that he did not get any additional information from him and understood that Hurkett had not been informed of the details. McQuid said that he did not call anyone else at the VSE. McQuid also said that the only additional step he may have taken at the time to acquire more information would have been to speak to Ivancoe:

> Q Okay. What, if any, other additional steps did you take beyond phoning Mr. Hurkett to attempt to acquire more information?
> A At this time, I don't believe that I took any additional steps.
> Q Did you not call in Mr. Ivancoe and try to find out if he had any information that could shed some light on this investigation?
> A Well, actually I probably, I know I would have brought this to his attention and I might, I might have asked him, but I had previously asked him about the Globus trading back in the previous fall.
> Q Okay. And I take it he had no additional information with respect to it?
> A No, he didn't.

¶ 379 There were several other sources of information available to McQuid at this time, both inside and outside the firm. The main source inside Pacific International would have been a review of the activity in the accounts. That review would have revealed the same information listed earlier. Sources outside of Pacific International would have included searches of the account holders and authorized persons as well as a review of any public information issued by or about Globus. McQuid also could have spoken to the person who was investigating the matter at the VSE or the person McQuid had spoken with at the FBI. Rather than trying to obtain this additional information, McQuid satisfied himself by speaking to Ivancoe, who was himself under investigation in the Globus matter. McQuid's failure to make further inquiries at the time is particularly surprising given that he knew the VSE was also reviewing Pacific International's supervision of Ivancoe in the Globus matter.

¶ 380 On June 5, Pacific International requested searches of 26 people from the VSE. At that time, the VSE offered two types of searches. A Level 1 search was a search of the US Central Registration Depository; it would reveal whether a person was, or had been, registered to trade securities in the US and whether the person had a criminal or regulatory history there. A Level 2 search was a search of media as well as the CRD. The searches requested on June 5 were Level 1 searches. They were part of a US account review project initiated by Pacific International in 1997. One of the names searched was Lake. The search revealed no information about her. The names of Kowalski, Vertsman and Khayut were not searched.

¶ 381 On January 6, 1998, the VSE requested Pacific International to provide account documentation for January through November 1996 for the four accounts.

¶ 382 On January 21, the VSE sent a fax to McQuid with an article from the Denver Post dated November 12, 1997. The article described the Globus indictment:

> Prosecuters have charged 18 people who participated in Globus sales with conducting a massive stock fraud and concealing the theft in foreign accounts from British Columbia to Caribbean islands. Seven have pleaded guilty. Two are accused of soliciting a hit man to murder people in New York who caught onto their fraud and shook them down for cash.
> …
>
> In eight months the Hillcrest [Hillcrest Financial Corp. – a small broker dealer in New York] brokers allegedly defrauded about 800 people, many of them elderly, of an estimated $7.3 million.
> …
>
> After Hillcrest brokers stopped pushing Globus stock in 1996, its price tumbled swiftly from a high of $8 to pennies a share.
> …
>
> The alleged ringleader of the Globus stock scheme was Alexander Shindman, a 31-year-old Russian immigrant also known as Fat Man.
>
> It was Shindman, prosecutors say, who told the Hillcrest brokers how to sell Globus stock with misleading telephone pitches. Meanwhile, his brother Boris was an officer and stockholder of Globus, the company the brokers were paid to promote.
>
> One reason for Hillcrest's extraordinary interest in selling the stock of a single company is spelled out in the federal indictment: In late 1995, officers of Globus formed another company that agreed to purchase

> Hillcrest. Pending approval of this sale by securities regulators, the buyers agreed to pay Hillcrest monthly fees and help run the brokerage house.
>
> According to the indictment, this is how the scheme worked:
>
> More than 600,000 shares of Globus Group stock were issued at a price of $1.50 per share. These were deposited at a brokerage firm in Vancouver, Canada, in the names of companies based in Antigua and the Bahamas, enabling the owners to conceal their interest in a stock they later resold at inflated prices. Still other companies were created to funnel money from the Bahamas back to New York, where most of the defendants lived.
>
> The Hillcrest brokers, meanwhile, used phone lists to solicit buyers throughout the country for Globus stock. Month after month they pumped up its price with false claims to as high as $8 a share in August and September. Globus put out phony press releases, claiming it had won an anti-trust suit against AT&T and was completing a multi-million dollar purchase of another company. The brokers used these news releases in their sales pitches. They also advertised their relationship with one of the nation's largest brokerage firms, Bear Stearns [Hillcrest's clearing firm].

¶ 383 McQuid said that he thought at the time that the Vancouver brokerage firm referred to in the article was probably Pacific International.

¶ 384 He also said that this was the first time he became aware of the Globus indictment.

¶ 385 McQuid said that he passed the Denver Post article to Richard Thomas, who had become manager of Compliance in July 1997. McQuid said that Thomas would have taken the action necessary to close the accounts. In fact, the Della, Virgo Bay and Leeward Cove accounts were restricted to no trades, but not closed. The Kowalski account had been closed in August 1997.

¶ 386 McQuid was asked what had led to this action being taken:

> Q What was the crystalizing event for the accounts being closed? Was it the article, the indictment, conversations with the regulators or what?
>
> A It was receiving the newspaper article that indicated that accounts at Pacific or what I assumed to be Pacific had been used in what looked like a stock manipulation. They had sold into that stock manipulation.
>
> Q Were there any Globus shares in those accounts at that time?
>
> A I don't think so.

Q Again, when was the last trade of Globus Securities through PI?
A I believe it was September of '96.
Q In light of that, why would the accounts have to be further dealt with in light of the fact there hadn't been any trades in the subject securities?
A Well, the newspaper article was -- contained some nasty information, and closed the account to make sure that you don't trade it again.
Q What was that nasty information?
A It talked about the promoters or the salesmen at Hillcrest, telling untruths about the security to inflate the price and selling to their clients.
Q When was the first time you became aware of those terrible allegations?
A In -- well, the FBI person mentioned to me that Hillcrest was involved, and that they were looking at where Hillcrest had purchased the securities from, and then the newspaper article that I just referred to.
Q Again, what was the first time that you became aware of allegations of lies outside of the firm being able -- with respect to securities that found their way to PI?
A On the 21st was the first solid indication.
Q Of January?
A 1998.

¶ 387 I have two concerns about McQuid's response.

¶ 388 First, the "nasty information", or "terrible allegations", involved more than "the salesmen at Hillcrest, telling untruths about the security to inflate the price and selling to their clients." The allegations also involved more than 600,000 Globus shares that had been issued at a price of $1.50 per share and "deposited at a brokerage firm in Vancouver, Canada, in the names of companies based in Antigua and the Bahamas, enabling the owners to conceal their interest in a stock they later resold at inflated prices." According to the article, those prices reached a high of $8 per share. McQuid would have known that a market manipulation involves both a pump and a dump. According to this article, the pump was done through Hillcrest, but the dump was done through a brokerage firm in Vancouver that McQuid assumed was Pacific International.

¶ 389 The second concern involves McQuid's response to this information. McQuid assumed that Pacific International was the Vancouver firm involved in the alleged Globus manipulation. He and Thomas restricted the accounts from trading. However, they did not obtain a copy of the indictment. They did not review the

accounts in light of the allegations in the indictment to determine whether the allegations involving Pacific International were true and, if they were, what steps Pacific International could have taken to detect and stop the abusive activity.

¶ 390 Compliance did not obtain the Globus indictment until July 12, 1999, when the VSE gave the firm a copy.

¶ 391 On July 14, 1999, McQuid sent a letter to Lake advising her that Pacific International would no longer be able to service the accounts for eleven companies. Each of the accounts had Lake as the authorized person and Ivancoe as the investment advisor. The accounts included those for Leeward Cove and Virgo Bay.

¶ 392 Thomas asked McQuid why they were not closing all of the accounts for which Lake was an authorized person. In an email to McQuid, he questioned: "Yes, but if Nancy Lake may not an acceptable person for Leigh doesn't that necessarily mean that she may not be an acceptable person for anyone else?"

¶ 393 In McQuid's email in response, he suggested that Ivancoe might have referred questionable people to Lake. McQuid expanded on that suggestion:

Q And you continue on [in the email], I understand the Nancy Lake issue, but if the VSE is right perhaps Leigh has attracted a certain element who he has then referred to Nancy Lake. What were you talking about there?

A Well, this is in the early -- the early stages, and my -- we were acting in a very arbitrary manner here, and my concern was not that Nancy Lake was a bad person, in fact I know her to be a honourable person, but rather that Leigh may have referred individuals to her which she then opened -- opened accounts for, and I wasn't willing to take any risks with respect to accounts that may have been referred -- may have been referred to Laky by Ivancoe, and that's why I was taking this action and at the same time if there were concerns about other Nancy Lake accounts then those should be dealt within their own merits.

Q On what basis do you develop an opinion about Ms. Lake? I think you indicated you thought her to be a honourable person?

A She has had -- has been the authorized person on brokerage accounts in this country for as long as I have been in the securities business, and she continues to have brokerage accounts in this city and this country today.

Q On what basis do you have the opinion or did you have the opinion that she was honourable?

A I had spoken to her on occasion. I had met her, I had never -- never come into possession of any information to indicate that she was anything other than honourable. Certainly all her transactions for us were conducted appropriately.

¶ 394 Lake was the sole authorized person on the Virgo Bay and Leeward Cove accounts. McQuid had seen the Globus indictment by this time and knew the role played by those accounts in the alleged manipulation of the market for Globus shares. This information should have caused Compliance to question whether all, or indeed any, of her transactions through offshore corporate accounts at Pacific International were conducted appropriately. And Compliance should have made those inquiries back in November 1996, when the call from the FBI first raised a concern about the Globus transactions in the Kowalski, Della, Virgo Bay and Leeward Cove accounts.

¶ 395 I conclude that Pacific International failed to make inquiries to learn the essential facts about these clients in November 1996, when McQuid received the call from the FBI. That failure to make inquiries continued until July 1999, despite:

- the US subpoena of December 1996;
- the search warrant of March 1997;
- orders for production from the Commission and a request for production from the VSE;
- advice from the VSE in April 1997 that it was investigating Ivancoe, and reviewing Pacific International's supervision of Ivancoe, in respect of Globus;
- the Denver Post article (which McQuid received in January 1998), which described the alleged Globus manipulation, including the involvement of a Vancouver firm that McQuid assumed was Pacific International; and
- the activity in the accounts.

3. Houge/Manion

¶ 396 Pacific International opened an account for Continental Capital & Equity Corporation in January 1993. Continental had a US address and described its business as "Investments". John Manion was the authorized person on the account.

¶ 397 Pacific International opened an account for Debra Lee & Associates in December 1996. Debra Lee had a US address and described its business as "Public Relations". The referral was J. Manion. David Houge and Debra Lee Houge, his wife, were the authorized persons on the account.

¶ 398 The investment advisors for the accounts were Dirk Rachfall and Michael Patterson.

¶ 399 Between mid December 1996 and mid January 1997, the Continental account transferred 167,200 shares of Legend Sports Inc. to the Debra Lee account and the Debra Lee account transferred $334,400 to the Continental account. Thomas said that there was documentation on the file indicating that there was an option between Debra Lee and Continental.

¶ 400 Legend shares were quoted on the OTC BB.

¶ 401 In early February 1997, Compliance observed that funds were being wired from the client into the Debra Lee account and, almost immediately, wired back out again to the client. To be exact, the funds were wired out to a US cheque cashing outlet, City Check, for the benefit of the client. The account statements showed two sets of transactions. $177,975 was wired in on January 15 and $175,000 was wired out on January 16. $592,975 was wired in on January 29 and $595,000 was wired out the same day.

¶ 402 McQuid was uncomfortable with this and confirmed in a memo to Rachfall and Patterson their advice to him that the client would not make a practice of this. McQuid's memo concluded:

> In the interim please advise the client (if a similar request is received) that we would prefer sending money only to the name under which the account is styled thereby permitting the client to make his own disbursements.

¶ 403 In cross-examination, McQuid said that he was concerned about this situation, where money was wired in and almost immediately wired out again, because this could be a technique used by a money launderer. However, in his direct testimony, McQuid had said that this situation could not be money laundering:

> Q Would there have been a concern with staff about money laundering issues?
>
> A Not money laundering, because it comes from the client. It's put on our account statement in the client's name, goes out to the client in the client's name, so there's no layering or anything that's occurring there, but it's unusual. And it's just because it's unusual it would attract attention.

¶ 404 McQuid's initial discomfort with this situation was well-founded. Having money come in from and go out to the client is no guarantee against money laundering.

The Commission issued a notice in April 1993 regarding money laundering and the new federal requirements. The money laundering notice observed:

> Money laundering is the conversion of the proceeds of economic crime into seemingly legitimate funds using complex transactions through the financial institution deposit and withdrawal system. Money laundering begins when the proceeds of crime are deposited into the financial system. Complex transactions are then used to obscure the audit trail of the funds so they appear to be legitimate when eventually withdrawn. The three typical stages of money laundering are placement, layering and integration.
> …
>
> Registrants are probably more at risk of being used in the second stage of money laundering, *layering*, the use of multiple transactions and institutions to obscure the original source and the final destination of funds. Securities markets are attractive to the money launderer for several reasons. Markets offer a wide variety of available investment options, liquidity, portability and ease of transfer. Securities markets also have the capacity to absorb huge amounts of capital, lawful or illicit, without attracting extensive regulatory review. Unlike mainstream banking, securities transactions allow the money launderer to change the form of funds, not just from cash in-hand to cash on-deposit, but from cash to a secure and liquid asset in an entirely different form. …

¶ 405 In Pacific International's 2000 Sales Procedures Manual, the firm referred to the risks of all wires, not just wires coming in from, or going out to, third parties:

> Wire transfers, however, are not without their risks. While they provide a paper trail, wire transfers are a preferred method of funds movement by those individuals engaged in money laundering activities, particularly because of the speed with which the transfers can be made between institutions. It is this speed that enables a money launderer to "layer" his transactions, that is, create a paper trail so active that it takes any investigatory body months or years to uncover the actual origin or ultimate destination of a flow of monies, because of all the financial institutions that may have unknowingly been a conduit for the wires.

¶ 406 Though Pacific International did not include this paragraph in its Sales Procedures Manual until 2000, the risks it described were not new. They were essentially the same risks set out in the Commission's money laundering notice of April 1993.

¶ 407 Rachfall and Patterson told McQuid that the client had told them that the money was being wired from the account to buy shares in emerging companies and that those shares would be sent to Pacific International by the end of February. McQuid said that Compliance followed up a month later and observed that shares worth a significant amount of money had been delivered into the account.

¶ 408 Debra Lee's February account statement showed that 282,000 Legend shares were delivered into the account on February 20. According to the account statement, the share price that month ranged from $4.62 to $4.90. Consequently, those shares would have been worth between $1.30 million and $1.38 million.

¶ 409 On June 5, Compliance requested a Level 1 search on Houge. They received the search results on July 4. The results included information from the Lexis/Nexis database indicating that Houge had a regulatory history. Specifically, the results consisted of two brief documents. One noted that, in 1985, the Securities and Exchange Commission had filed a complaint alleging that Houge had violated the anti-fraud provisions of the federal securities laws. The other noted that, in 1986, Houge had been sanctioned with a permanent injunction.

¶ 410 Both McQuid and Thomas saw the Houge search results. Thomas said that he could not tell whether this regulatory matter was serious without further information about the nature of the violation.

¶ 411 Compliance made two attempts to get that information. They contacted the VSE and were told that there was nothing further available. Then, McQuid and Rachfall telephoned Houge to ask him about the 1986 permanent injunction. Houge told them that the injunction was in relation to allegations of misstated financial reports filed by a public issuer and that he had signed the financial statements as a director of the issuer. Thomas said that McQuid told him about the call:

> Q Well, did Mr. McQuid tell you that Houge admitted that there were allegations against him that he was making material false statements to the public in order to get a benefit?
>
> A No. He did not, no. The -- the... Nor would I expect Mr. Houge to have done that over the telephone. If -- if someone is -- has been sanctioned for something like this, I think that the general tendency would be to -- to try to downplay that as much as possible and I think that that's what happened in this conversation.
>
> Q Well, if that was what your expectation was, in your view, is there something else you could have done to determine the exact nature of the allegations and findings?

A Yes. And that would be to get more detail from the Exchange, which was not forthcoming.
Q Was there any other method that you could have thought of at the time or was there anything that you thought of that you could have done to get information from a third source?
A I'm not aware of any other information or source. The Exchange was -- we relied on the Exchange to -- to give us the information that we asked for.

¶ 412 Thomas recognized that they needed to make further inquiries about the search results to determine the facts surrounding, and the seriousness of, the SEC proceedings against Houge. He also recognized that they would not get the truth from Houge himself.

¶ 413 Both Thomas and McQuid said that the VSE was the only information source they were aware of regarding the SEC's proceedings against Houge. I find their testimony on this point very difficult to accept.

¶ 414 Both Thomas and McQuid had worked in the securities industry for a number of years. Thomas was a lawyer. McQuid had been a member of the Commercial Crime Section of the RCMP. Compliance was their job.

¶ 415 At that time, one third of Pacific International's new clients were US residents and several of the investment advisors were trading heavily in US markets. They had recently embarked on a US account review project, in response to concerns about certain types of US accounts. All of this highlighted the importance of Pacific International knowing where to get accurate and complete information about US clients, securities, markets, laws, and regulatory and criminal proceedings. Pacific International needed that information to properly supervise its US business and know its US clients.

¶ 416 The two documents that Pacific International received with the Houge search results contained the reference numbers and dates (though one of the dates was incorrect) of the two SEC litigation releases regarding the Houge matter. One of the documents also referenced the filing date of the SEC complaint and the court in which it had been filed. In other testimony, Thomas said that he was familiar with SEC litigation releases and knew they were public documents.

¶ 417 Even though Compliance had reference numbers for the SEC litigation releases and information identifying the court in which the SEC filed the complaint, they made no attempt to follow up on this information. They did not contact the SEC or the court, or consult US counsel as to how they could obtain the SEC litigation releases or the complaint.

¶ 418 Either they did realize that they probably could obtain the information they needed through other sources, but failed to do so, or they really believed that the only information sources available to them regarding SEC proceedings were the Lexis/Nexis database and the VSE. Either way, they knew that they needed to make further inquiries about Houge but failed to adequately do so.

¶ 419 Had they made those inquiries, and reviewed the two SEC litigation releases and the complaint, they would have learned that Houge was alleged to have engaged in a scheme to defraud investors in an issuer whose shares were traded in the public over-the-counter market. According to the complaint, Houge (the president of the issuer) sold unregistered shares of the issuer while disseminating false and misleading publicity about the issuer's business, projected profits and future share price. The complaint also alleged that Houge caused the issuer to file annual reports with the SEC that misstated his beneficial ownership of the issuer's shares. Houge, without admitting or denying the allegations, consented to a permanent injunction and agreed to provide an accounting of his proceeds from the sale of the unregistered shares.

¶ 420 Thomas admitted that these were serious allegations and that, had Compliance known of them, they would have taken further steps and possibly closed Houge's accounts.

¶ 421 McQuid described the process that Compliance followed in general, and in the Houge case in particular, in responding to negative search results:

> A … As I previously testified, if the search results indicated a criminal history, then typically that was the end of it, the account was wound down and closed or transferred to another member firm. We typically would look at the account and determine whether it was a new account just being opened or whether it was an existing account that had a pattern of trading activity with us. If it did have a pattern of trading activity then we would look at that activity, determine -- try and determine to the extent that we could whether it was remarkable or not. We would look at the nature of the -- of the history being reported on the client, the age of the history, whether there had been a repeat matter since the date of that -- of that history, and from that we would make a determination in whether to keep the account open or not.
>
> With respect to Houge, my memory is that this is all the information that we had. We couldn't obtain from the VSE any -- any detail, if you will, on the matters being reported. We were also

> aware of the age of it, in excess of ten years old at this time. Because we couldn't obtain any printed record, if you will, as to the details, I know Richard Thomas and I met with -- with Mike and Dirk, and I actually participated in a telephone call with Houge. One of our procedures was that if something came to our attention which caused the -- called into question the business reputation or the creditworthiness of a client, then we would inquire further into that. And that's what we did with respect to Houge. We telephoned him and we asked for his explanation as to what the -- what this was all about. And as a result of that we made the decision to maintain his account.

¶ 422 In other testimony, McQuid said that another factor Compliance would consider was whether the activity that led to the regulatory history was activity that could be repeated in the account at Pacific International. However, he also acknowledged that the risk to Pacific International that a client might do something unlawful was higher if the client had any regulatory history than if the client had a clean past.

¶ 423 Thomas said that the activity in the Debra Lee account was unremarkable. The account statements from December 1996 through August 19997 showed that:

- the account traded mostly Legend shares;
- 282,000 Legend shares were received into the account on February 20;
- another 380,000 Legend shares were received into the account;
- $1.8 million was wired into the account during January and February;
- over $6.15 million was wired out of the account between December and August:
  - $4.3 million (31 wires) to the US cheque cashing outlet, City Check, for the benefit of the client;
  - $970,000 (26 wires) directly to the client or the Houges; and
  - $880,000 (26 wires) to third parties;
- the price for Legend shares shown in the December account statement ranged from $2.88 to $2.97; the price for Legend shares shown in the July account statement ranged from $5.19 to $6.34; and
- on August 31, the price for Legend shares was $5.50 and the account held 9,129 shares.

¶ 424 This account activity was not unremarkable. It should have raised a very serious concern as to whether the Debra Lee account was participating in a manipulation of the market for Legend shares. In order to resolve that concern, Pacific International needed to make further inquiries.

¶ 425 For example, Thomas acknowledged that Pacific International would have been able to see changes in trading volume and price for Legend. That testimony arose in the context of the indictment filed against Houge in respect of an alleged manipulation of the market for Legend shares. Thomas was asked if Pacific International ought to have known about the cold calling and recommendations by unregistered people to buy Legend shares:

> A What Pacific International would see is -- is probably an increase in volume in the -- in the trading of the issuer, if -- if it was an issuer that -- that we took a look at. So we'd see an increase in -- in volume and perhaps an increase in price as well. But we wouldn't have been able to detect -- we wouldn't have been able to detect false and misleading statements, for example, being made by those people.
>
> Q Was either the volume or the increase in price something which was noteworthy to the extent that compliance perhaps should have given some thought that there was something funny going on?
>
> A It -- securities have increases in volume and in price all the time. And we're not in a position to -- to tell whether or not it's -- it's being caused by improper activity or not.

¶ 426 Of course, Pacific International could not have conclusively determined that the increase in the price for Legend shares was caused by improper activity. Nor could Pacific International have conclusively determined that the activity in the Debra Lee account was part of a scheme to manipulate the market for Legend shares. Nor could Pacific International have conclusively determined that Houge was orchestrating such a manipulation. A registrant will rarely, if ever, be in a position to know with certainty that such a scheme is afoot.

¶ 427 However, Pacific International was expected to be inquisitive and pro-active with regard to its client's activities. The activities in the Debra Lee account, alone, should have been enough to prompt further inquiries. Those activities, combined with Houge's regulatory history, should have created a very high level of concern and led to extensive and detailed inquiries. On the basis of the information generated by those inquiries, Pacific International was expected to exercise its judgment as to whether the client was engaging in illegal, unfair or abusive trading activities.

¶ 428 Pacific International failed to make adequate inquiries about Houge and was therefore in no position to make a fully-informed judgment as to whether the activity in the Debra Lee account was improper and whether the firm should retain the account.

¶ 429 Despite this, Pacific International decided in August 1997 to retain the Debra Lee account, but subject it to heightened supervision.

¶ 430 Pacific International opened an account for Nyack Partners Ltd. in September. The referral was Houge. The authorized persons were Debra Lee Houge and Steven Houge, Houge's brother.

¶ 431 Compliance requested a Level 1 search on Manion on September 11 and received the results on September 25. They revealed that the SEC had instituted administrative proceedings against Manion and Continental in February 1996, and settled them the same month. The SEC ordered Manion and Continental to cease and desist from violating certain sections of the federal securities laws. Manion and Continental consented to the order without admitting or denying the SEC's findings.

¶ 432 The SEC found that a NASDAQ listed issuer paid Manion and Continental to write and distribute two glossy brochures designed to look like investment newsletters. The SEC found that the brochures misrepresented the issuer's financing and projected revenues. The SEC found that Continental sent the first brochure to 400,000 prospective investors, coordinated the responses, and gave the contact information for those who had responded to the issuer or to brokerage firms identified by the issuer. The SEC said that Continental sent the second brochure to 4000 investors who had responded to the first one. The SEC found that the brochures were mailed between December 1992 and April 1993. The SEC also found that the issuer's share price and trading volume rose significantly during that period: in early fall 1992, the share price averaged $5 on an average daily volume of 15,000 to 20,000 shares; on April 13, 1993, the share price reached a high of over $9 on a volume of 1.3 million shares. The SEC found that the issuer issued 148,500 shares to Continental as payment for its services and that Continental sold the shares for $781,000. The SEC also found that the issuer issued 1.8 million shares to Continental pursuant to an arrangement under which Continental sold the shares (for $9.8 million) and used the proceeds to pay the issuer's expenses.

¶ 433 Neither McQuid nor Thomas remembered seeing the Manion search results. Thomas said that he did approve the Manion accounts to remain open, but that he does not know why he did so.

¶ 434 Had Compliance followed their normal process for responding to negative search results, they would have looked at the activity in the Manion accounts, including the Continental account. They would have seen deliveries of Legend shares into the account and transfers of Legend shares from the account to the Debra Lee

account. By September 10, there were no Legend shares left in the Continental account. Compliance already knew that Houge also had a regulatory history and they had reviewed the activity in the Debra Lee account.

¶ 435 As well, on September 15 (10 days before Compliance received the Manion search results), the SEC had suspended trading in Legend shares. The SEC said there were questions about the accuracy and adequacy of publicly disseminated information concerning Legend's financial condition. Compliance should have known of the trading suspension, given their heightened supervision of the Debra Lee account.

¶ 436 Despite having all of this information, Compliance made no further inquiries about either Houge or Manion.

¶ 437 On October 9, the Commission issued an order requiring Pacific International to produce trading blotters for all transactions in Legend shares from August 1, 1996 to August 31, 1997. As well, Pacific International was required to produce account opening documentation, monthly statements and documentation respecting transactions in the accounts (such as stock receipt and delivery slips, wire transfer instructions, journal entries and cancelled cheques) for all accounts that traded Legend shares during that period.

¶ 438 On October 29, the VSE issued a request requiring Pacific International to produce all trading blotters with regard to activity in Orlando Super Card Inc. from May 13 to October 8, 1997. The VSE also requested new account forms, monthly account statements and other documentation (such as share receipt and delivery slips, and information regarding wires received into or sent from the accounts) for each client active in Orlando during that time. The information had been requested by the NASD. Orlando's shares were quoted on the OTC BB.

¶ 439 McQuid described the process at Pacific International for dealing with orders for production and other information requests from regulators:

> Q And you knew about having received this order around the time it came in? [This question related to an order for production regarding another group of accounts.]
>
> A I don't know that. Often the production orders would go directly to the operations area where the material was accumulated and the existence of the order was then put on the grid which was provided to compliance. I don't have any specific recall of having seen this one specifically.
>
> Q And so would you see the grid on a regular basis to see which orders were coming in on whichever dates?

A I probably would not see the grid on a regular basis. It would go directly from operation to the compliance staff that were performing the line function.

Q So you as the head of compliance then were not keeping track of the orders which you were receiving from your regulator?

A What I had done as head of compliance was to put a procedure in place in the firm firstly to ensure that the conditions of the order production were met in a timely manner, or if they couldn't be met the appropriate extensions were obtained. And a process to ensure that the compliance people had the information available to them for when they were reviewing account activity.

Q And so did you have a person then who was keeping track of which clients of PI were being looked into?

A As I said any production order, the information on the order which would include the clients or the security would go on a grid which was provided to the compliance staff.

Q And so would they review that to see which clients of PI were being -- had orders for production against them?

A They would -- they would have the information available to them so that when they were reviewing account statements they could have that in mind as they reviewed the account statements.

Q What I'm getting at is whether you were reviewing the orders to see whether there were certain clients or certain brokers whose clients were repeatedly having the commission or the VSE ordered information produced about?

A Well the production orders aren't allegations, they are simply a request for information. So to my knowledge the compliance staff didn't keep a tally, if you will, against any one particular client or one particular broker.

¶ 440 Orders for production, and other information requests from regulators, were handled by Operations. According to McQuid, Compliance would be informed, via the grid, of the existence of a request. However, Compliance would not be involved in the preparation of, or even see, the material gathered in response to the request. Therefore, in respect of the October 9 order for production, Compliance would have known only that the Commission had requested information about trading in Legend shares and the accounts that had traded them. The girl would not have identified those accounts or described the activity related to Legend shares in those accounts.

¶ 441 Again, according to McQuid, Pacific International would not keep track of information requests that involved a particular client or a particular investment advisor. Consequently, no one at Pacific International would have been expected

to note that Houge's Debra Lee account had traded Legend shares (as revealed in response to the October 9 information request) and that another account related to Houge – Nyack – had traded Orlando shares (as revealed in response to the October 29 information request). Nor would anyone have been expected to analyze the activity related to Legend and Orlando shares in these accounts.

¶ 442 It is true that requests for information are not allegations. However, they can provide a warning to the registrant that there may be a problem with a particular client or authorized person, a particular security or a particular investment advisor. The information gathered in response to an information request could raise concerns and questions that should prompt the registrant to make further inquiries.

¶ 443 Ironically, McQuid circulated a very topical Compliance bulletin around this time. On October 27, he sent to the investment advisors a bulletin regarding The Role of RRs and Members as Industry Gatekeepers. The bulletin reproduced the VSE's 1997 update of the gatekeeper notice. The notice reiterated the importance of a registrant's gatekeeper responsibilities:

> The world wide attention that has been placed on the Securities Industries in many jurisdictions makes it appropriate to review and restate the guidelines under which RR's and other industry participants should operate. In particular, the role of the Member and its employees in upholding the integrity of the market place (the role of "Gatekeeper") continues to be of major importance.

¶ 444 On November 3, the SEC suspended trading in Orlando shares. It did so because of questions about the trading, the true value of Orlando shares, and the accuracy of publicly disseminated information regarding Orlando's financial prospects.

¶ 445 On April 16, 1998, the Commission issued an order for production requiring Pacific International to produce certain information regarding the Debra Lee and Continental accounts, and trading in Legend shares.

¶ 446 On May 21, an indictment was filed in the US alleging that Houge manipulated the market for Legend shares. He was charged with conspiracy to commit securities fraud, wire fraud, money laundering and engaging in unlawful monetary transactions. The indictment alleged that Houge had opened the Debra Lee account at Pacific International and used the account to disburse and conceal the profits Houge had made from selling Legend shares at an inflated price. The indictment alleged that Houge caused certain transfers of shares to be made into the Debra Lee account and certain wires to be sent from the Debra Lee account, including wires to City Check and various other parties.

¶ 447 Thomas learned of the indictment on June 3. An RCMP corporal told him that Houge had been indicted and arrested, and gave him a copy of a US restraining order enjoining the Debra Lee and Nyack accounts at Pacific International.

¶ 448 The only information about the indictment in the restraining order was that Houge was charged with wire fraud and money laundering and that, were he to be convicted, an amount of not less than $5,236,198 would be subject to forfeiture. The restraining order provided no information about what Houge was alleged to have done. For example, it did not mention Legend.

¶ 449 Thomas said that, during his meeting with the corporal, he inquired about the issuers that were problematic for Houge in the Debra Lee and Nyack accounts. Thomas said that the corporal told him that there was a joint RCMP and FBI investigation relating to Houge and four OTC BB issuers. Legend was not one of them. Thomas said that Complaince reviewed the trading in the shares of those four issuers in the Houge accounts and found that it was minimal.

¶ 450 Thomas said that he did not ask the corporal what the charges against Houge were in relation to; nor did he ask him for a copy of the indictment.

¶ 451 Thomas said, essentially, that he assumed that the indictment related to the four issuers that were the subject of the joint RCMP and FBI investigation.

¶ 452 Once again, Compliance relied on others to provide them with information about their clients rather than getting the actual documents for themselves. In 1997, they relied solely on the VSE to give them information about the Houge complaint. Now, in 1998, they relied solely on an RCMP corporal to give them information about the Houge indictment. On both occasions, their inquiries were inadequate.

¶ 453 As a consequence of receiving the restraining order, Compliance froze the Debra Lee and Nyack accounts. The only other action they took in June 1998 was to check whether Houge or his wife had any other accounts at Pacific International. No action was taken with respect to the Manion accounts.

¶ 454 Matters came to a head in the summer of 1999. By that time, the activity in the Houge and Manion accounts at Pacific International was the subject of an indictment and a SEC complaint against Houge, and an indictment against Manion, Rachfall and Patterson. The activity involved the shares of two OTC BB issuers – Legend and Orlando.

¶ 455 Allegations involving Legend were set out in the Houge indictment (May 21, 1998), the Houge complaint (June 16, 1999), and the Manion/Rachfall/Patterson indictment (original indictment June 16, 1999; superseding indictment early July

1999). Those documents alleged that, between 1996 and 1997, Houge orchestrated the manipulation of the market for Legend shares. Specifically, the documents alleged:

- Manion and Continental acted as financial advisors to Legend.
- From December 1996 to July 1997, Houge obtained control of all, or nearly all, of the publicly traded Legend shares. He did this by purchasing shares in private transactions from individuals associated with Legend; he purchased at least 800,000 shares for $2 or less a share. He also bought shares in the market.
- Houge deposited the Legend shares into several accounts he controlled at Pacific International.
- Houge, directly or indirectly, artificially increased the price for Legend shares through a series of orchestrated trades executed by various market makers.
- To ensure public demand for the Legend shares, Houge entered into an agreement with the individuals who controlled branch offices of Global Strategies Group Inc., a US broker dealer. These individuals agreed to sell Legend shares to their clients in exchange for 50% of the sales proceeds. In addition, Houge and others purchased another US broker dealer and changed its name to First National Equity Corporation. Houge used First National and another US broker dealer called Amerivet Securities Inc., as well as Global, to sell Legend shares to retail investors.
- The Global, First National and Amerivet offices were boiler rooms. They were staffed with crews of registered and unregistered salespeople, and cold callers. These sales crews were placed and supervised by associates of the Columbo organized crime family and the Bor Russian Organization crime group. They controlled the sales crews through cash payments and extortion.
- The sales crews used scripts and pitch sheets when talking to investors. They provided investors with false and misleading information about the business activities and financial condition of Legend, and the future price of Legend shares.
- From November 1996 to September 1997, the sales crews sold Legend shares to the public for prices ranging from $3 to $7 a share.
- The source of the shares sold to the public was often Houge's accounts at Pacific International.
- On September 15, 1997, the SEC suspended trading in Legend shares because of questions about the accuracy and adequacy of publicly disseminated information concerning Legend's financial condition.
- Before that time, Houge sold at least 1 million Legend shares from his accounts at Pacific International and received over $6 million in sales proceeds.

- Houge disbursed and concealed the sales proceeds through the use of various domestic and offshore accounts, including the Debra Lee account at Pacific International.
- Houge caused wires to be sent from accounts at Pacific International to banks and a cheque cashing outlet in the US.
- Houge used 50% of the sales proceeds to pay the sales crews. He used the remaining 50% to buy the Legend shares that were resold to the public, to pay other expenses of the scheme, and to pay himself and the other participants in the scheme.

¶ 456 Allegations involving Orlando were set out in the Houge complaint and the Manion/Rachfall/Patterson indictment. Those documents alleged that, between August and November 1997, Houge orchestrated the manipulation of the market for Orlando shares. Specifically, the documents alleged:

- Individuals associated with Pacific International, namely Rachfall and Patterson, contacted Houge in August. They assured Houge they could obtain control of the publicly traded Orlando shares.
- With Rachfall's and Patterson's assistance, Houge purchased at least 1.1 million Orlando shares for an average price of $2.45 per share.
- Houge, directly or indirectly, artificially increased the price for Orlando shares through a series of orchestrated trades executed by various market makers.
- Houge used First National to sell Orlando shares to retail investors.
- The First National offices were boiler rooms. They were staffed with crews of registered and unregistered salespeople, and cold callers. These sales crews were placed and supervised by associates of the Columbo organized crime family and the Bor Russian Organization crime group. They controlled the sales crews through cash payments and extortion.
- The sales crews provided investors with false and misleading information about, among other things, the prospects for Orlando shares.
- From September to November 3, the sales crews sold at least 800,000 Orlando shares to the public for prices ranging from $5.50 to $6.00 per share.
- The source of the shares sold to the public was often Houge's accounts at Pacific International.
- On November 3, the SEC suspended trading in Orlando shares because of questions about the trading, the true value of Orlando shares, and the accuracy of publicly disseminated information about Orlando's financial prospects.
- Before that time, Houge received over $4 million in sales proceeds from his accounts at Pacific International.
- Houge transferred a portion of the sales proceeds to banks and a cheque cashing outlet in the US.

- Houge used 50% of the sales proceeds to pay the sales crews. He used the remaining 50% to buy the Orlando shares that were resold to the public, to pay other expenses of the scheme, and to pay himself and the other participants in the scheme.

¶ 457 I conclude that Pacific International failed to make inquiries to learn the essential facts about Houge and Manion in July 1997, when Compliance received the Houge search results. That failure to make inquiries continued until June 1999, when Pacific International closed the Manion accounts, despite:

- the Manion search results of September 1997;
- orders for production from the Commission and a request for production from the VSE;
- the US restraining order of June 1998, which referred to the Houge indictment; and
- the activity in the accounts.

¶ 458 Had Pacific International made adequate inquiries in July 1997, and reported what it learned to the regulators, the activities that led to the alleged Orlando manipulation might never have occurred.

4. Rousso/Hababou

¶ 459 Pacific International opened accounts for Marc Rousso in 1993 and 1994. One account was in Rousso's name and others were in the name of Ildico Limited, a company of which Rousso was president. Rousso had an address in France. Ildico had an address in the Bahamas. Ildico described its business as a holding company. Rousso was the authorized person on the Ildico accounts.

¶ 460 Pacific International opened an account for Philippe Hababou in 1995. Hababou had an address in France and described himself as being self-employed in the business of investment banking.

¶ 461 The investment advisors for all the accounts were Bruce Stratton and Elsie Emes.

¶ 462 On April 29, 1997, the VSE issued a request for information on behalf of the NASD. The NASD wanted account documentation for nine clients that traded shares in D.H. Marketing & Consulting Inc. between September 1996 and March 1997. One of the clients was Ildico. When asked if he made any inquires with respect to the Ildico account, McQuid said that he did not recall being aware of this request when it came in.

¶ 463 In July, concerns arose regarding money that was wired into the Ildico account and, ultimately, wired out soon after.

¶ 464 On July 22, MacFarlane raised a concern regarding a request to wire money from the Ildico account. As McQuid was out of the office, MacFarlane discussed his concern with Jean-Paul Bachellerie, via email and telephone.

¶ 465 After some research, MacFarlane and Bachellerie confirmed that the Ildico account had received five wires totalling $91,634 on July 18. The wires were from four different third parties, each of which appeared to be a company. One company sent two wires for $4,158.25 each. The other three companies each sent one wire for $27,772.50. Rousso claimed that he had been waiting 10 days for the wires to arrive. He now wanted to wire $83,000 from the Ildico account to Natalie Nisenbaum.

¶ 466 MacFarlane questioned whether this raised concerns about money laundering. Bachellerie told MacFarlane that it looked suspicious to him as well. In his testimony, Bachellerie described five aspects of the situation that made him suspicious:

- The client claimed the wires had been in transit for ten days, which was not normal;
- Five wires had come in from four different third parties;
- The wires were for like amounts (two for $4,158.25 and three for $27,772.50);
- There was a short time period between the receipt of the money and the request to have it wired out; and
- The request was to wire the money to a third party.

¶ 467 Neither MacFarlane nor Bachellerie was sure how to handle the situation. Bachellerie had Accounting correct the journal entries for the five incoming wires to show who had sent them. MacFarlane asked Emes to tell him what business reasons were served by the wires.

¶ 468 Emes responded: “Our client advised us that he was owed monies from a personal friend and upon receiving those funds wanted to invest them in a US deal.”

¶ 469 On receiving this response, MacFarlane and Bachellerie decided that they would “document all of this”. They discussed whether they should wire the money directly to Ildico and “have him do his own bookkeeping”. In the end, Bachellerie questioned whether wiring the money to Ildico would solve the problem and instead suggested to MacFarlane that he consult Sandra Tannas (Compliance). Bachellerie said that he was not involved after that, but that he expected

MacFarlane to not release the wire unless he was satisfied with Compliance's response to the matter.

¶ 470 Bachellerie confirmed that they both realized there was something suspicious about the situation but that neither of them knew what to do about it:

> A Well, I would like to add something, that at the time, I don't believe either of us really knew how to handle this issue. We both realized that there was something suspicious about it. We did some digging immediately and we found out what the facts were. But we were questioning how to appropriately deal with this.
> Q Okay. And you were put in that position because you said Mr. McQuid was away?
> A Yes, he was away until the next day.

¶ 471 On McQuid's return the next morning, MacFarlane sent him an email summarizing the situation. The email included a summary of a fax received that morning from Rousso:

> Ildico – rec. 5 wires (totalling $91,634.00 usf cr) from 4 different 3rd parties on July 18/97. This account did not owe any money – had a credit balance of $8,337.44 CR. On the surface there does not appear to be any sound business reason for these wires. We have instructions to wire $83,000 to Natalie Nisenbaum. I have expressed concern to Marc [Stratton's and Emes' assistant, not Marc Rousso] & Elsie that this could be perceived as possible money laundering. I suggested to Marc that we wire this amount to Ildico or to Marc Rousso personally and let him do his own banking/bookkeeping. Marc advises that Ildico & Rousso do not have bank accounts. I have discussed with JP & Sandra. Ildico has given us a fax stating the wires received were money owed "for business we are doing with them. Re the $83,000 wire - $50,000 to purchase 50 paintings by Mark Kostabi @ $1,000 & $33,000 to purchase 2 19th century paintings by James Clark".
> Tannas agrees to the wire but we think it is good idea for us to discuss/review the activity in both accounts.

¶ 472 McQuid said that, after hearing Rousso's explanation, he did not believe that this activity was suspicious:

> Q So in April '97 you receive a request or PI receives a request for documents from the VSE on behalf of the NASD. In July of '97 you have this activity in the account. Would you agree with me that the activity is very suspicious?

A Well, I think, firstly, our staff were trained to watch for the type of activity that is -- that is indicated here, and then to make -- if they observe it to make inquiries with respect to it, and that's exactly what happened here. It typifies the challenges that we have in compliance, that we may make observation of activity, but we may not be able to bring that to a conclusion that anything improper has occurred. So here there's been excellent compliance work done. A lot of people have been involved in it. Firstly, the journal entries, if you will, have been -- well, I guess firstly the matter was observed by staff, and it was escalated to other decision makers in the firm. Secondly, the journal entries were corrected to ensure that there was proper detail and a proper audit trail behind him. But, thirdly, the client was asked to give an explanation and not just -- and not just verbally but in writing so that the audit trail is even -- is even more complete, and then the wires have gone out which again completes the audit trail.

Q And do you agree with me that the activity is suspicious?

A I believe that the activity in the absence of an explanation was suspicious, but I believe that the explanation provided by the account given our knowledge of Mr. Rousso's business enterprises, that the activity is consistent with that, and once -- once that was obtained then I don't believe it's suspicious any longer.

Q And you don't find it suspicious that the client doesn't have a bank account?

A I don't find it suspicious that Ildico doesn't have a bank account, because often -- often corporate accounts will not have specific bank accounts, at least in my experience.

Q The e-mail says neither Ildico nor Rousso have bank accounts?

A I would wonder in hindsight about Rousso not having a bank account, but I have found in this business that people that are active in the stock market such as Rousso may use his brokerage account like a bank account. That's where he makes his money, and that's where he distributes his money from.

¶ 473 Tannas and MacFarlane thought that it would be a good idea to review and discuss the activity in the Ildico account. McQuid did not say whether that review took place.

¶ 474 I have three concerns about McQuid’s testimony regarding this matter.

¶ 475 The first is the weight McQuid gave to the explanation provided by the client, given that the explanation changed completely over a two day period. As Thomas recognized in the Houge matter, a client who has something to hide will probably

be prepared to lie about it. And he will probably be no less likely to lie in writing than he would be to lie verbally.

¶ 476 The second concern is the implication that an unbroken audit trail is a guarantee against money laundering. The Commission's money laundering notice of April 1993 provided guidance to registrants as to how they were most likely to be used as a tool for money laundering:

> Registrants are probably more at risk of being used in the second stage of money laundering, *layering*, the use of multiple transactions and institutions to obscure the original source and the final destination of funds. …

¶ 477 There is no suggestion in the notice that having an unbroken audit trail of these multiple transactions prevents money laundering from taking place. Pacific International clearly recognized this in its 2000 Sales Procedures Manual:

> Wire transfers, however, are not without their risks. While they provide a paper trail, wire transfers are a preferred method of funds movement by those individuals engaged in money laundering activities, particularly because of the speed with which the transfers can be made between institutions. It is this speed that enables a money launderer to "layer" his transactions, that is, create a paper trail so active that it takes any investigatory body months or years to uncover the actual origin or ultimate destination of a flow of monies, because of all the financial institutions that may have unknowingly been a conduit for the wires.

¶ 478 The third concern with McQuid's testimony is his characterization of the challenge faced by Compliance:

> … we may make observation of activity, but we may not be able to bring that to a conclusion that anything improper has occurred …

¶ 479 In fact, most money laundering, market manipulation or other fraudulent schemes will involve several players. Some of those players will know exactly what is going on; others will not. For the latter, it will almost certainly be impossible to actually conclude that anything improper has occurred, because they are not seeing the complete picture. They are seeing only parts of the picture – share deposits, transfers of shares and money between accounts, wires coming in and going out, or trading activity – transactions that are not themselves illegal or improper, but are part of a broader scheme that is.

¶ 480 As a result, a registrant that observes, or should have observed, suspicious activity, will probably not be able to conclusively determine whether the client is doing anything improper or illegal. All the registrant can do is make whatever additional inquiries it can, both inside and outside the firm, and make an informed and reasoned judgment as to whether the client is acting improperly. The Commission recognized this in its 1995 fair trading notice:

> Even if a registrant is not directly involved in an unfair or inequitable activity, the registrant is expected to be inquisitive and pro-active in dealing with such activities that are carried on by others and of which the registrant is or should be aware. Registrants should refuse to accept instructions from clients who, in the registrants' judgment, are engaged in illegal, unfair or abusive trading activities. …

¶ 481 The information request of April 1997 and the suspicious aspects of the Ildico transactions of July 1997 should have caused Compliance to make further inquiries about the client.

¶ 482 Pacific International opened an account for Haim Solomon in February 1998. Solomon had an address in Israel and described himself as being self employed in advertising. The referral was Hababou.

¶ 483 In late April and early May 1998, issues arose in connection with activity involving the shares of Pro Net Link Corp. in several Stratton and Emes accounts, including those of Rousso and Hababou. The shares of Pro Net Link were quoted on the OTC BB.

¶ 484 While reviewing a daily commission report, Max Meier noticed unusual commissions in respect of trades in Pro Net Link. McQuid asked Thomas to look at the trading in the issuer's shares.

¶ 485 On April 28, 1.5 million shares of Pro Net Link were received in the Ildico account. A US deposit letter was provided and Compliance approved the transaction.

¶ 486 On April 30, Thomas sent an email to Meier, McQuid and Tannas regarding Ildico's sales of Pro Net Link shares. He confirmed that Compliance was looking into the trades "with a view toward determining the answers to a number of issues". One was whether sales of Pro Net Link shares by various clients could be distributions in contravention of US securities laws. He noted that this might not be an issue because the clients had sold around 10% of the public float of 30 million shares since the beginning of the year. The second issue was whether a group of Stratton clients – Hababou, Robert Sambou and Micheline Baron – were

acting in concert. The third issue was whether these clients were acting as nominees for others.

¶ 487 On May 4, Tannas sent an email to Thomas regarding the Ildico, Sambou and Baron accounts:

> Though these accounts technically provide us with acceptable US deposit letters and do not in aggregate maintain large share positions here, the following suggest that we may in fact be selling for an affiliate [essentially a control person] and effecting a distribution:
>
> - Though the account holders provide deposit letters indicating the shares are being sold for the account holder's benefit, the accounts wire significant funds to common parties: Charles Nisenbaum and Sutton Capital Corp., Cherrystone Stamp.
> - It is not clear that Robert Sambou receives the benefit of any funds from the account that bears his name.

Tannas went on to suggest several responses, including not allowing third party wires, not accepting further deposits of Pro Net Link shares, and getting further comfort from the clients that the shares were being sold for their benefit.

¶ 488 On May 7, Thomas sent an email to Meier, McQuid, Tannas, MacFarlane and Stratton. He noted that there was another client, Nicole Piegnier, selling Pro Net Link shares. He also forwarded Tannas' email of May 4 and advised that he had discussed the outstanding issues with Stratton. He continued:

> Bruce is now aware that we have noticed a pattern of wires to a similar group of third parties for the proceeds of the [Pro Net Link] selling. I have suggested that the best way of protecting ourselves in this situation is to ensure that the proceeds go to the client (if the clients wish to direct their funds to others after they receive the money – that is their decision). Bruce agrees and will ensure that the proceeds go to the client (small third party wires will still be ok).

¶ 489 Thomas said that this mitigated their concerns regarding the nominee account issue. However, this response did not really address any of the three issues Thomas identified in his email of April 30 – illegal distribution, acting in concert or nominee accounts. It dealt with the activity that raised those issues, the third party wires, but not the issues themselves.

¶ 490 During this period, Julie Suo-Antilla (Operations) wrote a memo regarding Rousso, Hababou, Sambou and Baron. A handwritten note on the memo indicated that it was given to Tannas on May 4. Thomas said that he did not see the memo until the summer of 1999. The memo summarized a number of facts about the four clients:

Robert Sambou:

- Currently has a Bronx NY mailing address, he has had 3 addresses in 5 months.
- We have a copy of NY state identification card. It's not very clear but we can make out his signature. The address does not match.
- He has a residence address on the Ivory Coast of Africa (offshore).
- He prints his signature, and is not very consistent.
- He is a self employed investment banker.
- He has no bank accounts.
- He is worth millions.
- We had return mail on the address that was on the ID.
- He never wires money to himself, it is always to third parties including Sutton Cap, and Phillipe Hababou.
- Marc Rousso referral
- He deals with a lot of Pro Net Link Corp, and Intl Diamond Corp (formerly New Century Media)
- Wire instructions seem to come from same place as Micheline & Phillipe (shared office per Elsie)

Micheline Baron

- She has a New York city address.
- She has a residence address in the French West Indies (offshore).
- She is a self employed investment banker.
- She is worth millions.
- She has bank accounts.
- She sends wires to herself and to third parties including Sutton.
- Marc Rousso referral.
- Account forms were notarized in New York.
- Her signature looks like it may be computer generated on two of the wire requests. It was the exact same. Elsie informed, and told that it was unacceptable. No explanation offered.
- She deals with a lot of Pro Net Link Corp.

- Wire instructions seem to come from the same place as Robert & Phillipe (shared office per Elsie).

Phillipe Hababou

- Has a New York city address.
- He is a self employed investment banker.
- He is worth millions.
- He has also had addresses in France and England (offshore).
- He sends wires to himself and third parties.
- He does internal transfers to Ildico (Marc Rousso) and Robert Sambou.
- LHM [McQuid] has worked on this file in the past. (Nov 95)
- He bought a large chunk of the New Century media back in Nov 97 at a penny.
- He receives in physical stock, sells it, and wires out money. He also does a lot of trading in Jet Vacations, Log Point Techs, Intl Diamond Corp (formerly New Century Media).
- Wire instructions seem to come from same place as Robert & Micheline (shared office per Elsie).
- The printing on the power of attorney for the New Century Media in the file looks the same as Robert Sambou's signature on account forms (not margin card).

Marc Rousso

- He currently has a New York city address.
- He has had addresses in France, and the Bahamas (offshore).
- [Compliance], Jay and LHM have all looked at this file in the past.
- He is self employed in public relations.
- His form is old but it says his net worth is 100,000 plus.
- He wires out to third parties (through Ildico) not many outgoing wires though.
- He receives in third party wires (Oct & July 97)
- He does internal transfers to third parties (from Robert Sambou, from Philippe Hababou).
- He deals with a lot of Intl Diamond Corp (formerly New Century Media) and Pro Net Link (see transactions)
- He delivers in physical stock, sells it, sends out wires and does a lot of buying and selling in Pro Net Link, New Century Media (not Intl Diamond Corp), and DH Marketing.

¶ 491 The document in evidence did not include any transactions, as referenced in the second last bullet.

¶ 492 Thomas was asked whether seeing this memo at the time would have impacted his decision in this matter:

> Q If you had seen this memo at the relevant time, would it have impacted your decision as to what to do? If you can't answer, that's fine.
> A I think, I think that, generally speaking, there are, there are a number of issues here which, which would have directed my staff to, to provide me with, with more information on.
> Q Can you give a for instance?
> A Well, no, I think that, generally speaking, the, the, the, this, this document here is, is so inflammatory that, that I would, I would want to see a full workup on it. And, and that, that's really the best that I can tell you.

¶ 493 Thomas was also asked why he did not see the memo at this time:

> Q Do you know how it is that this memo didn't find its way into your hands during the relevant period?
> A I don't know.
> Q What was the reporting process there? Obviously you are getting e-mails on occasion from Ms. Tannas. Do you know whether it was her practice to receive information from others, form an opinion or a list of concerns, and not provide the source information to you?
> A I think that Ms. Tannas' practice was to provide me with, with information that she felt was relative -- relevant. And to the extent that she thought that she needed to provide me with detail, that she would do so. It, it may be that she looked into these issues and came -- and reached conclusions on her own about them.

¶ 494 I have two concerns about the circumstances surrounding, and the contents of, the Suo-Antilla memo.

¶ 495 The first is that important facts about four clients were identified by staff but did not reach the person who was making decisions with respect to those clients. Thomas indicated that Tannas provided him with the information that she thought was relevant and the detail that she thought he needed. In other words, the information Tannas provided to Thomas was within her discretion. In this case, Thomas does not know why she decided not to give him the information, even

though she knew that he was in the process of making decisions about these very clients. This points to a problem identified in the Holley Report:

> It was not clear to us, however, that written guidelines have been crafted to cover each core compliance function or that all compliance staff have a clear and equal understanding of the 'compliance mission statement' that should guide the application of their authority and the exercise of discretion.

In short, if staff are going to be given discretion, they must also be given guidance on how they are expected to exercise that discretion.

¶ 496 The second concern is the extent of the third party transactions regularly engaged in by these clients. Again, this was an issue raised in the Holley Report:

> Inter-Account Journals and Distributions to Third Parties
>
> This is a significant area of activity for the Operations Department. While the majority of journals are between related accounts of the same client, there appear to be a significant number of requests for journals between seemingly unrelated accounts. Current procedures allow for the movements of assets (securities or cash) between accounts based only on the instructions of the delivering party. We are advised that the Operations Department would not routinely inquire as to nature of the asset transfer or the nature of the relationship between the account holders. We are concerned that there could be accounts in which most or all of the assets are received from third party accounts and later distributed to third parties without those accounts being brought promptly to the attention of Compliance.
>
> Third party wires are of course a key issue for compliance and supervisory staff and are a central aspect of some of the recent U.S. indictments. Issuing cheques or initiating wire transfers to third parties is considered a service to clients, not unlike offering clients simple banking privileges. As a dealer, Pacific international will be expected by the regulators to monitor and, where appropriate, draw inferences from the financial transactions of its clients.
>
> Does a third-party wire suggest an undisclosed connection between the client and an issuer? Does it suggest the financial involvement in the account of an undisclosed person? Does it suggest some significant change in the financial circumstances of the client? Does it create a suspicion that the client may be involved in the laundering of money? (KPMG has

pointed out that third party wires are an instrument of choice for those involved in money laundering.)

The question, ultimately, is whether or not the benefits of offering third party wire services to clients outweigh the risks to Pacific International. We understand that the firm is actively reviewing its policies on third party wires and other distributions from accounts and that policy changes may result.

Recommendation 33 [B]

The movement of assets between otherwise unrelated parties (by way of journal or third party delivery or wire) raises questions about the true beneficial ownership of the account. We recommend that this activity be very closely monitored. Staff should be reminded of the significance of inter-account or third party activity from the perspective of compliance and effective supervision.

Recommendation 34

We recommend that the firm consider prohibiting or, at a minimum, substantially restricting the frequency of third party journals and distributions. To the extent that third party journals or transfers are allowed, we recommend that they be reviewed and approved by a senior staff member in Compliance or Operations who is familiar with the regulatory issues and who has the authority to reject any third party journal or distribution request.

Recommendation 35

We recommend that all transfers of assets, at least between apparently unrelated accounts, whether free or against funds, be authorized by both the delivering and the receiving client (not unlike a clearing item).

¶ 497 Meier's inquiry regarding unusual commissions brought this group of accounts to Compliance's attention. Thomas knew there were concerns that these clients were illegally distributing securities in the US, acting in concert, or acting as nominees. One of the key factors giving rise to these concerns was that the accounts wired significant funds to common third parties. Thomas dismissed those concerns, and made decisions regarding these clients, without thoroughly reviewing their financial transactions and drawing inferences from that activity as to whether the clients were doing something improper or illegal, such as money laundering or

market manipulation. He acknowledged that Suo-Antilla's memo raised a number of issues that should have led to further inquiries.

¶ 498 On May 19, the Commission issued an order requiring Pacific International to produce trading blotters for trades in D.H. Marketing from January 1994 to April 1998. The order also required Pacific International to produce account documentation for 19 clients, including Ildico, Rousso and Hababou.

¶ 499 On June 12, Pacific International formally restricted the accounts of Hababou, Charles Nisenbaum and two other clients from sending third party wires without Compliance approval.

¶ 500 On November 5, the VSE requested Pacific International to produce account documentation from January to October 1998 for Sambou.

¶ 501 On November 26, the Investment Dealers Association issued a bulletin regarding compliance requirements for firms dealing in foreign jurisdictions. The bulletin reminded firms that:

> Members should be vigilant in ensuring that related customers or customers otherwise acting in concert are not using accounts to trade small cap issues included on the OTC Bulletin Board, or in any other market inside or outside of Canada, to create a false appearance of trading activity or otherwise engage in manipulative activity. US regulators have expressed concern that, in some cases, cash account rules may have been inappropriately utilized to extend credit in order to facilitate such transactions.

¶ 502 On December 16, the Commission issued an order requiring Pacific International to produce trading blotters for all transactions in Pro Net Link from September 1997 to November 1998. The order also required Pacific International to produce documentation for three transfers of Pro Net Link shares, totalling 3,159,000 shares, to Cede & Co. The order also required Pacific International to produce account documentation for accounts in the name of, controlled by or held for the benefit of 15 individuals and six entities, including Hababou, Sambou, Charles Nisenbaum, Piegnier, Baron and Ildico.

¶ 503 On February 11, 1999, the VSE sent Pacific International the results of a Level 2 search on Rousso and Sambou. There was no information about Sambou. There were many articles about Rousso, but nothing indicating that he had a criminal or regulatory history. On February 22, Tannas sent an email to Thomas summarizing the Rousso search results:

The media searches on Rousso refer to a number of David Baines articles in the mid 90's which refer to:

- Rousso's involvement with a VSE promotion of 10 years ago, Wall Street Ventures. This company acquired a collection of Middle Eastern stamps at an allegedly inflated price. When the stamps were brought into Canada by a New York stamp dealer, Gary Gross, at the Blaine crossing, their value was declared as $37,000 but they were accompanied by an evaluation that indicated they could retail for $37,000,000. This prompted an investigation by US customs who issued a report saying that Rousso had provided the $37,000 valuation, that the $37,000,000 evaluation (prepared by Gross) was fraudulent and that Rousso was known in philatelic circles as "highly controversial" for his marketing practices. Rousso denied owning the stamps and said he intended to market the stamps on behalf of a VSE listed company. Wall Street Ventures ultimately acquired the stamps for $1.3 million.
- Rousso being "blacklisted" by the VSE in 1994.
- Rousso as one of several promoters of Thermo Tech Technologies in 1994. This stock rose from $3 in Aug/93 to $14 7/8 in Feb/94.
- Rousso being involved in a "series of controversial stamp deals in the US".

A number of articles from various sources in the late 80's (The Washington Post, The Asian Wall Street Journal, Los Angeles Times, Forbes, The Montreal Gazette) refer to Rousso as being shunned by legitimate stamp dealers.

- Rousso's stamp company was investigated in Florida in 1986 for illegal telemarketing practices and in California in 1988 for misrepresenting the value of stamps.
- Some stamp dealers have protested that Rousso persuaded newcomers to pay large sums for stamps of questionable value and that he has claimed to act for both the buyer and seller in large transactions that are impossible to verify.
- Rousso barters stamps for real estate and other property and was sued in one case because stamps he said were worth $350,000 in a trade for real estate were only worth $70,000.

There are no articles referring to Rousso being found guilty of fraud or anything else.

> Third parties receiving funds from Rousso's Ildico account include apparent stamp dealers.

¶ 504 Thomas responded to Tannas, copying McQuid. Tannas' original email was attached to the response:

> I think that it is interesting "business" pumping up the value of stamps and then selling them or bartering them for inflated prices. That this guy is still a client of ours and the referral for a number of Bruce's accounts (including Sambou's) may come back to haunt us.

¶ 505 On May 6, Compliance requested a second search on Rousso; the search revealed no new public information. Thomas said that Compliance did this because of a rumour that Rousso had been arrested. Thomas also said that he did not know about this at the time.

¶ 506 Also in May, Pacific International received two requests for information regarding Pro Net Link. The first was an order for production from the Commission for information to be provided to the SEC. The second was a subpoena from the US Department of Justice. The minutes for the Executive Meeting of May 27 referred to the subpoena:

> The meeting reviewed the legal report and it was noted that we have received a Subpoena from the US Department of Justice regarding trading in Pro Net Link. This involves Bruce Stratton & Elsie Emes and maybe Mike Patterson & Dirk Rachfall. We have retained US counsel to assist us in this matter.

¶ 507 Thomas said that the language in the minutes may have been imprecise and that it was his understanding that the investigation did not relate to trading in Pro Net Link:

> Q Yet the minutes to the exec meeting talk about a subpoena regarding trading. How do you explain that?
> A Correct, the -- the subpoena asked for -- for various types of information regarding a number of accounts that traded Pro Net Link, and the information would have included information regarding the -- the trading, perhaps including account statements or trading blotters.
> Q But to the best of your knowledge, the investigation was not trading per se?
> A That's correct, I -- I don't know -- I -- I don't know whether this Department of Justice investigation was a parallel one to the SEC

investigation. And I don't know what -- to that extent, I don't know what it was that the Department of Justice was looking at.

Q Can you explain why the minutes would say a subpoena relating to trading, when, in fact, your understanding was it wasn't trading?

A I didn't prepare the minutes, but this may be an example of imprecise language in the -- in the minutes.

¶ 508 It appears that Thomas' understanding of the nature of the Pro Net Link investigation was derived solely from the issuer's public filings:

Q But you did make some reference to an investigation. What do you know about any investigation relating to Pro Net Link?

A There were references to an SEC investigation contained in the issuer's filing statements. We became aware of, of that during 1999, the summer of 1999.

Q All right. Do you know what the nature of the investigation is?

A It had to do with issuer misconduct. I believe the investigation was into whether or not the issuer had misstated its assets.

Q And this nature of the investigation, how do you know about that?

A Because I read the filing statements. It's been a while since I've read them but there are filing statements on the, on the SEC EDGAR Web site which reference that.

¶ 509 There are several problems with Thomas' statement that the investigation had to do with issuer misconduct and not trading.

¶ 510 First, Pro Net Link would be disclosing in its public filings only information that was within its knowledge. It would be unlikely to know the full nature and extent of the SEC or Department of Justice investigations. Thomas would have, or should have, known that.

¶ 511 The second problem with Thomas' statement is that it is inconsistent with the type of documentation Pacific International was being asked to provide – information regarding the accounts that had traded Pro Net Link shares, including trading information.

¶ 512 Third, the Executive Meeting minutes stated that the subpoena regarded trading in Pro Net Link and that Stratton and Emes and, perhaps, Rachfall and Patterson were involved. The directors would not have been discussing the involvement of investment advisors in respect of an investigation relating solely to issuer misconduct.

¶ 513 Finally, Bachellerie asked about the issue and was told that Pacific International had done a fair amount of trading in Pro Net Link shares. He had a high level of concern about that and understood that McQuid and Thomas were also concerned:

> Q … prior to June there was a subpoena with respect to ProNet Link. Did you know anything about that?
> A I recall that, yes.
> Q I believe that occurred in May?
> A May of '99, yes.
> Q What do you recall?
> A Well, I recall having quite a high level of concern about that, about that subpoena. I can't recall where it was from exactly. I think it came from the U.S. district attorney. It sounded very -- I was concerned by it, and I asked Mr. McQuid and Mr. Thomas questions about the issue, and I found that we had done a fair amount of trading in ProNet Link.
> Q What did you do -- what was the result of those discussions? Were you told what they were doing or do you recall?
> A I don't recall exactly what the result of the discussions were. I recall that they also had concerns and that they were taking appropriate steps.

¶ 514 Those steps did not appear to include making any further inquiries or restricting the accounts.

¶ 515 As well, Thomas knew, or should have known after he looked at the issuer's public filings, that the Pro Net Link investigation was looking at both trading at Pacific International and possible issuer misstatement of assets. That made the investigation more serious and more suggestive of a possible market manipulation.

¶ 516 On June 4, D.H. Marketing sent a letter to Thomas, confirming a discussion the president of the issuer had had with Thomas earlier in the day. The letter stated that D.H. Marketing had agreed to sell 200,000 of its shares, at $1.60 per share, to Ildico. D.H. Marketing had received only $80,000 of the $320,000 owing and was now trying to recover either the shares that had not been paid for or any money received from their sale. The letter noted: "We were told Marc Rousso (Ildico, Ltd.) was arrested and put in jail for whatever reasons and my efforts to reach Ildico have failed."

¶ 517 Three days later, Thomas sent a letter to Ildico, to the attention of Rousso. He copied McQuid on the letter. Thomas advised Rousso that Pacific International had become aware of the dispute between Ildico and D.H. Marketing. He

acknowledged that the disputed shares had been deposited into Ildico's account. He continued:

> Because of this adverse claim we have, regretfully, been forced to place account restrictions on the Ildico accounts until such time as a resolution of this dispute is reached. We will release the accounts once we are satisfied that Pacific has no further liability, or potential liability with respect to the shares and credit balance in the accounts or upon receipt of an Order from the Supreme Court of British Columbia directing us as to how to dispose of the account holdings.

¶ 518 Thomas said that the Ildico accounts were restricted from trading and releasing assets.

¶ 519 On June 14, Pacific International's US counsel confirmed that Rousso had been arrested. Thomas said that the only information they were able to get about the charge was that it was some form of bank fraud. However, they had no formal information about the nature of the charge. Thomas said that he believed the document under which Rousso had been arrested was under seal.

¶ 520 That day, Thomas sent an email to Compliance and Operations, copied to McQuid and Emes, regarding the Ildico accounts:

> Please code all accounts "no release of assets without prior Compliance approval". We have received information which would indicate that Mr. Rousso's arrest was a very serious matter.

¶ 521 On June 18, an indictment was filed against Hababou (aka Haim Solomon or Malko), charging him with money laundering and other offences. The indictment alleged that, between July 1995 and June 1996:

- One of Hababou's co-conspirators (referred to as John Doe) purchased an issuer called Prime International Products Inc. Doe caused Prime to issue 18 million restricted shares to his nominees, in order to ensure his undisclosed control of the company.
- Doe designated Hababou and the co-conspirators to act as his nominal officers, directors and shareholders of Prime.
- Doe, Hababou and the co-conspirators issued large blocks of free-trading Prime shares in the names of Doe's nominees. Those nominees included Hababou and various offshore companies that Doe controlled and over which Hababou exercised power of attorney. The offshore companies included Ildico

Ltd. (Bahamas), Fister Universal Ltd. (Bahamas), Vienex Holdings Corporation (Bahamas) and Shabby Invest Ltd. S.A. (Panama).

- Doe, Hababou and the co-conspirators deposited the free-trading Prime shares into accounts at Pacific International, which the indictment described as "a securities brokerage firm with offices in Vancouver, British Columbia". Those accounts were in the names of Hababou and Ildico.
- Doe was thereby able to retain ownership and control of at least 2 million free-trading Prime shares without disclosing this to the SEC or prospective investors.
- Doe, Hababou and the co-conspirators took steps to merge Prime with Public Info, exchanging the 18 million restricted Prime shares for all of the Public Info shares.
- Doe, Hababou and the co-conspirators sold on the OTC BB the bulk of the free-trading Prime shares held by Doe's nominees (over 2 million shares), while making misrepresentations to increase the price of the shares.
- Doe, Hababou and the co-conspirators solicited investors by falsely representing that they had inside information about some future event involving Prime that would substantially increase the value of the shares.
- Doe, Hababou and the co-conspirators filed with the SEC, and publicly disseminated, information that they knew was false and misrepresented Prime's affairs.
- Doe realized over $5.3 million by selling the bulk of the free-trading Prime shares held by his nominees.
- Doe, Hababou and the co-conspirators caused approximately $4 million of the sale proceeds to be wired from the accounts at Pacific International to accounts controlled by Hababou and certain co-conspirators at various entities. These entities included Avis Currency Exchange Inc. (a currency exchange in New York), Boardwalk Regency Corporation (which operated Caesars Casino in New Jersey) and a bank in New York.
- Hababou exchanged $1.2 million that had been sent to Avis into various foreign currencies. He then withdrew the funds from Avis for the benefit of himself, Doe and the co-conspirators.
- Hababou withdrew $580,000 that had been sent to Caesars Casino, for the benefit of himself, Doe and the co-conspirators.
- Doe and the co-conspirators used $2.2 million that had been transferred to accounts at a bank in New York, for their personal benefit.
- Hababou caused Avis and Caesars Casino to file reports with the US Treasury Department that contained false information about the true owner of funds withdrawn by Hababou.

¶ 522 The indictment described ten wire transfers allegedly sent from the Hababou and Ildico accounts at Pacific International.

¶ 523 The news release that announced the filing of the indictment also stated that Hababou had been arrested on December 23, 1998, pursuant to a French warrant for his arrest as a fugitive dated February 19, 1996.

¶ 524 Thomas restricted the Hababou and Solomon accounts to "no transactions without prior Compliance approval". He also had Compliance look at the accounts into which free trading Prime shares had been delivered. They determined that 3 million shares had been delivered into Hababou and Ildico accounts. There had been eight or nine deliveries over an 18 month period. The largest had been an electronic delivery of over 1 million shares from an account at a US broker dealer.

¶ 525 Between September 1995 and December 1998, the Hababou account wired out $9,727,311:

- $2,396,500 to the client;
- $1,006,372 to other Pacific International clients, including Ildico;
- $2,200,000 to lawyers;
- $395,380 to issuers;
- $98,000 to stamp dealers;
- $2,250,000 to Avis Currency Exchange; and
- $1,381,050 to other third parties.

¶ 526 During the same period, the Hababou account journalled $561,970 to other accounts at Pacific International. Approximately $224,000 of that went to other Hababou accounts.

¶ 527 Between August 1994 and June 1999, the Ildico account wired out $10,065,346:

- $361,711 to the client;
- $1,226,000 to other Pacific International clients, including Hababou;
- $50,000 to lawyers;
- $395,600 to issuers;
- $1,140,940 to stamp dealers;
- $415,000 to Avis Currency Exchange; and
- $6,476,095 to other third parties.

¶ 528 During the same period, the Ildico account journalled $736,685 to other accounts at Pacific International.

¶ 529 I conclude that Pacific International failed to make inquiries to learn the essential facts about Rousso and Ildico in July 1997, after Credit and Compliance dealt with

the suspicious wire activity in the Ildico account. Though Tannas and MacFarlane recommended that they review the activity in the account, it does not appear that such a review took place.

¶ 530 I conclude that Pacific International failed to make inquiries to learn the essential facts about Rousso, Ildico and Hababou in May 1998, when issues arose regarding transactions in their accounts related to Pro Net Link. The information in the Tannas and Suo-Antilla memos should have led Pacific International to make further inquiries about these clients.

¶ 531 The failure to make inquiries continued until June 1999, when Pacific International restricted the accounts, despite:

- orders for production from the Commission and a request for production from the VSE;
- the Rousso search results of February 1999;
- the US subpoena and SEC request for information regarding Pro Net Link of May 1999; and
- the activity in the accounts.

5. Gladstone

¶ 532 Pacific International opened an account for Richard Gladstone and his wife, Lauri, in June 1996. The address was in Boca Raton, Florida. Gladstone said that he and his wife were travel consultants with Sterling Travel. He said that they were not officers, directors or insiders of an issuer traded on an exchange or the OTC BB. He said that they traded with two other Vancouver dealers as well as Pacific International.

¶ 533 The investment advisors for the Gladstone accounts were Rachfall and Patterson.

¶ 534 In December 1996, Compliance requested a Level 2 search on Gladstone. McQuid said that they ordered this search because it was becoming their policy to search active accounts. Compliance received the search results in January 1997.

¶ 535 The search results revealed that, in June 1992, the NASD expelled Morgan Gladstone & Co. Inc. from membership in the NASD and banned Gladstone from association with any member of the NASD in any capacity. The firm and Gladstone were ordered to pay restitution of $155,876 before seeking re-entry into the industry and Gladstone was fined $100,000. In a notice to members, the NASD said that the firm, acting through Gladstone, had “effected principal transactions in over-the-counter corporate securities with public customers at

prices that were unfair and unreasonable. The markups on these transactions ranged from 25 to 150 percent above the prevailing market price …". Also, Gladstone had failed to adequately supervise the activities of the firm's representatives.

¶ 536 In 1990, the Florida Division of Securities withdrew the firm's licence and banned Gladstone from acting in a management position at any broker dealer. The Securities Division had alleged that the firm, at Gladstone's direction, sold unregistered securities, charged its clients excessive markups and failed to keep proper books and records. The firm and Gladstone accepted the sanctions without admitting or denying the allegations.

¶ 537 The search results also included an article dated September 3, 1990, from the South Florida Business Journal. The article reported the Florida Securities Division action and described Gladstone's history:

> Gladstone entered the securities industry working for Joel Nadel's Newsletter Management Corp., which published penny stock and investment newsletters. The Security and Exchange Commission currently is suing Nadel, alleging that he accepted cash payments and stock in exchange for touting various stocks, including several tied to accused swindler James A. Laiacona.
>
> State documents show that Gladstone, while continuing to work for Newsletter Management, became president of Chelsea Securities Corp. of New York in 1981.
>
> He went to work in 1985 for a New Jersey brokerage called Weaver Johnson & Co. The following year he joined F.D. Roberts Securities, the notorious mob-connected brokerage that has been the subject of federal investigations the last three years.
>
> While remaining licensed at F.D. Roberts, Gladstone opened Morgan Gladstone in early 1986.
>
> In 1987 the division accused Gladstone of operating Morgan Gladstone, then called J. Morgan Financial Services, an unlicensed and illegal branch office of F.D. Roberts.
>
> State regulators conducted a routine inspection of the firm's offices and found it used unlicensed brokers to conduct trades, failed to keep proper records, conducted trades without securing proper confirmations and published a newsletter that contained fraudulent information.

> Gladstone, without admitting or denying the allegations, agreed to an administrative order that stipulated he abide by state law.
>
> Gladstone became embroiled in another dispute with the division when he was accused of participating in a scheme that Newsletter Management hatched to distribute free stock to subscribers. Gladstone eventually convinced regulators that he was not involved with the firm at the time the stock was being distributed.

¶ 538 McQuid first saw these search results in July 1997. He said he did not know why it took so long for him to learn of these results.

¶ 539 The results revealed a recent and serious regulatory history. They also revealed that Gladstone was reported to have worked for, and then operated an unlicensed and illegal branch office of, a "notorious mob-connected brokerage".

¶ 540 A Business Week article regarding organized crime on Wall Street had been published in December 1996, just one month before Compliance received the Gladstone search results. Hauchecorne had sent the article to McQuid and told McQuid that the client he knew as Metzer was really Philip Abramo. According to the article, Abramo had been identified in court documents as a ranking member in the New Jersey-based DeCavalcante organized crime family. The article also said that a three month investigation by Business Week revealed that substantial elements of the small-cap market had been "turned into a veritable Mob franchise". The article claimed that the mob's chief means of livelihood was "ripping off investors by the time-tested method of driving share prices upward – and dumping them on the public through aggressive cold-calling." The article said that that the cold calling was done through a network of stock promoters, securities dealers and boiler rooms, and that the brokerages were located mainly in New York and Florida.

¶ 541 After McQuid was taken through the Business Week article at the hearing, he was asked if he had been concerned that there might be similar problems in other accounts at Pacific International:

> Q Now, you have already had a couple of unpleasant surprises in accounts at Pacific International, correct?
> A Yes.
> Q And now you are reading an article which is saying that this high-ranking member of the Mafia has been successful in infiltrating himself surreptitiously to the securities industry, correct?
> A Yes.

Q Aren't you becoming concerned as to whether there may be more infiltrations in your particular firm of organized crime?
A No, I'm not. I felt that I had dealt with the Hauchecorne accounts properly.
Q But given that these people, Abramo and similar types, have the ability to surreptitiously infiltrate themselves, doesn't it occur to you that there could be more that I don't know about? There could be more bad surprises coming?
A I think, Mr. Hilford, that, that business and, and our business specifically, have certain policies and procedures that are laid out by the, by the industry. We follow those policies and procedures, and I think for the, for the most part, they were, they were effective. But if somebody is set upon executing a scheme, it is, it is a due diligence process. It's not a science and there has always been a risk and will continue to be a risk that people like this will succeed to one degree or another if they're set upon executing a scheme.

…

Q Let's say that, let's say that nothing had happened in your firm prior to you reading this article. In other words, no Hauchecorne incident, nothing had happened up to this time. No phone calls from the FBI on Globus, no Badger, Langley, Larder criminal complaint. [These three clients had been charged in October 1996 in the US with conspiracy to commit securities fraud.] Nothing had happened. If you were reading this article and it's -- would you have thought to yourself, you know, we do a fair amount of business in the over-the-counter market. Maybe I had better be a little more vigilant and look into this. Because this article is saying the Mob is tied up in, in these markets and that they're hard to root out?
A I, I think how I understood this article was that, was that these are, these are people who were influencing the, the price of securities. And how do you, how do you ferret that out if that activity isn't, isn't occurring through, through your, yourselves in a way that you can recognize?
Q Are you posing the question to me?
A No, I'm not.
Q Okay. So, I will ask you again. Would -- if nothing had gone wrong up to this point in time, would this article have caused you concern given that you do business in the very markets they're discussing, would it have caused you a concern that may be the Mob had infiltrated accounts at your firm?

A No, no it would not. These are the, these are the largest marketplaces in the world monitored by agencies of the most powerful nation in the, the world. Where there are opportunities for financial gain, unfortunately there, there will always be people who, who try to take advantage of, of that. And I think what our obligation as a dealer is, is to make sure that the transactions that our clients are participating in are, are suitable for them and that they're not doing something that improperly influences the market price of the security.

Q Now, given that you had already had some serious problems at Pacific International prior to this article being published, didn't it occur to you that there might be more problems looming around the corner at Pacific International?

A No, it did not.

¶ 542 The Gladstone search results suggested that there might be a potentially very serious problem looming around the corner at Pacific International – here was another client reported to have a connection to organized crime, as well as a serious regulatory history. Despite this, Compliance did not inform McQuid of these results.

¶ 543 On February 21, the Commission issued an order requiring Pacific International to produce account opening documentation, and correspondence and monthly statements from September 1, 1995 to October 31, 1996, for 19 accounts. Three were Gladstone accounts. Four were accounts of Badger, Langley or Larder.

¶ 544 McQuid said that he did not know that he would have seen the order at the time. He said that he thought that all of the accounts had probably traded a common security.

¶ 545 On May 14, the Commission issued an order requiring Pacific International to produce account documentation from January 1995 to April 1997 for 15 accounts. These included accounts for Gladstone, Wahoo International and Second Capital Resources. Again, McQuid did not recall whether he saw the order at the time. He said that, had he known about both the February and the May orders, he would have felt that they were related to each other.

¶ 546 On July 11, Tannas sent a memo to McQuid regarding 13 accounts with a connection to Gladstone. She noted that the accounts appeared to have "a number of the elements that make them high risk from a regulatory point of view." Those elements were:

- Gladstone's regulatory history;
- the recent Commission orders for production of information regarding accounts of Gladstone, Wahoo and Second Capital Resources, "which likely originate with US regulations"; and
- that certain of the accounts were "selling accounts" for OTC BB shares.

¶ 547 Tannas also noted that the Wahoo account submitted a US deposit letter in unacceptable form. She attached an appendix to the memo setting out information about each of the 13 accounts:

- Gladstone
  - "Selling account – receives in large blocks of US BB stocks"
  - client lives in Boca Raton, Florida
- Gladstone
  - "MGN-S account Sells and buys a variety of US issuers"
- Gladstone
  - inactive
- Wahoo
  - "Selling account – receives in large blocks of US BB stocks"
  - account address is in the Bahamas
  - US deposit letter was faxed from Gladstone's office in Florida
  - journalled stock to a Gladstone account
  - transferred $400,000 to a Gladstone account since January 1997
- Wahoo
  - buys and sells one US BB stock
- Wahoo
  - inactive
- Atom Corp.
  - "Selling account – receives in large blocks of US BB stocks"
  - account has the same Bahamian address as the Wahoo accounts
  - received stock from Gladstone and Wahoo accounts
- Atom Corp.
  - inactive
- Mercacorp Inc.
  - received large block of US BB stock
  - buys and sells US BB stocks
  - account has a Swiss address
  - account received shares from, and journalled shares to, a Gladstone account
- Mercacorp Inc.
  - received a large block of US BB stock
  - buys and sells US BB stocks

- First Capital Resources
  - "Selling account – receives in blocks of US BB stocks"
  - account has California address
  - account made a cash transfer to a Gladstone account
- Second Capital Resources
  - relatively inactive
  - same address and offices as First Capital accounts
- Second Capital Resources
  - relatively inactive

¶ 548 McQuid described his response to this information about Gladstone:

> A The, the memo led to some additional account searches and also led to a meeting with the, with the investment advisors over, not only this account, but, but other accounts.
> Q And did you give any thought to the nature of the violations in deciding what to do with the account?
> A Yes, we did.
> Q What were those considerations?
> A We looked at the, at the age of the, of the client's history. We looked at the, the nature of it, and we looked at our experience with the client to this point in time. We tried to, to form a judgment as to whether the, the history was something that the client could repeat in the activity in his, his brokerage account. And then we took a decision as to whether to, to maintain the, the account. And that wasn't all done on July 11th. That occurred over, over a period of time.
>
> We had, we had also conducted some very specialized searches on, on accounts also at this time. All of that information was, was compiled and, and discussed in a meeting. Eventually the decision was taken to continue the account but to subject it to, to a heightened supervision. And the account appeared on our compliance update for, for several weeks thereafter indicating that the account was being, was being watched closely. In fact, I think it's fair to say that it was, it was watched very closely for the entire time that it was at PI.

¶ 549 McQuid also said that Compliance looked at the transactions in Gladstone's accounts. He said that they did not see anything remarkable about the trading in the accounts.

¶ 550 McQuid's answer focussed solely on process. He provided no information as to the specific aspects of Gladstone's regulatory history or account activity that persuaded them to retain his accounts.

¶ 551 Gladstone was a US resident. He had a recent and serious regulatory history; his brokerage firm had been shut down by the NASD and he had been banned from association with any NASD member in any capacity. He was reported to have worked for, and operated an unlicensed and illegal branch office of, a "notorious mob-connected brokerage" in the US. His accounts had been the subject of two recent Commission orders for production which likely originated with US regulators. Some of his accounts were very active. He was involved in a group of accounts, several of which received in large blocks of OTC BB shares which they then sold through Pacific International. The accounts in the group also journalled shares and money between each other. Several of the accounts in the group shared the same address in the Bahamas. As well, Pacific International knew by the end of 1997 at the latest that Gladstone had accounts at at least three other Canadian firms and two US firms.

¶ 552 All of these factors were suspicious and raised a significant question about Gladstone – had Gladstone been using his accounts at Pacific International, or would he use them in the future, as part of an illegal scheme? The answer to that question was an essential fact about Gladstone that Pacific International needed to know before it continued to retain his accounts. Pacific International would not have been able to definitively answer that question. However, it was expected to exercise its judgment on the basis of all the information that was available to it at the time, both inside and outside the firm.

¶ 553 In that regard, it does not appear that Compliance made any further inquiries about the relationship between these clients, or about the OTC BB securities these clients were trading, before they decided to retain Gladstone's accounts.

¶ 554 McQuid provided little information that would alleviate the suspicions that had been raised about Gladstone and his accounts. McQuid did say that Compliance did not see anything remarkable about the trading in Gladstone's accounts. Even accepting that to be true, it is difficult to see how that one factor could outweigh all the other suspicious factors described above.

¶ 555 About a year later, on June 24, 1998, the Commission issued an order requiring Pacific International to produce account documentation for the period from June 1995 to June 1997 for accounts of Gladstone, First Capital and Wahoo.

¶ 556 On July 21, Tannas sent a memo to Thomas regarding a 1996 Fortune magazine article. The article referred to a short selling group that had caused the collapse of

two US broker dealers in 1995 and was alleged to be connected to Gurian. She noted that Fiero Brothers was said to have been a member of the short selling group and that Pacific International had recently done a trade through Fiero for the Dragon Development account.

¶ 557 McQuid said that the Dagon account had been referred by Gladstone and that he thought "there had even been activity amongst the accounts." McQuid said that both Gurian and Gladstone lived in Boca Raton.

¶ 558 McQuid and Thomas wanted to find out if Gladstone had any connection to Gurian. Thomas and Rachfall decided that Rachfall should call Gladstone about Gurian. Thomas said that they decided that Rachfall would inquire about Phil Gurnsey rather than Phil Gurian, because they were concerned that Gladstone would be dishonest if they used Gurian's real name:

Q … Did you and Mr. Rachfall plan for him to have a conversation with Richard Gladstone about Phil Gurian?
A Yes.
Q And did you decide that he should use the name Phil Gurnsey rather than the name Phil Gurian when you spoke to him about it?
A That was Mr. Rachfall's idea, in an effort to disguise who it was that we were asking questions about.
Q So he was -- you had discussed having him called to find out about Gurian, but you wanted to disguise who you were calling about?
A Yes, because if Mr. Gladstone had been doing business directly with Mr. Gurian, a direct inquiry might not have elicited the types of responses which we wanted to have from him.
Q So you both knew at this point that Mr. Gladstone had a regulatory history, correct?
A Yes.
Q And you decided that you couldn't trust this client with a regulatory history enough to straight out ask him if he knew Gurian, correct?
A We wanted to elicit honest responses from him.
Q You were concerned he would be dishonest if you used the real name rather than Phil Gurnsey, a phoney name?
A Sure.
Q Because you didn't trust your client?
A I think when we make a compliance inquiry like this, it's always a useful thing never to trust what someone's response is going to be. This is not your routine type of inquiry.
Q I will put it to you again, sir, you didn't trust this client?

A Well, I don't know whether you can trust him or not, and I think that his responses actually indicated that we could trust him to a degree.
Q Your response just now is I don't know whether you can trust him or not. I'm looking for whether you trusted him before making the telephone call. You did not trust him before placing the -- before Mr. Rachfall placed the call, correct?
A We wanted to find out whether Mr. Gladstone had any connections with Mr. Gurian. If he did have those types of connections, he's not the type of person we wanted to have a client of ours, so we wanted to create the inquiry in such a manner as would elicit honest answers from Mr. Gladstone. Did I have an opinion as to whether we could trust him or not in advance? I don't recall my thinking process on that.
Q So you don't recall whether you trusted him or not?
A No.

¶ 559 Thomas summarized the results of Rachfall's conversation with Gladstone in an email to Rachfall:

> Just to confirm my understanding of your conversation with Richard Gladstone this afternoon.
>
> 1) when asked if he knew "Phil Gurnsey" he said that he didn't know anyone by that name but he did know a Phil Gurian;
>
> 2) when he asked why you wanted to know, you said that you knew of someone who might do some business with Phil;
>
> 3) when you asked if Phil was a good guy or a bad guy Gladstone said that he was a bad guy and recommended we stay away from doing business with him;
>
> 4) Gladstone said that Gurian was involved in a group called Quantum Group, which had possibly recently lost money on IBUY.
>
> This is useful information. If you have any other comments please add them.

¶ 560 McQuid said that he and Thomas were satisfied from this that Gladstone was not connected to Gurian.

¶ 561 I have two concerns about Thomas' description of the Gladstone telephone call.

¶ 562 The first is that Gladstone's comment about Gurian was no guarantee that Gladstone was not connected in some way to Gurian. Gurian's involvement with organized crime and the securities industry had been widely publicized by this time. Thomas could not have expected Gladstone to indicate that he was connected to Gurian any more than he had expected Houge to tell them the real reason Houge had been sanctioned by the SEC. It is evident that Thomas did not trust Gladstone before Rachfall made the call; had he trusted Gladstone, there would have been no need to use a different name. It is difficult to see how Gladstone's response could have reduced that distrust.

¶ 563 The second concern relates to Thomas' remark that, if Gladstone had "those types of connections", he was not the type of person Pacific International wanted as a client. Presumably, the type of connection Thomas was referring to was a connection to organized crime. Pacific International learned in January 1997 that Gladstone may well have had that type of connection. The Gladstone search results had revealed that he was reported to have worked for, and operated an illegal branch office of, a broker dealer that was connected to the mob. It is not reasonable that Pacific International would be prepared to tolerate a possible connection to one organized crime group but not another.

¶ 564 On April 7, 1999, Tannas sent an email to Thomas regarding transactions in the shares of Semiconductor Laser International Corp. in the accounts of two clients – Gladstone and Jeno Weiser. Weiser was a lawyer and the authorized person on a number of Swiss accounts. The shares of Semiconductor were quoted on the OTC BB. Tannas said that three Weiser accounts held just over 13% of Semiconductor's issued capital and described the source of the shares. One of the Weiser accounts, Thirkell Trading, had bought 500,000 shares from a Gladstone account on February 25, 1999. She described the source of those shares:

> The source of the Gladstone shares bought by Thirkell: Gladstone received in 174,600 shares by DDI from First Marathon in Feb and March. In February he received 325,000 shares for free from Amex Corp [Jeno Weiser] 023-0086-1. Amex received the 325,000 for free from Mercacorp (Jeno Weiser). Mercacorp received the shares from Dafico Inv (Jeno Weiser) 02087690 in May/98. Dafico received the shares from Richard Gladstone. Gladstone received the shares from Firstimpex (Jeno Weiser) in Feb/98. Firstimpex deposited legended shares in Jan/98.

Tannas' memo concluded:

> We need to consider what kind of comfort we need that we do not have an affiliate position.

¶ 565 Tannas sent a follow up email on May 12. Thomas responded the next day:

> The accounts have not sold [Semiconductor shares] since I spoke with Mike in early April. Both Mike and Dirk are aware of the issue and are not selling stock for any of Jeno's accounts now. Not much we can do about earlier sales.
>
> I will be speaking with Mike and Dirk about where to go from here.

¶ 566 Thomas did not mention Gladstone. Nor did he instruct Tannas to make further inquiries about the relationship between Gladstone and Weiser, or the past activity in their accounts.

¶ 567 On June 23, 1999, Tannas sent a memo to Thomas regarding recent activity in the Gladstone accounts. McQuid explained why this memo was prepared:

> A When the Hogue/Manion indictment was issued in, in, earlier in June 1999, it caused us to relook at all of the accounts of, of [Rachfall and Patterson]. And this memo results from, from that new look at the Gladstone account.

¶ 568 Tannas made several observations about one Gladstone account. Additional information about that account, which was not included in Tannas' memo, is also noted:

- The account held short positions in a variety of OTC BB issuers.
- The account held one long position, $500,000 in shares of Sterling World Wide Corp., an OTC BB issuer.
- A search of Sterling's SEC filings revealed that:
  - Sterling once owned Gladstone's travel agency and that Gladstone was a consultant to the issuer; and
  - the president of Sterling was married to a man who, in 1997, pleaded guilty to securities fraud and was ordered to be deported.
- The account received in 500,000 Sterling shares on January 13, 1998. At that time, the account was credited $1,495,007 or $3.00 per share. The account received in another 500,000 shares on April 1, 1999. At that time, the account was credited $3,346,875 or $6.69 per share. The shares were sold or journalled to another Gladstone account. [additional information]
- In recent months, the account received in several million shares of Eutro Group Holdings Inc., an OTC BB issuer. The shares were received in several tranches and then sold.

- The Eutro group shares were delivered in three tranches: 700,000 on November 3, 1998; 5,000,000 on March 8, 1999; and 2,000,000 on May 14, 1999. No value was attributed to the shares in the account statements. The account statements showed that the sale price was $.027 on November 5, 1998, the date of the first sale from the account that month, and $.0845 on May 28, 1999, the date of the last sale from the account. [additional information]
- Pacific International knew by this time that Gladstone had accounts with at least four other Canadian firms and nine US firms. [additional information]
- The account normally wired money to the Gladstones, or to financial institutions or US or Canadian brokerages.
- From February 1997 to June 1999, the account wired out $7,367,075:
  - $3,711,500 to the client;
  - $213,000 to other Pacific International clients;
  - $2,203,750 to lawyers;
  - $250,000 to a US transfer agent;
  - $362,625 against stock; and
  - $626,200 to other third parties. [additional information]
- During the same period, the account journalled out $5,363,713. $3 million went to the client. The remainder went to other Pacific International clients, usually against stock. [additional information]

¶ 569 Tannas also observed in her memo that, over the past year, Gladstone had received shares from, and transferred money to, a number of Weiser accounts. She attached an appendix showing that journal activity. The shares received included 1,303,468 shares of Semiconductor.

¶ 570 After reviewing Tannas' memo, McQuid and Thomas decided to close the Gladstone accounts. McQuid said they did this because Gladstone had a regulatory history, because the accounts were active and because a second Rachfall and Patterson client had just been indicted. Thomas noted in an email of June 23 that they had decided to close the accounts even though they could not point to any improper activity in the accounts "on the information which [we] currently have".

¶ 571 On June 14, 2000, the FBI issued a press release announcing that "… 120 defendants, including members and associates of the five Organized Crime Families of La Cosa Nostra in the New York City area, have been charged with securities fraud and related crimes. Sixteen Indictments and seven criminal Complaints unsealed today in Manhattan federal court allege fraud in connection with the publicly traded securities of 19 companies and the private placement of securities of 16 other companies."

¶ 572 One of the indictments charged Gladstone and three others with conspiracy to commit securities fraud, securities fraud and wire fraud. The FBI press release included a summary of the Gladstone indictment:

> United States v. Gladstone et al., 00 Cr. 652, charges four defendants with fraud in connection with the private placement of stock issued by Ivy Entertainment.com, Inc., a marketing and distribution company specializing in the entertainment, hospitality, financial and technology businesses. The defendants include: RICHARD GLADSTONE, Ivy's President [and three others]. According to the Indictment, from May 1999 to October 1999, the defendants, in order to sell Ivy securities, agreed to pay exorbitant sales commissions to brokers, and to conceal those payments from investors.

¶ 573 The indictment noted that, in October 1999, Ivy merged with Eutro Group. However, Pacific International never traded Ivy shares.

¶ 574 Gladstone was acquitted in 2001.

¶ 575 Weiser, and his accounts, also became the subject of legal proceedings. In November 1999, Weiser's brother-in-law, Sholam Weiss, was convicted of 76 counts of money laundering, wire fraud, interstate transportation of stolen property, making false statements, obstruction of justice, racketeering and racketeering conspiracy. The fraudulent scheme in which he participated caused the collapse of a US life insurance company, generating losses of $450 million. Weiss was sentenced to 845 years in prison and ordered to pay $125 million in restitution to the insurance company and a $123 million fine.

¶ 576 In December 1999, the receiver for the insurance company obtained a default judgment against Weiss for $339 million. In February 2001, the receiver filed a Statement of Claim in the Ontario Superior Court against Weiss, Pacific International, Rachfall, Patterson, five Weiser companies that once had accounts at Pacific International – Thirkell Trading, Mercacorp, Dafico, First Imprex and Danvers Investment Corp. – and others. The receiver alleged that the Weiser companies were "fronts for the illegal and criminal activity of Weiss" and that Weiss directly and personally controlled their accounts at Pacific International.

¶ 577 Thomas said that Weiss was not authorized on any accounts at Pacific International and, to the best of Thomas' knowledge, did not operate any accounts at Pacific International. Pacific International did not learn of the relationship between Weiser and Weiss until August 2000, when it was disclosed by Patterson.

¶ 578 The receiver sought from Pacific International declaratory and injunctive relief, as well as production of documents and an accounting. Pacific International produced the requested information. Thomas had no further knowledge of the Ontario proceeding.

¶ 579 I conclude that Pacific International failed to make inquiries to learn the essential facts about Gladstone in January 1997, when Compliance received the Gladstone search results. That failure to make inquiries continued until July 1999, when Pacific International closed Gladstone's accounts, despite:

- orders for production from the Commission;
- the Tannas memo of July 1997, which raised a concern about the connection between Gladstone and a group of ten other accounts;
- the Tannas memo of July 1998, which raised a concern that Gladstone was connected to Gurian;
- the Tannas memo of April 1999, which raised a concern about the connection between Gladstone and the Weiser accounts; and
- the activity in the accounts.

6. Findings

¶ 580 During his testimony regarding Gladstone, McQuid spoke at length about his views of the role of Compliance, the duty to know your client, the gatekeeper responsibility and the respective responsibilities of regulators and registrants:

> Q You allowed, after receiving this information [the Gladstone search results], you allowed his account to continue to operate, correct?
> A Yes, we did. We, we considered the matter closely in the context that I've said before, how old the allegation was, what the client's trading history had been with us up to that point in time, whether the activities were something that the client could perform in, in his brokerage account. We ensured that it was put on our compliance update list. It was monitored closely for, for a, specifically on that list for a, for a number of months. And at the end of the day, Mr. Gladstone was never alleged to have done anything improper in his trading with our firm.
> Q Now, you have already stated on a number of occasions that activity can't catch all wrongdoing that occurs by the client outside of the firm, correct?
> A No, it, no, it cannot.

Q So you have here someone who I'm saying is untrustworthy and you are allowing the accounts to continue on the basis that you are going to follow his activity closely, correct?

A But, Mr. Hilford, isn't, isn't that my, my obligation and I, and I satisfied that obligation? I mean, this, this commission decided years ago that Fats Robertson could have a brokerage account, and to the extent that he was able to have a brokerage account, then the, the brokerage firm had a duty to diligently supervise that account. That's what we did here.

Q And I take it you are standing by your, your decision?

A That's, that's what, that's what we should be doing. If we, if we have an account, first of all, we have no, no obligation under any rules or regulations to, to do a search on that account unless something comes to our attention, and even that requirement has been changed under IDA rules now, that they have relaxed that. But, but notwithstanding that, we, we did a search on Mr. Gladstone, we learned of his, of his, of his past and his past regulatory history. We, we closely supervised his account. And he never was alleged to have done anything improper in his account at, at Pacific International. Is that not how the system is, is, is supposed to work?

Q Gladstone did eventually have an allegation made against him, correct?

A Yes, he did, for activity that did not occur at Pacific International and he was acquitted by the courts of the United States with respect to that allegation.

Q Do you think that --

A I'm not supporting Mr. Gladstone but I am just saying that when he had his account with us, we, we properly supervised his, his, his account and he, if he was, if he continued to be an untrustworthy person, he did not do anything in our account that was improper.

Q But when -- let's move away to a theoretical question to you, sir. You have a client --

A I am having trouble hearing you again.

Q Sorry. Let's say you have a client. They're convicted of something, nothing to do with in your accounts. In other accounts at other brokerage firms.

A Yes.

Q Don't you think it still reflects badly upon your firm that you had that person as a client?

A Well, that's, that's the irony I think of this entire matter, is that I had always understood that our obligation was to diligently supervise the, the activity in the accounts that, that we have. And let's say

that the, the client does offend. If it was activity that we should have observed in our, in our account, then I always understood that we had a responsibility there. But I certainly never understood that I had a regulatory responsibility for actions of a client committed outside of our firm. I never understood that.

Q Didn't you think that your gatekeeper responsibility included keeping criminals out of PI as clients?

A As I have said before in these proceedings, I believe that the, the, the regulation of the securities industry is, is best served by a strong partnership between the regulators and the industry. We, we have to take guidance from, from the regulators, and if they have not seen fit to remove, say, a person like Mr. Gladstone from, from, from, from the capital markets because of a self-regulatory, a regulatory history, and we elect to have an account for Mr. Gladstone, then our obligation is to supervise that account diligently, and we did that Mr. Hilford.

Q But whose job is it to know your client? Is it your job or is it your regulator's job?

A Well, our -- the, the responsibility in the context of the know your client rule, and again, let's, let's remember that the, the know your client rule in the, in the industry is, is to know your client in, in terms of the suitability of the transactions for that, for that client. That responsibility is, is ours. But if Mr. Gladstone is a, is a person that doesn't deserve to have trading, trading privileges, then I'm confident that our regulators will deal with that.

Q I mean, do you think --

A They have not removed him from the capital markets today that I'm aware of.

Q Do you think your regulators know more about your 30,000 clients than you do?

A I believe in some cases they may, yes.

Q Do you think your regulators know more than the millions of clients of brokerage firms in this province than the brokerage firms do?

A In some cases they may, Mr. Hilford. It -- they're different organizations. You -- the regulators have powers of inquiry, powers to subpoena people to, to give, to give statements, to, to, to look at the books and records of any place that that person may have, have, have an account. What we see in, in a, in an internal compliance department are the transactions that the client does through us. It is those transactions that we can, we can view and try and form judgments on, and that's what we did with respect to Mr. Gladstone and I believe that we did it properly.

Q I mean --

A I'm not, I'm not supporting his character. Please don't get me wrong. But what I, but what I am saying is that, is that he was entitled to trade in the capital markets. We found out about his self-regulatory history, not a criminal history. That's not what I am talking about here. I am talking about a self-regulatory history. We monitored his account closely. The documents you have demonstrate that. And at the end of the day, he didn't do anything improper in his accounts with us. And at the end of the day, when we elected to remove an entire segment of business, his was one of the accounts that closed, and as you well know, it got transferred to another British Columbia securities registrant.

Q Do you think that that somehow makes it all better, that many of your criminal clients left PI and went to some other brokerage firm in British Columbia?

A Not necessarily, but I think it does put it in context.

Q You appreciate this is a self-regulatory industry, correct?

A Yes, I do.

Q I mean, you understand that you as the designated compliance officer, was the person who was charged with the responsibility of having compliance with the rules and regulations of the securities laws of British Columbia, correct?

A Yes.

Q It's not someone's job from the commission to come down and sit beside you and tell you how to do your job, is it?

A No. I, I don't think that I've ever said that, and if I've implied that, that would not be something that I meant to imply. But I do believe strongly that it's, that it's a partnership. I believe that, that this Commission, the staff of this Commission and other regulators probably did know more about Mr. Gladstone's activities outside of our firm than, than we did. But we monitored his activity closely. Our documents demonstrate that. He did not do anything improper in our firm. Probably because, if he was inclined to, because of the supervision that we, that we put in place.

Q But are you saying if a regulator doesn't take someone out of the industry, that that gives you some good housekeeping seal of approval and you can just take them on as a client regardless of what information you may have about them?

A No. I did not say that. I did not say that at all. What I did say was that if we determined that if a person that was entitled to trade in the capital markets, but he had a regulatory history, then I felt we had an obligation to supervise that, that account more, more closely. That is what we did here.

¶ 581 I have three concerns about McQuid's views on these issues.

¶ 582 First, McQuid distinguished between the two aspects of the know your client rule and suggested that the registrant has a different responsibility with respect to each. The first aspect is protection of the client, which can be roughly characterized as suitability. McQuid acknowledged that this was Pacific International's responsibility: "… let's remember that the, the know your client rule in the, in the industry is, is to know your client in, in terms of the suitability of the transactions for that, for that client. That responsibility is, is ours." The second aspect is protection of the market, which can be roughly characterized as the gatekeeper responsibility. McQuid suggested that this was the responsibility of the regulators as well as Pacific International, in "partnership": "… But if Mr. Gladstone is a, is a person that doesn't deserve to have trading, trading privileges, then I'm confident that our regulators will deal with that … if we determined that if a person that was entitled to trade in the capital markets, but he had a regulatory history, then I felt we had an obligation to supervise that, that account more, more closely. That is what we did here."

¶ 583 McQuid seemed to base his concept of a gatekeeper partnership on his belief that the regulator may, in some cases, know more about a registrant's clients than the registrant, because the regulator has powers of inquiry. It may be true, in an extremely limited number of cases, that a regulator may know more about a registrant's client than the registrant. However, Pacific International could not extrapolate from this that the regulator will remove the trading rights of every person that should not be participating in the capital market. McQuid's confidence in this regard is misplaced. No regulator has the information or the resources to shoulder such a responsibility, no matter how effective the regulator's surveillance and enforcement programs.

¶ 584 It was because the Legislature and the Commission recognized this that they imposed the gatekeeper responsibility on registrants. Registrants deal with their clients on a daily basis. They can monitor their activity, question that activity and seek out additional information as required from inside and outside the firm. If registrants perform their gatekeeper role properly, they will identify possible improper or illegal market activity at an early stage and prevent it from continuing. They are far better placed than regulators to perform that role. Registrants, and registrants alone, bear the responsibility to know their clients, from the aspects of both suitability and gatekeeper. Whether a regulator may also have information about a particular client is irrelevant; the registrant is expected to act independently and make reasoned judgments on the basis of the information that is available to it. The registrant can not assume that the person is an

acceptable participant in the capital market simply because no regulator has removed him from that market.

¶ 585 My second concern is that McQuid had a very restricted view of the information sources about a client that are available to a registrant: "What we see in, in a, in an internal compliance department are the transactions that the client does through us. It is those transactions that we can, we can view and try and form judgments on …". In fact, Pacific International's Compliance staff, at times, used a variety of external information sources. Those sources included searches, market data, public filings by issuers and various websites and discussion groups. However, there were other external information sources that Compliance did not use effectively, such as material respecting criminal and regulatory proceedings. There were also internal information sources that Compliance did not use effectively; information requests from regulators, for example, provide clues as to possible problems with certain clients, securities or investment advisors.

¶ 586 My third concern with McQuid's testimony relates to his unequivocal statement that Gladstone did not do anything in his accounts at Pacific International that was improper: "… we properly supervised his, his, his account and he, if he was, if he continued to be an untrustworthy person, he did not do anything in our account that was improper." McQuid seemed to base his statement on the fact that no regulator or prosecutor alleged that Gladstone did anything improper in his accounts at Pacific International. The first problem with McQuid's position is that, as I observed above, no regulator will be able to identify, let alone take action against, all market misconduct. Second, regulatory and criminal proceedings are generally brought after the misconduct has occurred. The goal of the gatekeeper function is to identify and stop misconduct in its early stages, so as to limit the damage done to the capital market and to investors. The fact that Gladstone was not alleged to have done anything improper or illegal in his accounts at Pacific International is no guarantee that such activity did not take place or that Pacific International properly supervised his accounts.

¶ 587 Whether a registrant has met its know your client responsibilities must be determined by looking at the adequacy of the supervisory regime applied to the client's account, and by the inquiries made and actions taken by the registrant when that supervision generates issues or concerns.

¶ 588 Account supervision for suitability purposes is generally straightforward. In most cases, the registrant will be able to tell from looking at the client documentation and account activity whether the transactions in the account were suitable for the client.

¶ 589 Account supervision for gatekeeper purposes is not that simple. In many cases, the activity in a single account, or group of accounts, at a single registrant will be only part of a broader scheme, such as market manipulation or money laundering. And that activity, in itself, will not be illegal or improper, such as deposits of securities or third party wires. However, even if that activity is not, in a vacuum, illegal or improper, the registrant is expected to be cognizant of the role that activity could be playing in a broader illegal scheme.

¶ 590 One of the essential facts a registrant needs to know about a client is whether the client is using his account as part of a broader illegal scheme.

¶ 591 If the registrant learns of something that raises a concern in this regard, the registrant must make inquiries, using all sources of information available to it. The registrant must then exercise its judgment on the basis of that information.

¶ 592 In many, if not most, cases, the registrant will not be able to know with certainty that the client is, for example, participating in a manipulation. In such a case, the registrant must exercise its judgment, on a fully informed basis, recognizing that it has a responsibility to act in the public interest to protect the integrity of the capital market.

¶ 593 Pacific International was required to exercise its judgment on several occasions when dealing with the Ubiquity, Globus, Houge/Manion, Rousso/Hababou and Gladstone accounts. On many of those occasions, it did not exercise its judgment on a fully informed basis. Despite a concern having been raised about the client, or the activity in the client's accounts, Pacific International did not make the inquiries necessary to get the information it needed to make a fully informed decision. As I have concluded, Pacific International failed to make inquiries to learn the essential facts about these clients. Had Pacific International made those inquiries, it would likely have made different decisions in a number of cases.

¶ 594 Consequently, I find that Pacific International contravened section 48 of the Rules and acted contrary to the public interest by failing to fulfil its role as a gatekeeper of the capital market.

III. ESTABLISH AND APPLY WRITTEN PRUDENT BUSINESS PROCEDURES

¶ 595 Section 44(1) of the Rules provided:

> 44(1) A dealer, portfolio manager or investment counsel must establish and apply written prudent business procedures for dealing with clients in compliance with the Act and the regulations.

¶ 596 During the period between 1995 and 1999, Pacific International had one manual – the Sales Procedures Manual. It was dated October 1995. The manual was directed at investment advisors and covered the following topics:

- opening accounts;
- specialized accounts (RRSP and institutional);
- trading;
- option trading;
- client accounting and securities;
- commission and other charges to client accounts;
- compliance/credit policies;
- investment advisor remuneration;
- corporate finance; and
- research department.

¶ 597 McQuid said that the manual was supplemented by Compliance bulletins and Operations bulletins:

> A The policy or the policy sales procedures manual was augmented by compliance bulletins and operations bulletins and other memos and e-mails dealing with separate issues.
> Q To whom were those latter types of documents given?
> A They would be given to investment advisors and sales assistants, trading staff, and other staff to the extent that they would be impacted by them.
> Q So there was two types of bulletins, there was operations and compliance bulletins?
> A That's correct.
> Q What type of information was contained in such documents?
> A Operations bulletins for the most part would –would cover items under the control and direction of the operations department. It might relate to opening new accounts, it might relate to RRSPs, reorganization issues, entitlement issues, certificate handling.
> Q Those are the operation bulletins?
> A That's correct. The compliance bulletins would cover matters of compliance that had been instituted as a result of regulatory changes or policy changes within the firm.

Q And do you have some examples of the types of things that were contained in compliance bulletins?
A Sure. We looked at a previous one dealing with the restriction of investment advisors trading bulletin board stocks in the Canadian grey market.
Q How frequently were these bulletins issued?
A As required.
Q During the material time, that is '95 to 1999 can you ballpark the number of operations and compliance bulletins that were issued?
A Over that period combining both of them, perhaps a hundred.
Q And what happens to these memos, they were given to whom?
A They were given to investment advisors, and they were give to sales assistants, they were given to trading staff, they were given to staff to the extent that they were impacted by the – by the bulletin, and they would also have gone to the directors and officers of the firm.
Q Do you know what these people did when they received the bulletins?
A Well, I hope they paid attention to them.
Q Were they instructed to collate them and keep them in one place?
A They didn't specifically receive that instruction, although that would be the expectation that any professional would keep – keep it for a reference.

¶ 598 I have three concerns with this process. First, keeping track of, and familiar with, up to 100 additional documents on a variety of topics would not be easy for investment advisors or staff. Second, not all Pacific International employees were given all bulletins. Finally, it appears that new employees received just the manual and not previously issued bulletins. McQuid said that, when Hauchecorne joined Pacific International, he was given the manual; McQuid did not refer to the bulletins:

MR. WARES: When he joined Pacific International from another organization, with perhaps different compliance policies, what steps did management take to ensure that Mr. Hauchecorne had sufficient knowledge of Pacific International's operating policies?
A We had a, a sales procedures manual, which was -- which was provided to him. Additionally, our operations manager worked closely with him during the transfer of his accounts to Pacific International and the -- and the types of things that he needed to do in order to get not only his accounts moved, but trading at Pacific International.

¶ 599 The Holley Report examined the compliance and supervisory policies and practices at Pacific International. The report began by describing the standards of supervision appropriate for the firm:

> Standards of Supervision
>
> In order to meet its regulatory obligations and to minimize the risks to both the firm and its clients, Pacific International must always apply supervisory procedures that are appropriate to its specific business and clientele. It must do so in an environment of increasing litigation and more aggressive regulatory enforcement. To minimize the risk of civil or regulatory liability, the objectives of Pacific International should be:
>
> 1. to rigorously apply supervisory procedures that reflect the real-world risks of trading in the securities which are of interest to its clients;
>
> 2. to diligently document both its procedures and its supervisory activities;
>
> 3. in applying its procedures, to meet or exceed the standards set for it by the SROs and by its own policies;
>
> 4. to perform its compliance functions as well as or better than its competitors; and
>
> 5. to base its actions on the assumption that it is in a fiduciary relationship with each of its clients and that it is vicariously liable for the actions of its representatives and employees.
>
> Expectations and Standards of Conduct
>
> The standards of 'prudent supervision' will generally increase when:
>
> - trading in, or advising on, riskier securities;
>
> - acting for less experienced clients, less reputable clients, or for clients who are insiders, promoters or control persons;
>
> - the nature of the transactions requested by clients could give rise to concerns about unfair or abusive practices or could pose a threat to the reputation of the firm or the integrity of the capital markets.

¶ 600 Between 1995 and 1999, an increasing proportion of Pacific International's business was with US or offshore clients, who were experienced market participants, trading OTC BB securities.

¶ 601 Client protection, or suitability, was not the primary issue with these clients. Pacific International was not registered in the US and could deal with US clients only on an unsolicited basis. Investment advisors could not give advice to US clients. They could only accept orders.

¶ 602 McQuid acknowledged that most of Pacific International's policies and procedures were directed at client protection:

> A Often in compliance what we try and do is to understand -- let me back up a little bit. Most of our policies and procedures are directed at ensuring or trying to ensure that our investment advisors do not inappropriately deal with our customers' accounts, and in addition to that we try and supervise the activity in the client accounts to ensure as much as we can that it's not inappropriate activity in the marketplace. …

¶ 603 In fact, Pacific International's manual contained essentially no supervisory procedures regarding:

- US or offshore clients;
- clients who were experienced market participants;
- clients who had regulatory histories;
- the trading of OTC BB or other risky securities; or
- how to recognize and respond to a transaction, or a series of transactions, that raised a concern that the client was participating in abusive market conduct, such as insider trading, market manipulation or money laundering.

The only references to US markets were a direction to send orders for US securities to certain trade desks and a description of the commissions payable on US trades. The only reference to US clients was an instruction to the investment advisor to get signed fax copies of the new client application form and a non-solicitation form.

¶ 604 Nor did the manual provide any other guidance regarding Pacific International's gatekeeper responsibilities when dealing with these, or any other, types of clients. The compliance/credit section stated that investment advisors were expected to ensure that any orders they accepted did not "impact the integrity of the public

marketplace." However, the remainder of the section focussed on the suitability, rather than the gatekeeper, aspect of the know your client rule.

¶ 605 Several of Pacific International's Compliance and Operations bulletins were in evidence. Some bulletins dealt with the risk to the firm that US share certificates received from clients could be rejected by the transfer agent (certificate or transfer risk) or could be subject to resale restrictions. Those bulletins required clients to provide a US securities deposit letter for deposits beyond a threshold number of shares and required US share certificates to be forwarded to the transfer agent for re-registration in Pacific International's name before the shares could be traded. Some bulletins dealt with the risk to the firm of directed dealer to dealer trades in OTC BB securities (trades in the grey market). Those bulletins prohibited such trades, which could leave the firm with a debit balance secured only by an illiquid or unmarketable security; they required all trades of OTC BB securities to be done through a US market maker. Some bulletins dealt with the risk to the firm of dealing with US clients while the firm was not registered in the US. Those bulletins restricted the types of US clients Pacific International would accept; they prohibited investment advisors from opening accounts for a US resident who was over 75 or did not provide initial equity of at least $75,000.

¶ 606 Three bulletins concerned the firm's gatekeeper responsibilities. Each included a copy of one of the VSE's gatekeeper notices or the Commission's fair trading notice. However, those bulletins were sent only to the investment advisors. And the bulletins accompanying the notices provided no additional comment or guidance. They made no attempt to apply the principles in the notices to the real-world risks of Pacific International's business.

¶ 607 There was one exception. A Compliance bulletin of October 1995 included a copy of the VSE's 1994 gatekeeper notice and observed that "the accounts which should receive close consideration in this context are those of insider clients." The bulletin reminded investment advisors that their gatekeeper responsibilities in respect of insider clients required the investment advisor to routinely ask the client if the client was filing his insider reports.

¶ 608 None of the bulletins set up procedures to ensure that Pacific International met its know your client responsibilities – which, for US clients, were essentially gatekeeper responsibilities – in respect of its US clients who were experienced market participants, its US clients who had regulatory histories, its clients who were trading OTC BB securities, or its clients who were participating in suspicious transactions.

¶ 609 The Holley Report raised other concerns regarding Pacific International's written policies and procedures:

> It is essential that Pacific International maintain a clear and easily referenced manual containing its sales compliance policies and procedures. The firm's existing manual has been updated regularly through the issuance of compliance and operations bulletins. In some cases, however, the written policies do not reflect the firm's practice or do not describe the general criteria applied in granting exceptions to written policy. A significant number of policy changes implemented in recent months have further complicated the issue.
>
> Some months ago the compliance staff retained an external consultant to consolidate, review and update the Procedures Manual. That project has been subject to a few delays for reasons unrelated to current events.
>
> Recommendation 1
>
> We recommend that the project to update the firm's Procedures and Sales Compliance Manual be a priority. The revised Manual should reflect all recent policy changes as well as any changes that result from this review or from other management initiatives. Once the Manual is complete, the firm should schedule sessions with all staff (including sales, compliance, operations and trading staff) to go over, in detail, the firm's revised policies and to ensure that all employees understand and accept the procedures and the obligations that apply to them and to the firm's clients.
>
> Recommendation 2
>
> We recommend that the Procedures and Sales Compliance Manual contain more detailed information concerning money laundering and the proceeds of crime to ensure that all staff are aware of the specific legislative requirements, the polity rationale underlying the requirements, the types of activities that they should be alert to, the importance of 'know your client' to the prevention of money laundering activity, and any current regulatory notices and expectations.

I would expand Recommendation 2 to include more detailed information concerning other types of abusive market conduct, such as insider trading and market manipulation.

¶ 610 In his testimony, Holley also expanded on Recommendation 2:

> A Uhm, yes, in general terms, although what I had intended by Recommendation 2 in my report is probably something more

> focussed and, and more developed than had been set out in this NIN [the Commission's money laundering notice of April 1993], more specific to the real tools and the experience that had been gained about how brokerage firms can be used in a money laundering process. So I had hoped to go beyond the contents of this notice.
>
> …
>
> A Well, certainly the NIN touches on a number of the same subjects and it hopefully would be a useful document. I always like to have people read anything I wrote. But my recommendation was I think to elaborate and focus on even more pragmatic examples of the sorts of things that investment advisors and compliance personnel should be alert to.

¶ 611 The Holley Report also noted that Pacific International had not developed guidelines regarding either the core compliance functions or the exercise of discretion by Compliance and other staff:

> Pacific International has prepared certain guidelines and procedures to assist compliance staff in the course of their compliance duties (e.g. daily and monthly activity review). The guidelines and procedures may appear in job descriptions or in memorandums and e-mail notes available on the 'Compliance Drive'. It was not clear to us, however, that written guidelines have been crafted to cover each core compliance function or that all compliance staff have a clear and equal understanding of the 'compliance mission statement' that should guide the application of their authority and the exercise of discretion.
>
> Recommendation 4
>
> We recommend that the firm compile a central Compliance Procedures Manual that sets out, in an easily referenced form:
>
> a) a compliance mission statement, crafted and approved by the Board, that sets out goals and objectives of management with respect to the compliance function and management's expectations as to how staff are to apply their authority and exercise their discretion. The mission statement should make it clear to all staff the important roles that they are expected to play with respect to the protection of clients and protection of the firm and its reputation.

b) a clear statement of the responsibility and authority of each department (including compliance, operations, credit and trading) and of each supervisor with respect to the firm's compliance program.

c) specific guidelines that staff are expected to apply in the review of trades, journal requests, receipts to or deliveries from client accounts, new account application forms, commission reports, status slips and monthly statements to ensure that the firm's standards are consistently and rigorously applied. Those guidelines should cover:

i. the types of problems or errors that staff are expected to look for and detect;

ii. the general procedures to be followed in dealing with problems as they arise;

iii. the extent of staff's authority to decline new accounts, trades or transaction requests and the circumstances in which anomalies are to be brought to the attention of supervisory staff or management.

¶ 612 In his testimony, Holley expanded on Recommendation 4:

A Yes, the, the comment here is that the -- while the policy sets out the nature of the supervisory duties that are being fulfilled in both daily and monthly reviews, we're suggesting the guidelines as to P.I.'s expectations for each -- each staff member as to exactly how they were to go through that process and the -- the sorts of highlights or anomalous transactions that they might be alert to and the method through which they could review those and the process through which they could bring any anomalies to the attention of management should be, would be valuably to be included in an internal guideline.

Q Okay. And was the result of not having these core compliance functions in a, a written guideline form, and I'm going back to your text, that all compliance staff did not have a clear and equal understanding of the compliance mission statement that should guide the application of their authority in the exercise of discretion?

A Well, certainly one of the objectives in crafting guidelines would be to ensure that all of the staff members doing those functions approached it in the same way and understood exactly what it was that they were intended to achieve through the course of their

reviews. And there was certainly some differences in perspective among the staff members we interviewed about relative priorities or, you know, the issues that they thought was relevant to focus on, we thought that should be standardized across all those people who were performing that function.

Q Okay. And if we go to the next page, your recommendation 4 deals with the specific aspects of these general principles you have just been discussing, correct?

A Yes.

Q And if we look at recommendation 4 a., and I'm looking at the bottom half of that recommendation, you say: The mission statement should make it clear to all staff the important roles they are expected to play with respect to the protection of clients and protection of the firm and its reputation. Do you see where I am?

A Yes, I do.

Q And I take it that that aspect of compliance, the protection of the firm and its reputation, that -- there was nothing in writing dealing with those aspects prior to this point, is that correct?

A I can't recall specifically, Mr. Hilford, whether or not there were parts of the compliance manual, the existing compliance manual that commented on the protection of the firm. Certainly it was my recommendation that they expand on that and make it clear to all staff, both from the representatives to the operations staff, to the trading staff and the compliance staff what that mission statement was and to ensure that each aspect, client protection, protection of the firm, protection of the integrity of the market, all of those conditions were clearly set out and understood equally by those people involved in the process.

…

Q Taking a look at recommendation 4 b.: A clear statement of the responsibility and authority of each department (including compliance, operations, credit and trading) and of each supervisor with respect to the firm's compliance program. You saw where I was?

A Yes.

Q Now, I take it what you're getting at there was a written statement making it clear that there were compliance responsibilities in departments outside of compliance?

A Absolutely, yeah.

Q Okay. And up to that point in time, no such written statement existed; is that correct?

A Again, I certainly can't recall what comments may have been made in -- in existing materials. Certainly my recommendation that there were -- there was a value in setting out two things, both the -- the issue with respect to responsibility of each department, but also clarifying their authority. And one of the things that I thought was inadequately described at that time was the authority, for instance, of a trader or a trade staff member, an operations staff member to exercise authority, refuse an account or refuse a trade or, you know, demand additional information before they proceeded with a transaction in which they were involved. So, certainly I think the authority had not been as clearly set out as it should be.

…

Q And I take it the specific guidelines that you're recommending there, that they did not exist prior to this recommendation; is that correct?

A Well, the guidelines existed primarily in the policies and procedures that had been established by the SROs. In particular, VSE policy CR04, I think it was at the time, and IDA Policy 2, which is the minimum standards of -- of supervision. What my recommendation was is those policies are fairly general, they set -- they set out the specific criteria to be applied or the issues to be addressed. In my experience, reading that policy, different staff members will interpret it differently and they'll apply different skill sets. They'll usually apply their knowledge base to determining what they think are improprieties. Operation staff, for instance, are more attuned to looking for potential settlement problems or good delivery problems with securities, those sorts of things. Whereas someone in a -- from a compliance background will often look for, you know, a slightly different focus - issues of potential market misconduct, unsuitability, those sorts of things. Because each of the groups are involved in different aspects of the supervisory process, I think it's important that they apply similar general guidelines. They expand on their own knowledge, for instance, in operations staff, to become more familiar of the types of things that would be of interest to compliance, the sorts of things that might suggest an improper trading, the improper trading conduct on the part of a client. And that's not automatic. When you look at trading staff and operations staff and compliance staff, they tend to focus on their -- they apply their supervisory responsibilities on a relatively narrow level and narrow -- from a very narrow perspective. The purpose of the guidelines is to try to make sure everybody is essentially singing from the same song sheet or

applying the same criteria when they look at transactions for their participation.

Q You had mentioned that what -- what did exist at the time was the general sort of rules from the SROs. What you were looking for was a more specific application of those rules, correct?

A Yes, more -- more elaboration on each of those things, beyond what was in the I-- the SRO's policies and beyond what existed in the firm's job descriptions internally.

Q And by being more specific, one would then be more consistent in application, correct?

A That was the objective, yes.

Q Okay. And in being more specific, would you want the guidelines, the specific guidelines to meet the types of clients and the types of business that Pacific International was in?

A Certainly.

¶ 613 Indeed, the SROs recognized that the minimum standards set out in their policies would be inadequate in some situations. VSE Policy Statement CR06, effective March 1993, set out minimum industry standards for retail account supervision. The introduction to the policy stated:

> The document does not … [p]reclude members from establishing a higher standard of supervision and in certain situations, a higher standard may be necessary to ensure proper supervision.

IDA Policy No. 2, on the same subject, contained the same statement.

¶ 614 The Holley Report described situations where higher standards of account supervision would be necessary:

> In our view, the standards of account supervision expected of dealers will generally increase whenever the dealer is trading in risky securities (particularly in securities of non-reporting issuers and OTC BB securities), trading for non-resident clients about whom less information may be available, and trading for 'market participants' (registrants, promoters, investor relations personnel, insiders and control persons).
>
> As part of the know-your-client requirements, registrants are obliged to make inquiries concerning the 'business and financial reputation' of potential clients in many circumstances. The regulations, however, do not set out specific criteria about how a dealer is to exercise judgment in determining whether or not a client is 'acceptable'. Dealers must establish their own guidelines regarding the acceptance of clients based on their

assessment of risk and on their ability to effectively supervise account activity.

As a general principal, we believe that the firm can best protect itself by concentrating its supervisory efforts on the careful assessment of clients at the time they first come to the firm.

Pacific International has information systems and processes in place to assist staff in conducting detailed reviews of the business and regulatory background of potential clients. Some of the background checks that can be conducted are fairly comprehensive but time consuming and expensive and cannot be done for every new client. We understand that staff has considerable discretion in determining the nature and extent of inquiries to be made in each case, but that they generally conduct more rigorous background checks whenever an NCAF indicates that the client, particularly a non-resident client, is a 'market participant'.

Recommendation 17

We recommend that the firm establish clear written policies (in the Compliance Procedures Manual) to guide the compliance staff in determining what checks are to be done for every client (for example, Canada 411, Stockwatch, etc.) and what additional checks are to be done for clients who are market participants, non-residents or who intend to trade primarily in non-reporting or OTC BB securities (for example, Infospace, contracjobs.com, sec.gov, NASDR, Lexis-Nexis, stockkdetective.com). The firm's written policy statement should also clearly state the expectation of the Board as to how discretion is to be exercised by staff in determining whether or not to approve an account of a person with a questionable business or financial history.

Recommendation 18

To reduce the cost of more rigorous background checks, the firm should examine the feasibility of providing additional research tools (e.g. Lexis-Nexis or similar systems) to staff in-house. The firm should also look to outside sources, including regulators and other investigative professionals, for additional training on the most effective research techniques and tools.

Recommendation 19

We recommend that the firm create a simple checklist so that staff can record the checks that were done for any account prior to approval. The

> checklist would be included in the account documentation so that the person approving the account is aware of the extent of the review conducted and informed of any anomalous results.

¶ 615 The Holley Report identified two particular problems with Pacific International's new account procedures. The first involved verification of the client's identity, as required under the federal money laundering legislation:

> … A significant number of 'unverified' accounts were maintained by Pacific International beyond the six-month period during which verification was required. …

¶ 616 The second problem involved approval of new accounts by a partner, director or officer of the firm:

> The new account approval procedures in effect prior to July 14, 1999, left open the possibility that, under certain circumstances, an account could be opened and active for a considerable period of time before being brought forward for the signature of a PDO of the firm. This possibility was not consistent with regulatory expectations that all new accounts be approved by a PDO within 24 hours. …

¶ 617 Holley noted that, in July 1999, Pacific International implemented new procedures to address both these problems.

¶ 618 Up until that time, however, those two compliance failures weakened Pacific International's ability to know its clients. Both the Conduct and Practices Handbook and the Holley Report emphasized the importance to a registrant of carefully assessing a client at the time the client comes to the firm. Identity verification and PDO approval are important parts of that process.

¶ 619 Identity verification confirms an essential fact about a new client – the client's identity. PDO approval is the final step in the risk assessment process for a new client – the PDO must confirm the supervisory regime appropriate for the client and decide whether to accept the account. The PDO should not accept an account unless the PDO is satisfied that the registrant can establish and effectively apply that appropriate supervisory regime. Both the registrant and the capital market are put at risk if the account is allowed to operate before the completion of that risk assessment and approval process.

¶ 620 Pacific International's experiences with the five groups of accounts described earlier revealed several situations where staff were unclear about their

responsibilities, the procedures they should follow or the manner in which they should exercise their discretion:

- Operations took instructions from Gurian, a person who was not authorized on the Ubiquity account, as to who was authorized on the account;
- Operations wired out over $1.7 million from the Ubiquity account on the faxed instructions of someone they had been told was no longer authorized on the account;
- Compliance learned of the Globus and Houge indictments but failed to get copies of them;
- Compliance did not give to McQuid for several months the January 1997 Gladstone search results, which reported Gladstone to be involved with a firm connected to organized crime. Nor did Compliance give to Thomas the May 1998 Suo-Antilla memo regarding Rousso, which Thomas described as inflammatory;
- Credit was responsible for dealing with requests for wires. Credit did not know how to handle the suspicious wire activity in the Ildico account in July 1997;
- The direction to staff regarding third party wires was inconsistent. In a memo of February 1997, McQuid said that "we would prefer sending money only to the name under which the account is styled thereby permitting the client to make his own disbursements." Thomas, on the other hand, took the position that "it's [the client's] money, and the extent to which we, which we can question it is, is limited I think.";
- Compliance staff had complete discretion with respect to ordering searches from the VSE – which clients or authorized persons, when, how often, Level 1 or Level 2; and
- Operations staff had complete discretion with respect to what information or concerns were forwarded to Compliance. This was significant, as Operations was the recipient of much information that was important from a know your client perspective – new client information, requests for wires and journals, and information requests from regulators.

¶ 621 The Holley Report also noted that it was difficult for staff to meet their regulatory responsibilities without appropriate education:

> The international nature of securities markets has increased the complexity of Pacific International's regulatory operations and has added new legal considerations for the operation of client accounts. In our view, it is difficult for staff to keep up with these legal and regulatory challenges without the benefit of directed educational programs.

> We are advised that Pacific International has, in the past, provided a number of compliance training programs through staff and through external legal counsel. We believe these programs should be supplemented by training sessions on specific topics such as money laundering, proceeds of crime, Internet fraud and OTC Bulletin Board fraud.

VSE Policy Statement CR06 also emphasized the importance of education: "A major aspect of self-regulation is the ongoing education of staff in all areas of sales compliance."

¶ 622 Pacific International was required to establish and apply written prudent business procedures for dealing with clients in compliance with the Act and regulations. I have found that Pacific International failed to comply with the know your client rule in its dealings with certain clients, each of whom was a higher risk client dealing in higher risk securities. I conclude that one of the reasons for this failure was the firm's lack of written prudent procedures and guidance, as well as training, for investment advisors and staff regarding Pacific International's gatekeeper responsibilities, particularly in respect of this higher risk business. Consequently, I find that Pacific International failed to establish and apply written prudent business procedures in this regard, contrary to section 44 of the Rules.

IV. DUTY OF DIRECTORS

¶ 623 The general duties of a director were set out in section 118 of the *Company Act*, RSBC 1996, c. 62:

> 118(1) Every director of a company, in exercising the director's powers and performing the director's functions, must
>
> (a) act honestly and in good faith and in the best interests of the company, and
> (b) exercise the care, diligence and skill of a reasonably prudent person.
>
> (2) The provisions of this section are in addition to, and not in derogation of, any enactment or rule of law or equity relating to the duties or liabilities of directors of a company.

¶ 624 The Commission considered these duties in *Re Slightham* [1996] 30 BCSC Weekly Summary 38. After reviewing the English, American and Canadian authorities, the Commission concluded at page 70 of that decision:

> In summary, though there may be a dearth of case law in Canada on the issue of the duty of care of directors, there is sufficient law from which we can derive certain basic principles. Those principles certainly take us beyond the standards established for English directors in Re City Equitable Fire Ins. Co. They impose on directors a duty to put in place adequate systems for the management of the company, which would include the flow of information that is necessary to the directors and upon which they will base their decisions. Should that information generate concerns or otherwise put the directors on inquiry, they must take the necessary steps to resolve those concerns or initiate the appropriate inquiry. In short, the directors, all the directors, have a duty to ensure that the affairs and business of the company are being properly managed.
> …
>
> It is the responsibility of the directors to ensure that a company complies with applicable legislation and its listing agreement. Directors exercising the care, diligence and skill of a reasonably prudent person may delegate this responsibility to management of the company, but, if they do so, must also set up adequate systems to satisfy themselves that compliance is in fact taking place and, if matters arise that should put them on notice, take the steps necessary to resolve the concern. …

1. Systems in Place in 1995

¶ 625 In 1995, the directors of Pacific International knew, or should have known, the regulatory environment in which the firm conducted its business. In particular, that regulatory environment included three important notices.

¶ 626 A Commission notice of April 1993 dealt with money laundering and the new federal requirements. The money laundering notice began by defining money laundering:

> Money laundering is the conversion of the proceeds of economic crime into seemingly legitimate funds using complex transactions through the financial institution deposit and withdrawal system. Money laundering begins when the proceeds of crime are deposited into the financial system. Complex transactions are then used to obscure the audit trail of the funds so they appear to be legitimate when eventually withdrawn. The three typical stages of money laundering are placement, layering and integration.

¶ 627 The notice described the particular risks associated with the securities industry:

> Because securities transactions are generally not settled in cash the securities industry is less at risk than mainstream banking from the initial *placement* of proceeds of crime. Most securities transactions are settled by cheque drawn on another financial institution at which the funds have already been deposited. Nevertheless, payment for securities in cash is not uncommon and the risk of registrants being used at the placement stage of a money laundering scheme cannot be ignored.
>
> Registrants are probably more at risk of being used in the second stage of money laundering, *layering*, the use of multiple transactions and institutions to obscure the original source and the final destination of funds. Securities markets are attractive to the money launderer for several reasons. Markets offer a wide variety of available investment options, liquidity, portability and ease of transfer. Securities markets also have the capacity to absorb huge amounts of capital, lawful or illicit, without attracting extensive regulatory review. Unlike mainstream banking, securities transactions allow the money launderer to change the form of funds, not just from cash in-hand to cash on-deposit, but from cash to a secure and liquid asset in an entirely different form. Instruments that are cash equivalents, such as bearer bonds and other "street form" negotiable securities, may be particularly attractive as vehicles for money laundering.
>
> For these reasons, securities markets can offer the sophisticated money launderer an ideal route for effective *integration* of the proceeds of crime into the legitimate economy.

¶ 628 The notice provided guidance on the identity verification requirements of the federal law. It also provided general guidance on recognizing and responding to suspicious transactions:

> Money launderers use an almost unlimited array of types of transactions, and therefore it is difficult to define a suspicious transaction. However, a suspicious transaction will often be one which is inconsistent with an investor's known legitimate business or personal activities or with the normal business of that type of investor. The key to recognizing a suspicious transaction is knowing enough about the investor's business or investment objectives to recognize when a transaction, or series of transactions, is unusual.
>
> To prevent the investment industry from being used for money laundering, registrants should consider the following questions before entering into a transaction:

- Does the registrant know the investor personally?
- Is the transaction in question in keeping with the investor's investment objectives?
- Is the transaction in keeping with normal practice in the market to which it relates, i.e., with reference to market size and frequency?
- Is the role of any intermediary involved in this transaction unusual?
- Is the transaction to be settled normally?
- Are there other transactions linked to the transaction in question that could be designed to disguise money and divert it into other destinations and beneficiaries?

¶ 629 The notice described a number of situations that were more prone to money laundering activities. Those situations included transactions involving third parties. The notice stated that registrants may need to make additional inquiries in those situations. Finally, the notice advised registrants to introduce procedures to identify possible money laundering:

> Registrants should introduce appropriate procedures to generate a level of awareness and vigilance to enable a report to be made to the designated director or officer responsible for compliance with the Act if suspicious transactions are encountered. The designated director or officer should be able to provide direction on suspicious transactions both internally and to law enforcement agencies.

¶ 630 The directors discussed money laundering and the new federal requirements at their Executive Meetings of June 8 and September 22, 1993. The discussions focussed on the identity verification requirements. The discussions did not address the need to recognize and respond to suspicious transactions.

¶ 631 A VSE notice of April 1994 reminded registrants – both firms and investment advisors – of their role as industry gatekeepers. It was an update to a notice issued in 1989. The gatekeeper notice described the responsibility of registrants to act as gatekeepers of the capital market:

> The world wide attention that has been placed on the Securities Industries in many jurisdictions makes it appropriate to review and restate the guidelines under which RR's and other industry participants should operate. In particular, the role of the Member and its employees in upholding the integrity of the market place (the role of "Gatekeeper") continues to be of major importance.

> The Know Your Client rule is one of the fundamental rules of the Securities Industry. It is incumbent upon any RR to have as full a knowledge as possible of the personal circumstances and investment objectives of all clients, both on an initial and an ongoing basis. It follows that it is the duty of RR's to act in the best interests of their clients.
>
> However, the RR's must also act in the best interests of their employers and through them the whole Securities Industry. From this it follows that if the RR becomes aware, through knowledge of the client or otherwise, that the intention or effect of the trading by a client would be in breach of the Securities Act or impugn the integrity of the market place, then it is incumbent on the RR in the capacity of "Gatekeeper" within the Securities Industry, to draw the matter to the attention of Management of the firm and the Member shall draw this to the attention of the Exchange. Further, willful blindness on the part of RR's, may equally be construed as failure to meet their responsibilities.
>
> It is, in this regard, important for each RR to be aware of potential signs of market manipulation. These would include such characteristics as market dominance, price leadership, high closing, etc. The Exchange assumes that RR's are aware of possible signs of manipulations. RR's are in fact in the best position to be aware of any market scheme at its outset, because of their knowledge of their clients and their trading patterns.
>
> In assessing whether any RR is participating in any market scheme, the Exchange will be reviewing, in addition to whether there was direct participation, the broader questions of whether the RR knew or ought to have known that there was some scheme afoot.

¶ 632 A Commission notice of January 1995 reminded all market participants – registrants, insiders, issuers, and investors – that public participation in the capital market depends to a great degree on investor confidence in the fairness and integrity of that market. The fair trading notice set out some fundamental principles:

> Some of the most fundamental principles of fair trading are set out in the following:
>
> "When investors and potential investors see activity they are entitled to assume that it is real activity. They are entitled to assume that the prices they pay and receive are determined by the unimpeded interaction of real supply and real demand so that those prices are the collective marketplace

> judgments that they purport to be." [Re: Edward J. Mawod & Co., 46 S.E.C. 865, 871-872 (1977), aff'd, 591 F.2d 588 (10th Cir. 1979)]
>
> Clearly, any attempt to interfere with the normal forces of supply and demand in the marketplace, or any attempt to create a misleading appearance with respect to the price of a security or its trading volume, is contrary to these fundamental principles and undermines public confidence in the market.

¶ 633 After providing several examples of abusive trading practices, the notice turned its focus to registrants:

> Registrants have a responsibility to stock exchanges, to their clients and to the market place generally to ensure that their activities are carried out responsibly and in compliance with the letter and spirit of the legislation and exchange rules and by-laws. The following are examples of some of the activities that are expressly prohibited by exchanges and do not comply with the principles of fair trading:
>
> (a) making a fictitious transaction;
>
> (b) giving or accepting an order which a person knows or ought to know does not involve a change of ownership of the securities in question;
>
> (c) purchasing, selling, or offering to purchase or sell securities where the person knows or ought to know that the effect of such a purchase or sale would be to unduly disturb the normal position of the market or to create an abnormal market condition in which market prices do not fairly reflect current market values, or being a party to any plan or scheme to do so;
>
> (d) confirming a transaction when no trade has been executed;
>
> (e) indiscriminate or improper solicitation of orders either by telephone or otherwise;
>
> (f) high pressure or other trading tactics of a character considered undesirable;
>
> (g) using or participating in the use of any manipulative or deceptive method of trading where the person knows or ought to know the nature of the method; and
>
> (h) violation of any statute applicable to trading in securities.

> Even if a registrant is not directly involved in an unfair or inequitable activity, the registrant is expected to be inquisitive and pro-active in dealing with such activities that are carried on by others and of which the registrant is or should be aware. Registrants should refuse to accept instructions from clients who, in the registrants' judgment, are engaged in illegal, unfair or abusive trading activities. All such instructions or orders should be reported immediately to the registrant's senior management. Senior management are expected to bring matters concerning serious misconduct in the markets to the attention of the stock exchange or the Compliance and Enforcement Division of the Commission.

¶ 634 In 1995, the directors also knew that one third of the accounts opened at Pacific International at that time were for US residents. McQuid told them that at the Executive Meeting of May 4, 1995. Meier acknowledged that this was a significant number.

¶ 635 Because Pacific International was not registered in the US, it could not solicit clients there. As Meier acknowledged, each of Pacific International's US clients was referred, either by another client or by an issuer.

¶ 636 Again because Pacific International was not registered in the US, it could not solicit trades from, or offer advice to, its US clients. It could only accept orders. It follows from this that Pacific International's US clients had concluded that they did not require Pacific International's advice; they were looking only for order execution. This should have suggested to the directors that the firm's US clients were more experienced market participants. McQuid certainly recognized this:

> Q To what do you attribute the fact that there appear to be quite a few experienced American market players at Pacific International?
>
> A I think what I attribute it to is the fact that we did non-solicited business with, with American residents. So I think what that meant was that the client had to seek you out rather than you seeking the firm out. And it was, it was people who typically didn't require the, the advice of a broker that would be participating in the unsolicited trades.
>
> Q Perhaps you could expound on that a little bit. What do you mean, they don't need a broker?
>
> A They're, they're sophisticated. They're experienced. They make their own decisions and they're not necessarily looking for ideas from the broker.

¶ 637 McQuid said that these US experienced market participants did most of Pacific International's OTC BB business:

> A The business that we had on the bulletin board for the most part was active participation by experienced market people, normally resident in the U.S. …

¶ 638 McQuid also said that US experienced market participants presented a certain kind of risk:

> A … Promoters or directors or insiders of issuers or experienced market participants present yet another risk partly because those are the people that regulators we think would be most mindful of. Additionally because these are the type of people that are out talking about – about perhaps the securities of they're promoting or the securities they're insiders of, and from time to time they step over the bounds of what is passing information or promoting their security and that fine line between promoting a security and manipulating a security, …

¶ 639 In 1995, the directors also knew that Pacific International had started to do business on the OTC BB and that there were risks associated with that market. Meier confirmed this:

> Q Okay. I'm going to suggest to you, sir, that you were aware that there were certain risks associated with the OTC BB market; is that fair?
> A I agree with you.
> Q And these risks were brought to the attention of the executive committee in executive committee meetings, correct?
> A Correct.

¶ 640 Meier acknowledged that the OTC BB:

- was a relatively new market;
- was a less regulated market;
- had issuers that were less regulated;
- had volatile stocks; and
- had a lot of players who were promoters, insiders, control persons or otherwise closely associated with an issuer.

¶ 641 Meier acknowledged that the OTC BB was on the risky side of the securities business:

> Q Okay. You realized, prior to entering into this market, that the OTC BB was on the risky side of the business, correct?
> A Yes, just like the VSE of the early '80s, say.

¶ 642 He also acknowledged that he knew all of these things before Pacific International started to do business on the OTC BB.

¶ 643 Meier said that he agreed with the following excerpt from the Holley Report:

> The standards of 'prudent supervision' will generally increase when:
> - trading in, or advising on, riskier securities;
> - acting for less experienced clients, less reputable clients, or for clients who are insiders, promoters or control persons;
> - the nature of the transactions requested by clients could give rise to concerns about unfair or abusive practices or could pose a threat to the reputation of the firm or the integrity of the capital markets.

¶ 644 Meier also said that Pacific International's standards of supervision did increase:

> Q Okay. Now, you have already agreed that this OTC BB market was on the riskier side of the business, correct?
> A Yes.
> Q Okay. Do you then agree that the standard of prudent supervision will have to increase, given that fact?
> A Yes.
> Q Okay. And you have already agreed that the OTC BB market had insiders, promoters and control persons, correct?
> A Just like the VSE.
> Q Yes. You do still agree that the OTC BB market has insiders, promoters and control persons, correct?
> A Yes.
> Q And you agree then that the standard of prudent supervision will have to increase because of that fact, correct?
> A Yes, it does and it did.

¶ 645 The evidence does not support Meier's statement.

¶ 646 In 1995, the directors knew, or should have known, the written policies and procedures for dealing with clients that were in place at Pacific International. The

firm's Sales Procedures Manual was dated October 1995. It contained essentially no supervisory procedures regarding:

- US or offshore clients;
- clients who were experienced market participants;
- clients who had regulatory histories;
- the trading of OTC BB or other risky securities; or
- how to recognize and respond to a transaction, or a series of transactions, that raised a concern that the client was participating in abusive market conduct, such as insider trading, market manipulation or money laundering.

¶ 647 These were the very types of transactions that registrants had been warned to watch out for in the money laundering, gatekeeper and fair trading notices.

¶ 648 The manual did not provide any guidance regarding Pacific International's gatekeeper responsibilities when dealing with these, or any other, types of clients.

¶ 649 Nor was any practical guidance available in any Compliance or Operations bulletins. In 1995, McQuid prepared two Compliance bulletins regarding the gatekeeper responsibility; one included a copy of the fair trading notice and the other included a copy of the gatekeeper notice. However, those bulletins were sent only to the investment advisors. And the bulletins provided no additional comment or guidance. The only exception was that one of the bulletins reminded investment advisors that they had to routinely ask an insider client if the client was filing his insider reports. Otherwise, the bulletins made no attempt to apply the principles in the notices to the real world risks of Pacific International's business.

¶ 650 There was another problem with the procedures in place at Pacific International in 1995. The directors had delegated the responsibility for Pacific International's compliance with legislative and regulatory requirements – including know your client – to McQuid and Compliance. However, there was no compliance procedures manual at the firm. There were no written procedures or guidance regarding:

- the goals and objectives of the firm's compliance function;
- the responsibility and authority of each department with respect to the firm's compliance function;
- the client and transaction reviews that staff were expected to do;
- the problems, errors or suspicious transactions that staff were expected to recognize and the manner in which they were expected to respond to them;
- the circumstances in which anomalies were to be brought to management's attention; or

- the manner in which staff were expected to apply their authority and exercise their discretion.

¶ 651 I conclude that there were no supervisory or compliance procedures in place that would allow the directors to satisfy themselves that Pacific International was complying with the requirement to know, and prudently supervise, its higher risk clients dealing in higher risk securities.

¶ 652 The directors said that they did establish a flow of information to the board regarding compliance matters. Specifically, they expected to be informed of significant compliance matters. Meier provided a list of those significant compliance matters:

> Q You have already agreed that you had an oversight responsibility for compliance at the firm, correct?
> A Yes.
> Q You had delegated primary responsibility to Mr. McQuid, correct?
> A Yes.
> Q Do you agree with me that there should have been systems in place to ensure that important information was transmitted from Mr. McQuid to you on compliance issues?
> A Yes. I think I specified yesterday which ones I thought should have been brought to my attention and I can quickly list it: complaints from regulators against Pacific International, complaints or investigation by regulators against our investment advisors, lawsuits, and client complaints of any sizeable nature. Those were the things that were expected to be brought. Everything else was really at the discretion of Mr. McQuid. If, if these criminal things would have happened in our accounts, of course, that would be something I would like to know.
> …
> Q … In the list that you gave, you didn't seem to include clients being charged with criminal indictments, but I take it you – that is something that you wanted to have brought to your attention?
> A That I would have left to the, to the judgment of Mr. McQuid.
> Q Okay. That's what I was trying to sort out. So –
> A If it's not related to trading at Pacific International. If they get criminally charged about something they did at Pacific International , yes, --
> Q Sure.
> A --it would have to be elevated.

> Q Okay. So if clients are criminally charged, but it's not to do with trading at Pacific International , then you didn't feel the necessity of insisting that that information be provided to you so you could conduct your oversight compliance responsibilities; do I have that correct?
> A You have that correct, and I would have expected them to do whatever the appropriate measures were, in that case, like, freezing the account or closing accounts or things like that.

¶ 653 Bachellerie had a slightly different expectation regarding proceedings against a client that did not involve activity at Pacific International:

> A I wouldn't need to know about those types of situations generally, but I would want to know if that client had participated in similar activity at PI and compliance was of the view that -- that we could be at risk. …

¶ 654 The other directors described the significant compliance matters about which they expected to be informed in essentially the same terms as Meier and Bachellerie.

¶ 655 Even assuming that this represented an adequate flow of information to the directors regarding compliance matters, there was yet another problem. There were no procedures in place to ensure, to the extent possible, that the directors would actually receive all of the information they expected.

¶ 656 Almost all of the significant compliance matters on Meier's list would come to Compliance's attention in the normal course of events – complaints or investigations by regulators about Pacific International or its investment advisors, lawsuits, or significant client complaints. However, criminal or regulatory proceedings against a client would not normally come to Compliance's attention. And there were no procedures in place to try to ensure that Compliance would learn of such proceedings in a timely manner, such as a requirement for regular searches of clients who already had a regulatory history. Indeed, even when Compliance happened to learn of the 1997 Globus indictment and the 1998 Houge indictment, they did not get copies of the indictments to see whether the allegations involved activity at Pacific International (or activity similar to the client's activity at Pacific International).

¶ 657 The directors could not say that they had set up an adequate flow of information to the board unless they were satisfied that the procedures they had established would generate the information they required.

¶ 658 I have found that Pacific International failed to comply with the know your client rule in its dealings with certain clients, each of whom was a higher risk client dealing in higher risk securities. I have also found that Pacific International failed to establish and apply written prudent business procedures in respect of this higher risk business, and that this failure contributed to the firm's breach of the know your client rule.

¶ 659 The directors of Pacific International delegated the responsibility for compliance with the firm's legislative and regulatory requirements – including know your client – to McQuid and Compliance. In 1995, the directors knew that an increasing proportion of Pacific International's new accounts were for higher risk clients dealing in higher risk securities. The directors also knew that this type of business required higher standards of supervision. Despite this, the directors did not ensure that Pacific International had adequate supervisory and compliance procedures in place to meet these higher standards. Nor did the directors ensure that they were getting the information they required to satisfy themselves that the firm was complying with its legislative and regulatory requirements in this regard.

¶ 660 Consequently, I find that the directors failed to exercise the care, diligence and skill of a reasonably prudent person, contrary to section 118 of the *Company Act*, and acted contrary to the public interest.

2. Events After 1995

¶ 661 In late June and July 1996, the directors received information that raised serious concerns about Hauchecorne and the Ubiquity accounts:

- Ubiquity retained a lawyer and demanded the return of $1.7 million that had been wired out of the Ubiquity account;
- McQuid had received calls from Gurian, who claimed to have entered orders on the Ubiquity account and who accused Hauchecorne of stealing the $1.7 million; and
- Hauchecorne had been assaulted in his hotel room in New York by Gurian, Metzer and two others.

¶ 662 The directors instructed that Hauchecorne be interviewed by Pacific International's lawyer. McQuid attended the interview. In the lawyer's memo summarizing the interview, he stated:

> Hauchecorne says he is convinced that Gurian got the money from "mob" types and that he lost millions of dollars U.S. with his Cellstar and Osicom stock-plays. He notes that [in the hotel room] Metzer asked where "his"

> money was, referring to the Ubiquity/First Nassau accounts. Hauchecorne says something evidently went wrong with Cellstar and that Gurian has had to justify the losses. Hauchecorne is of the opinion that Gibson may not exist. If she does, however, he believes she is a nominee for Gurian. (Hauchecorne says he can try to locate documents filed with the SEC that says that Gibson is the beneficial owner of Ubiquity.)

It is unclear whether any of the directors saw this memo. If not, they should have.

¶ 663 In December 1996, Business Week published a ten page article, its cover story, titled "The Mob on Wall Street". Hauchecorne faxed the article to McQuid and told McQuid that he recognized the client he knew as Metzer as one of the people whose picture was in the article – Philip Abramo.

¶ 664 The article said that Abramo had been identified in court documents as a ranking member, or capo, in the New Jersey-based DeCavalcante organized crime family. The article described Abramo as "easily the highest-ranking reputed mobster to be engaged full-time in Wall Street activities."

¶ 665 The article also stated that a "three-month investigation by BUSINESS WEEK reveals that substantial elements of the small-cap market have been turned into a veritable Mob franchise, under the very noses of regulators and law enforcement." The article continued:

> Among BUSINESS WEEK's findings:
>
> ■ The Mob has established a network of stock promoters, securities dealers, and the all-important "boiler rooms"—a crucial part of Mob manipulation schemes—that sell stocks nationwide through hard-sell cold-calling. The brokerages are located mainly in the New York area and in Florida …
>
> ■ Four organized crime families as well as elements of the Russian Mob directly own or control, through front men, perhaps two dozen brokerage firms that make markets in hundreds of stocks. …
>
> ■ Traders and brokers have been subjected in recent months to increasing levels of violent "persuasion" and punishment—threats and beatings. …
>
> ■ Using offshore accounts in the Bahamas and elsewhere, the Mob has engineered lucrative schemes involving low-priced stock under Regulation S of the securities laws. Organized crime members profit from the runup in such stocks and also from short-selling the stocks on the way down. …

> ■ The Mob's activities seem confined almost exclusively to stocks traded in the over-the-counter "bulletin board" and NASDAQ small-cap markets. …
>
> ■ Wall Street has become so lucrative for the Mob that it is allegedly a major source of income for high-level members of organized crime—few of whom have ever been publicly identified as having ties to the Street. …
>
> ■ Mob-related activities on the Street are the subject of inquiries by the FBI and the office of [the] Manhattan District Attorney …

¶ 666 McQuid acknowledged that the article was a red flag that organized crime was involved in the OTC BB market:

> Q Do you agree with me that this article in general provided a red flag to you, and anyone who read it, that the Mob was mixed up in the OTC BB market as well as the small-cap market?
> A Yes.
> Q And as I recall, immediately upon receiving this fax and receiving the preceding phone call from Mr. Hauchecorne, you informed the other members of your executive committee of your conversation with Hauchecorne and of the, of this article; is that correct?
> A Yes.

¶ 667 Some of the directors read the article. Others did not. Meier said that having it confirmed that at least one of the men in the hotel room was mafia did not create a whole other level of concern for any of them; they already knew the men in the hotel room were bad people. Meier also said that they did not take any additional measures that they had not already taken.

¶ 668 Business Week published a second article in March 1997, titled "The Mob on Wall Street: Why You Can't See It". The article focussed on the alleged manipulation of the market for the shares of SC&T International Inc. The article said:

> How do Abramo and other reputed Mob financiers and stock promoters keep their machinations from regulatory and public scrutiny? The answer to this question can be summed up in two words: offshore companies.
>
> Usually, the offshore financial mechanisms used by the Mob are enmeshed in secrecy. But lately some answers have turned up -- all surround the December, 1995, initial public offering of a small Phoenix-based company

that makes multimedia components, SC&T International Inc. At the center of this tale are a half-dozen shadowy Bahamian entities and Sovereign Equity Management Corp., which brought SC&T public. Street sources say Sovereign is controlled by Abramo through a man named Philip Gurian, whose National Association of Securities Dealers registration was revoked in 1991.

Gurian was the key player in organizing the offshore financial conduits that handled the SC&T deal.
…

Gurian's involvement in the Bahamian companies would ordinarily never have come to light. Not a word was said about him in the SC&T prospectus or in the papers filed with the SEC by the offshore entities in connection with the offering. But there was an unforeseen development. Several months after the SC&T offering, some $ 1.7 million allegedly disappeared from Ubiquity's accounts held at a Canadian brokerage. In a suit filed against the brokerage and others by Ubiquity, the firm notes that the person who "provided all trading instructions" for the firm was none other than Phil Gurian. Gurian describes himself as merely an "adviser" to the Bahamian accounts. But he acknowledges that he directed the trading for Ubiquity and other Bahamians involved in the SC&T deal.

The case of the missing $ 1.7 million is a saga within a saga. Ubiquity claims in the suit that the money was stolen by a Canadian broker and a convicted penny-stock manipulator, Eric Wynn -- whose "coffee" meetings with President Clinton have lately gained notoriety. Efforts to obtain an interview with Wynn, who recently began serving a prison sentence for securities fraud, were unsuccessful. In a statement to BUSINESS WEEK, he denies involvement in any theft and claims the theft never took place. Wynn says that Gurian falsely claimed that the money was stolen. He maintains that Gurian hatched a scheme to defraud the Canadian broker and its insurance company by falsely claiming the loss and then unsuccessfully sought to involve Wynn in the scheme. Gurian vigorously denies Wynn's allegations.

The Royal Canadian Mounted Police investigated the reported disappearance of the money – and came up with an intriguing tidbit about Ubiquity's ownership. According to a summary of the RCMP investigation, a copy of which was obtained by BUSINESS WEEK, an ominous incident took place after the money was found missing. A Canadian broker, accused in the suit of joining with Wynn in stealing the money, was visited in a Manhattan hotel room in mid-1996 by Gurian and

> what the report describes as “three males.” An RCMP investigator, who requested anonymity, says the three were described to the RCMP as “hoodlums.”
>
> Gurian says he brought along three “friends” to intimidate the broker, but denies they were “hoodlums.” He also denies reports, from sources familiar with the incident, that one of the three was an angry Abramo, who allegedly claimed the stolen money was his. Abramo’s [lawyer] declined comment.
> …
>
> If Ubiquity was the victim of a heist, it was not the only party to the SC&T saga to have lost big. SC&T shareholders saw their shares, which went public at $ 5, climb to $ 8 in June before plummeting to pennies by yearend. Sovereign ceased supporting the stock.

¶ 669 Some of the directors said that they were not told about this article. Others said that they read it and recognized that it would have been damaging to Pacific International’s reputation had the firm’s name been mentioned. Meier acknowledged that Pacific International was at reputational risk:

> Q Okay. So I'm suggesting to you that given the March 24th, '97 article, which refers to your firm without naming it, it must have occurred to you that you were at a reputational risk, correct?
> A That's right.
> Q And did it not occur to you that, you know, at least we better perhaps look into the non-resident accounts and the OTCBB accounts and the -- and the, the problems as I've defined them in previous questions in Hauchecorne's -- some of Hauchecorne's accounts and some of Rachfall and Patterson's accounts and some of Ivancoe's accounts, did it not begin to take form that maybe we better look into this more because we're at a serious reputational risk?
> A Right. Obviously, as you know the answer, in, in the summer of 1999 is when we thought we had enough information that caused us to do what we did. And at no stage before did we or compliance think that -- that those type of drastic measures that we took in the summer of '99 were necessary.

¶ 670 The directors should not have assumed, as some of them did, that they could dismiss the Business Week articles as sensational and inaccurate. Business Week was a reputable business magazine and the directors knew that the sections in the

second article involving their firm were accurate. Nor should the directors have assumed that the Hauchecorne-Ubiquity matter was an isolated event.

¶ 671 The Hauchecorne-Ubiquity matter, combined with the Business Week articles, certainly raised a red flag that organized crime was involved in the OTC BB and that Pacific International was at reputational risk. They also should have put the directors on notice that there could be problems with the supervisory and compliance procedures in place at the firm and the adequacy of the information flowing to the board in this regard. Indeed, it is hard to imagine a bigger red flag, or a more serious warning, that such problems could exist.

¶ 672 By March 1997, the directors knew that a group of Hauchecorne's accounts appeared to have been operated for the benefit of a high ranking member of the mafia. The directors also knew that organized crime appeared to be involved in the OTC BB, a market in which Pacific International was doing an increasing amount of business. That information should have caused the directors to initiate inquiries to determine:

- how the Ubiquity accounts came to be opened and the nature of the activity in the accounts;
- whether any of the other investment advisors who were heavily involved in the OTC BB had similar clients; and
- the changes that needed to be made to prevent such clients from opening or operating accounts at Pacific International.

¶ 673 For example, had the directors made inquiries regarding the opening of and activity in the Ubiquity accounts, they would have learned that there were in fact problems with the supervisory and compliance procedures in place at the firm and with the adequacy of the information flowing to the board:

- The account opening documentation for the Ubiquity accounts lacked important information about the clients and the persons authorized on the accounts. As well, the address for each client was a post office box in the Bahamas.
- The identity of the authorized persons on the Ubiquity account was ambiguous. Operations had been taking instructions in that regard from Gurian, who was himself not authorized on the account. The signature of one of the authorized persons had changed, but no inquiries had been made about the change.
- Operations had wired out $1.7 million to a bank in Hong Kong on the faxed instructions of a person whom they had been told was no longer authorized on the account.

- Gurian gave very detailed instructions on the Ubiquity accounts on an almost daily basis.
- Gurian had many brokers, so many that he sometimes became confused about which accounts he had where.
- Hauchecorne believed that Gurian got his money from "mob" types and had lost millions of dollars with "his Cellstar and Osicom stock-plays."
- Some of the Ubiquity accounts traded shares of Cellstar and Osicom. The Ubiquity account received in and traded shares of SC&T.
- Gurian's calls to McQuid raised concerns that Hauchecorne had been taking orders from an unauthorized person, that Hauchecorne had been making discretionary trades, and that Hauchecorne had stolen $1.5 million. McQuid failed to adequately follow up on those concerns or to inform the other directors of them at the time of the calls.

¶ 674 Had the directors made those inquiries and learned this information, they could have taken the action necessary to deal with the problems they were facing.

¶ 675 First, the directors should have put in place more robust written supervisory and compliance procedures in respect of its higher risk business. Compliance did take some steps, such as doing more searches and requiring faxed wire instructions to be confirmed with the client. However, the directors did not put in place written procedures to ensure that Pacific International was complying with the requirement to know, and prudently supervise, its higher risk clients dealing in higher risk securities.

¶ 676 Second, the directors should have increased the flow of information to the board about this higher risk business. Without that additional information, the directors could not satisfy themselves that Pacific International was complying with its regulatory obligations in respect of its higher risk business. Nor could the directors satisfy themselves that Pacific International was properly managing the risk to its reputation, and to the integrity of the capital market, presented by that business.

¶ 677 Because the directors did not increase the flow of information to the board in this regard, the directors were not told of the following events (with a few exceptions):

- On October 9, 1996, three clients – Badger, Langley and Larder – were charged in a US criminal complaint with conspiracy to commit securities fraud in connection with the shares of an issuer quoted on the OTC BB. Badger was also charged with criminal contempt for contravening a 1976 order permanently enjoining him from violating the antifraud, securities registration and broker dealer registration provisions of federal securities laws.

Compliance learned of the complaint in October 1996 and restricted the accounts of these clients. The investment advisors for the accounts were Rachfall and Patterson. McQuid did not know whether he saw the complaint at the time.

- Between November 1996 and April 1997, Compliance learned of various aspects of an investigation regarding Globus shares, which were quoted on the OTC BB. Globus shares had been received and traded in four accounts – Kowalski, Della, Virgo Bay and Leeward Cove. The investment advisor for the accounts was Ivancoe.

  - In November 1996, the FBI contacted McQuid;
  - In December 1996, Compliance received a US subpoena;
  - In March 1997, the RCMP executed a search warrant at Pacific International; and
  - In April 1997, the VSE advised McQuid that it was investigating the conduct of Ivancoe, as it related to trading in Globus shares, and Pacific International, as it related to the supervision of Ivancoe. The directors were told of the Ivancoe investigation.

- In January 1997, Compliance received search results on Gladstone. Gladstone had a serious regulatory history and a 1990 South Floria Business Journal article reported that Gladstone had worked for, and allegedly operated an illegal branch office of, a "notorious mob-connected brokerage that has been the subject of federal investigations the last three years."

- On May 8, 1997, Tannas sent an email to McQuid regarding various risks associated with US accounts. She noted that:

  - US securities regulators have a tendency to go after individuals with regulatory histories;
  - A dealer through which an illegal distribution is sold may be liable under US securities laws;
  - US individuals with regulatory histories "like to sell US securities from Canadian brokerages" and these accounts attract the attention of the SEC; and
  - These types of accounts are "high risk" and "not at all rare".

- In May 1997, the SEC filed a civil complaint against a Pacific International client, Todd Moore, and others. The others included another Vancouver dealer and one of the dealer's investment advisors. The complaint alleged that Moore participated in a market manipulation that generated profits of more than $5

million. Moore's accounts at Pacific International were closed in August 1999. Thomas said that he was generally aware of the complaint at the time, but did not know that Moore also had an account at Pacific International.

- In July 1997, Compliance received the results of 32 searches. The clients searched were US residents, with active accounts, who described themselves as being in occupations such as investments, consulting or public relations. In short, they were experienced market participants. Of the 32 names searched, 17 were, or had been, a US registrant. Eight had a regulatory history.

- On December 10, 1997, Thomas sent an email to McQuid raising concerns about the increasing number of investment advisors trading directly with US market makers. Thomas said that the list was more extensive than he had thought and that he could not guarantee that it was complete. The list included Hauchecorne, Ivancoe, Rachfall and Patterson. Thomas said that the practice presented a number of difficulties:

  - The lack of trade oversight meant that there was no control over credit; the investment advisor could enter an order for virtually any amount;
  - As no ticket was submitted, they would not know who the trade was for;
  - Pacific International would still be liable to settle, if the investment advisor refused to acknowledge the trade; and
  - Some of the investment advisors on the list did not have taped lines.

- In January 1998, McQuid learned of the Globus indictment, which had been filed in March 1997, from a Denver Post article faxed to him by the VSE. The article described the alleged Globus manipulation and said that Globus shares had been "deposited at a brokerage firm in Vancouver, Canada, in the names of companies based in Antigua and the Bahamas, enabling the owners to conceal their interest in a stock they later resold at inflated prices." McQuid thought at the time that the Vancouver firm was probably Pacific International. Compliance restricted the four accounts, but did not obtain a copy of the indictment.

- In a letter dated March 24, 1998, VSE examiners noted that certain accounts had several securities transfers to seemingly unrelated accounts. The examiners asked whether the relationship between the parties was documented in the client files and for a description of the nature of the frequent transfers. Bachellerie responded to this question in a letter dated April 15, 1998:

  > We advise that all transfers between the [five client accounts] were undertaken on the clients' express written instructions. We do not

> have any documentation in our files which might indicate what sort of business relationship these clients have with each other. However, in our view, we would be in violation of our obligations to our clients if we did not comply with their express direction. That having been said, the frequency of the transfers has already caused Compliance to question the activity in these client accounts (we noticed this activity some time ago) and we are currently in the process of attempting to determine the nature of their relationship.

- On May 21, 1998, Tannas sent an email to Thomas re: Deposit Letters/Third Party Wires. The email began:

  > As you know we have had a few clients who
  > - give us US Deposit letters which state that shares are being sold for the client's benefit and
  > - blithely wire proceeds to third parties.
  >
  > Accounts which give us deposit letters should not complicate matters by having the ability to obtain third party cheques or wires.
  > …
  >
  > We need to decide how we want to deal with this:
  > - case by case basis
  > - all accounts with US deposit letters
  > - all US accounts

  Thomas replied that they would deal with it on a case by case basis.

- In June 1998, Thomas received a US restraining order enjoining the Houge accounts at Pacific International. The order had been issued in relation to the Houge indictment, which had been filed on May 21. Compliance restricted Houge's accounts, but did not obtain a copy of the indictment.

- On July 28, 1998, Tannas sent an email to Thomas re: Sal Mazzo/ Hauchecorne Accounts. She said that Compliance had noted that a number of active Hauchecorne accounts had been referred by Mazzeo and that Mazzeo was mentioned in a Barron's article of October 1996. The article had been included in the search results for another client. Mazzeo had a regulatory history. The article reported that Mazzeo and his father had been the principals in "a bucket shop with ties to several New York Mafia families that cost investors some $350 million when it collapsed in 1985." The next day, Tannas sent a second email to Thomas and McQuid. She said that Compliance had found what appeared to be a Reuters release reprinted in an internet discussion

group for a stock currently traded by another Pacific International client. She continued:

> The "release" refers to the fact that Salvatore Mazzeo a New York stock promoter pled guilty on or about June 23 to an attempt to commit "enterprise corruption". It refers to two off-shore companies fronted by a foreign diplomat "based in Canada while representing a third country". No stock is named. No individuals other than Mazzeo are named. There is no apparent reason for the release to be quoted in the discussion group for [the stock].

Thomas and McQuid decided to retain the referred accounts, but subject them to heightened supervision.

- In October 1998, the SEC announced an internet fraud sweep. The SEC brought 23 enforcement actions against 44 individuals and companies. All 23 cases involved a range of internet conduct including fraudulent spams, online newsletters, message board postings and websites. The SEC release announcing the sweep said that the authors of the fraudulent material "unlawfully touted more than 235 Microcap companies". The release quoted the SEC's Director of Enforcement:

  > In all of these cases, the Internet promoters gave ostensibly independent opinions about Microcap companies that in reality were bought and paid for. Not only did they lie about their own independence, some of them lied about the companies they featured, then took advantage of any quick spike in price to sell their shares for a fast and easy profit. …

  The release listed 12 complaints and 11 administrative proceedings. Four of the complaints were issued against past or current Pacific International clients. With respect to the two current clients, Compliance closed the accounts of one but retained the accounts of the other, subject to heightened supervision. Compliance did not obtain copies of the complaints.

  Thomas sent the directors a copy of the SEC release. However, he did not tell at least some of them that four of the complaints were issued against past or current Pacific International clients.

¶ 678 Had the directors been told of these events, they would have been expected to take the action necessary to resolve the increasing concerns the events raised about the adequacy of the supervisory and compliance procedures in place for Pacific

International's higher risk business. Because the directors did not have this information, they did not take that action. It was not until June 1999, when they were faced with a number of US indictments, the arrest of Rachfall and Patterson, and much negative publicity, that the directors of Pacific International finally took corrective action.

¶ 679 One of the directors sent an email to Meier in early July 1999:

> Max, I'd like to suggest that we have a special Exec meeting to talk about our U.S. business. I'd like to see Larry come up with some recommendations as to how we can tighten up, give us a description of the business that our "risky" brokers conduct so that we all have a clear understanding, etc. I'd also like to know how and when we do name searches on new US clients, do we do name searches on old accounts that later on have unusual trading activity? If we notice unusual activity are we going to take a tougher stand and ask for full explanations? We need to closely review and verify the answers to our questions on the US Deposit letters and Compliance should keep a running tally of the trading and stock received for each account as this can trickle in over time without being aware of it. What will we do from now on for US accounts where we see a lot of stock delivered in and out of the account, third party cheques issued, and unusual trading – I think we now need to take a much harder look at this as our procedures in the past are obviously not designed to properly deal with this. We can't fix up the past but we certainly can put things in place to deal with this in the future. We need to learn from our mistakes and move forward.
>
> …
>
> As you know, I made a hard decision about my business because I became uncomfortable with my client. There may be warning signals with other accounts of the firm and I think it is Compliance's responsibility to uncover these and bring it to our attention so that we can deal with it – we may have to make several of these hard decisions in the next while to demonstrate to the regulators and our brokers and clients that we take this seriously.

The directors of Pacific International should have initiated these inquiries long before the summer of 1999. Because they did not, they failed to take the action necessary to:

- ensure that Pacific International was complying with the requirement to know, and prudently supervise, its higher risk clients dealing in higher risk securities; and
- properly manage the risk to Pacific International's reputation, and to the integrity of the capital market, presented by that business.

¶ 680 Consequently, I once again find that the directors failed to exercise the care, diligence and skill of a reasonably prudent person, contrary to section 118 of the *Company Act*, and acted contrary to the public interest.

V. CONCLUSION

¶ 681 Registrants are the gatekeepers of the capital market. They must be vigilant in identifying and preventing conduct that could threaten the integrity of that market.

¶ 682 In a case like this, with its focus on rules and procedures and complex transactions, it is easy to forget why market integrity is so important. Without it, issuers will not be able to raise money efficiently and at the lowest possible cost. Without it, investors will be harmed.

¶ 683 Registrants must never forget, or ignore, the key role they are expected to play in ensuring the integrity of the capital market.

¶ 684 September 12, 2006

Adrienne Salvail-Lopez
Vice Chair