2011 BCSECCOM 197

Mutual Fund Dealers Association of Canada
Tony Tung-Yuan Lin

Section 28 of the *Securities Act*, RSBC 1996, c. 418

Hearing and Review

Panel	Brent W. Aitken	Vice Chair
	Bradley Doney	Commissioner
	Don Rowlatt	Commissioner
Date of Hearing	January 27 & 28, 2011	
Date of Decision	April 21, 2011	

Appearing

Hugh Corbett Clement Wai	For the Mutual Fund Dealers Association of Canada
Andrew G. Sandilands Jennifer Chew	For Tony Tung-Yuan Lin

Decision

I Introduction

¶ 1 This is a hearing and review under section 28 of the *Securities Act,* RSBC 1996, c. 418 of an August 31, 2009 decision of a hearing panel of the Mutual Fund Dealers Association of Canada. The MFDA hearing panel found there was insufficient evidence to prove that Lin violated MFDA Rules 2.1.1 and 2.1.4 by engaging in excessive trading, as alleged by MFDA staff.

¶ 2 The MFDA says that the MFDA hearing panel erred in making that finding, and in doing so set a bad precedent. The MFDA asks that we:
- set aside the MFDA panel's decision,
- find that Lin engaged in excessive trading and impose appropriate penalties (or in the alternative remit those issues to the MFDA for a new hearing),
- determine certain conduct to be contrary to MFDA rules and to the public interest and therefore not permitted, and
- order costs in favour of the MFDA.

II Background

¶ 3 At the relevant time Lin was a registered mutual fund salesperson with Leaders Wealth Management Inc., a mutual fund dealer registered under the Act.

¶ 4 Between December 2005 and mid-February 2006 Lin processed 34 redemption and purchase transactions in accounts for 8 clients. The transactions involved mutual funds all from the same "family" of funds.

¶ 5 Lin recommended to 2 of the clients that they redeem an amount equal to their gains on funds they had purchased on a front-end load basis and re-invest the proceeds in the deferred sales charge (DSC) version of the same funds. The clients agreed. The transactions yielded $7,000 in commissions for Lin.

¶ 6 Lin recommended to 7 clients (including one of the two described in the previous paragraph) that they invest their gains on some of their mutual funds into different funds managed by the same company. The gains came from DSC funds that were not subject to a redemption fee. Lin recommended the clients reinvest the proceeds in the DSC version of the same funds. The clients agreed. The transactions yielded $58,000 in commissions for Lin.

¶ 7 Lin's clients were active traders. The MFDA hearing panel noted that there were hundreds of switches in these client accounts over the five- to seven-year period leading up to the impugned transactions. Lin testified in the MFDA hearing that he had not been charging switch fees, but he was no longer prepared to facilitate these clients' frequent trading activity without either charging switch fees or receiving a DSC commission from the mutual fund manager.

¶ 8 Lin offered these clients the option of paying a switch fee instead of re-investing in the DSC versions of the funds (and thereby restarting the associated redemption fee schedule). In connection with previous purchases of mutual funds from Lin the clients had received written disclosure that specifically described redemption fee schedules.

¶ 9 Lin says this arrangement was part of a "compensation program" (a term coined by his counsel at the MFDA hearing) into which he entered with these clients. Whether this compensation program in fact existed was a point of contention in the MFDA hearing and before us. The MFDA hearing panel found that it did exist. In our opinion, although this finding was reasonable, the existence of the compensation program is not relevant. What is relevant is the nature of the understanding that existed between Lin and the 8 clients, whether or not that understanding was part of a so-called compensation program.

¶ 10 Lin testified in the MFDA hearing that he discussed the commission proposal with his clients in meetings, including the implications of the DSC structure and the consequent restarting of the redemption fee schedule. Lin's clients all signed the trade tickets for the transactions before they were processed. One of them signed a document that Lin prepared stating:

> "We (client name) hereby acknowledge that by purchasing mutual fund units from our account (account #) will generate commission from front-end into deferred sales charge. [*sic*]"

¶ 11 Leaders' compliance officer told Lin this document was unnecessary, although about a month after the impugned transactions were processed Leaders developed its own form, in which the clients acknowledged that they were fully aware that the specified switch instructions generated additional commissions payable to Lin and that a new DSC redemption fee schedule would apply. All of the clients (other than the one who signed Lin's earlier form) signed this acknowledgement.

¶ 12 The clients were not interviewed by MFDA investigators, and none of them testified at the MFDA hearing. There is no evidence that contradicts Lin's evidence, nor is there any evidence that his clients did not understand the substance of the arrangement. Neither is there any evidence that Lin's clients objected to the arrangement, to Lin's commissions, to the investments, or to the new DSC redemption fee schedule that applied to their investments.

¶ 13 The MFDA says that Lin's structuring of the transactions as he did was of no benefit to his clients, and indeed caused them harm (for example, by restarting the redemption fee schedule in their DSC funds), and that there was no economic purpose to these transactions other than to increase the amount of commission that Lin could earn. That, says the MFDA, constitutes excessive trading, and is, by definition, contrary to MFDA rules 2.1.1 (standard of conduct) and 2.1.4 (conflict of interest).

III Analysis

A Commission's authority and standard of review

¶ 14 On a hearing and review under section 28 of the Act, the Commission may confirm or vary the decision under review, or make another decision it considers proper.

¶ 15 The Commission's standard for reviewing decisions of a self regulatory body like the MFDA is set out in section 5.9(a) of BC Policy 15-601 as follows:

> "5.9(a) The Commission does not provide parties with a second opinion on a matter decided by an SRO. If the decision under

review is reasonable and was made in accordance with the law, the evidence, and the public interest, the Commission is generally reluctant to interfere simply because it might have made a different decision in the circumstances. For this reason, generally, the person requesting the review presents a case for having the decision revoked or varied and the SRO responds to that case.

In these circumstances, the Commission generally confirms the decision of the SRO, unless

- the SRO has made an error in law
- the SRO has overlooked material evidence
- new and compelling evidence is presented to the Commission or
- the Commission's view of the public interest is different from the SRO's."

B Issues

¶ 16 The MFDA says the MFDA hearing panel erred in its decision in several respects. In this review, we need deal with only two. The MFDA says the panel erred by:

1. declining to apply relevant regulatory principles and by failing to develop and apply a test for excessive trading, and in so doing erred in its interpretation of Rule 2.1.1, and

2. placing undue reliance on the clients' consent, and in so doing erred in its interpretation of Rule 2.1.4.

¶ 17 These alleged errors raise two related but separate issues:

1. Was the MFDA hearing panel's interpretation and application of the relevant regulatory principles about excessive trading reasonable and made in accordance with the law, the evidence, and the public interest?

2. Was the MFDA hearing panel's decision that there was insufficient evidence to find that Lin contravened MFDA Rules 2.1.1 and 2.1.4 reasonable and made in accordance with the law, the evidence, and the public interest?

C Discussion

1. The MFDA hearing panel's interpretation and application of the relevant regulatory principles about excessive trading

¶ 18 The MFDA does not have a specific rule prohibiting excessive trading. Instead, the MFDA treats excessive trading as a contravention of its Rules 2.1.1 (standard of conduct) and 2.1.4 (conflict of interest).

¶ 19 These are the parts of MFDA Rules 2.1.1 and 2.1.4 relevant to this review:

> "**Rule 2.1.1 Standard of Conduct.**
> Each Member and each Approved Person of a Member shall:
> (a) deal fairly, honestly and in good faith with its clients;
> (b) observe high standards of ethics and conduct in the transaction of business;
> (c) not engage in any business conduct or practice which is unbecoming or detrimental to the public interest; and
> . . . .
>
> **Rule 2.1.4 Conflicts of Interest**
> (a) Each Member and Approved Person shall be aware of the possibility of conflicts of interest arising between the interests of the Member or Approved Person and the interests of the client. . . .
>
> (b) In the event that such a conflict or potential conflict of interest arises, the Member and the Approved Person shall ensure it is addressed by the exercise of responsible business judgment influenced only by the best interests of the client and in compliance with Rules 2.1.4(c) and (d).
>
> (c) Any conflict or potential conflict of interest that arises as referred to in Rule 2.1.4 (a) shall be immediately disclosed in writing to the client by the Member, or by the Approved Person as the Member directs, prior to the Member or Approved Person proceeding with the proposed transaction giving rise to the conflict or potential conflict.
> . . . ."

¶ 20 The MFDA says Rules 2.1.1 and 2.1.4 are principles-based and intentionally broad so they can be interpreted in a manner consistent with the MFDA's primary mandate of investor protection.

¶ 21 At the time of Lin's impugned transactions in late 2005 and early 2006, the MFDA had any published any guidance or other information about what, in the

mutual fund context, would constitute excessive trading. About two years later, in October 2007, the MFDA issued Member Regulation Notice MR-0065 *Churning*. MR-0065 provides guidance from the MFDA about what constitutes excessive trading and expresses the MFDA's view that excessive trading contravenes Rules 2.1.1 and 2.1.4.

¶ 22 These are excerpts from MR-0065 that describe the MFDA staff definition of churning:

"**MEMBER REGULATION NOTICE**

CHURNING

This Notice clarifies the position of MFDA staff with respect to churning and excessive trading and the obligations of MFDA Members and Approved Persons in this regard.

MFDA staff has encountered trading practices involving mutual funds or other products that may be considered churning, which is a form of excessive trading. MFDA staff defines churning as any practice whereby an Approved Person recommends a trade or multiple trades in a client's account where the trade(s) will have little or no economic benefit for the client and where there is little or no rationale for the trade(s) other than the generation of commissions or other benefits for the Approved Person.

Background

Members and Approved Persons are obligated to deal fairly, honestly and in good faith with clients and observe high standards of ethics and conduct in the transaction of business in accordance with MFDA Rule 2.1.1. MFDA 2.1.4 requires Members to ensure that any conflict of interest is addressed by the exercise of responsible business judgment influenced only by the best interests of the client. Minimum standards for account supervision detailed in MFDA Policy 2 include a requirement to review account activity for excessive trading or switching.

Mutual fund investing is typically geared towards a long term buy-and-hold strategy and MFDA staff would not expect to see frequent trading in client accounts as a general rule. A pattern of frequent trading may suggest the purpose of the transactions was simply to earn commissions.

Prohibited Trading Activity

MFDA staff has observed certain trading activity where Approved Persons earn additional compensation, but clients do not receive any discernable economic benefit, contrary to MFDA Rules 2.1.1 and 2.1.4. Transactions that are executed simply to generate commissions should be prohibited. The following are some examples of such activity:

- the redemption and subsequent re-purchase of the same fund, generating a commission on the transaction for the Approved Person; and
- the movement of money between funds in the same fund family executed as a redemption and re-purchase rather than a switch, generating a commission higher than a typical switch fee.

. . .

Questionable Trades

MFDA staff has identified other transactions that may cause concern from a regulatory standpoint and, although they may be justified as being in the client's best interests in some limited cases, they should be monitored closely as part of each Member's trade supervision procedures.

. . .

MFDA staff is of the opinion that these and other similar transactions can only be executed if there is a valid documented reason for the trade and it is not executed simply for the purpose of increasing the Approved Person's compensation. In the limited circumstances where such activity may be justifiable . . . Approved Persons must provide clients with appropriate disclosure . . . . In staff's view, this disclosure would include, among other things:

- a statement that the client's DSC schedule will be reset, where applicable;
- specific detail of the amount of commissions the Approved Person will earn on the trade(s); and
- specific details of any direct costs to the client on the trade(s).

> This disclosure should be provided and explained to the client at the time of each transaction and evidence that the disclosure has been provided to the client should be maintained in the client's file. As a best practice, the Member may require clients to acknowledge receipt of the disclosure by signing a standard disclosure form to be retained by the Member. . . .
> . . .
> Members and Approved Persons are also reminded that disclosure or client consent cannot be viewed as a means to justify churning. All trading recommendations must be in the best interests of the client."

¶ 23 The MFDA hearing panel said MR-0065 was not relevant and declined to consider it because "Member Regulation Notices do not have any retroactive effect", citing *Gary Alan Price* [2009] MFDA Central Regional Council, File No. 200814. *Price*, decided in June 2009 and later set aside on other grounds, was not cited to the panel by the parties and they were not given an opportunity to make submissions on it.

¶ 24 Another MFDA hearing panel, in an earlier case decided in April 2009, *Farm Mutual Financial Services Inc.* [2009] MFDA File No. 200812, ruled that principles expressed in member regulation notices issued after the impugned conduct could be considered by MFDA hearing panels.

¶ 25 In our opinion, the panel erred in refusing to consider MR-0065. MR-0065 is a member regulation notice. Member regulation notices are not instruments intended to legislate conduct – they merely provide MFDA members with the MFDA's interpretation of rules. Hearing panels may consider the MFDA's interpretation of rules in its member regulation notices, even if the notice is issued after the impugned conduct. That said, the notices are not binding, and a hearing panel is free to make its own interpretation of the rules despite the content of a member regulation notice.

¶ 26 An unfortunate aspect of MR-0065 is that in the section entitled "Prohibited Trading Activity" it purports to prohibit the activities described in that section. That is inconsistent with the interpretative, as opposed to legislative, nature of member regulation notices. To the extent a member regulation notice uses language purporting to prohibit specific conduct, it has no legal force – it is no more than the MFDA's opinion that the conduct contravenes a rule.

¶ 27 Having rejected MR-0065 and, apparently, the submissions of the MFDA about what constitutes excessive trading in the mutual fund context, the panel instead

adopted the definition of churning in *International Futures Limited v. Calvin Ford* [1981] BCJ No. 1967:

> "Churning occurs when a broker, exercising control over the volume and frequency of trading, abuses his customer's confidence for personal gain by initiating transactions that are excessive in view of the character of the account."

¶ 28 The panel went on to find that Lin did not exercise discretionary control over the accounts in question, and therefore he could not be found to have engaged in excessive trading.

¶ 29 In our opinion, the panel erred in its adoption of the *International Futures* churning definition in its interpretation of excessive trading as it applies in the mutual fund context. As the MFDA pointed out in its submissions, even in the securities dealer context, there can be conduct that could constitute churning even when the broker does not have discretionary authority.

¶ 30 The *International Futures* definition is especially inappropriate in the mutual fund context to the extent it limits a finding of churning to circumstances in which a broker has discretionary trading authority. Such authority is prohibited under MFDA rules, so the adoption of that definition would mean, essentially, that no MFDA member could ever be found to have engaged in excessive trading.

¶ 31 That outcome would not be in the public interest. There are clearly potential courses of conduct in the mutual fund context that could, on a common sense interpretation, amount to excessive trading. Some of these are described in MR-0065.

¶ 32 The MFDA hearing panel found the scope of misconduct contemplated by Rule 2.1.1 was limited to the specific types of misconduct in previous cases and could not be interpreted as extending beyond those case types to include excessive trading.

¶ 33 In our opinion, in so doing the panel erred in law. Rule 2.1.1 is intentionally broad so that the MFDA can discipline members for misconduct not specifically prohibited yet is clearly contrary to the public interest. Excessive trading falls into that category. The Investment Industry Regulatory Organization of Canada (IIROC) has no specific prohibition against excessive trading yet has long disciplined its members for churning through its equivalent to MFDA Rule 2.1.1, and continues to do so. It is in the public interest that the MFDA be entitled to take the same approach.

¶ 34 We find the MFDA hearing panel erred in law in its interpretation and application of Rule 2.1.1 as it relates to the relevant regulatory principles about excessive trading. We find that its interpretation would also not be in the public interest. We set aside that aspect of the panel's decision.

2. The MFDA hearing panel's decision that there was insufficient evidence to find that Lin contravened MFDA Rules 2.1.1 and 2.1.4

Sufficiency of the evidence

¶ 35 Lin's evidence at the MFDA hearing was that he discussed the commission proposal with his clients, including the implications of the application of a new DSC redemption fee schedule to the reinvested funds. He said he was candid with his clients, that they knew the implications of his compensation proposal, and that they consented.

¶ 36 The MFDA hearing panel accepted Lin's evidence. The panel had the opportunity to observe Lin testify, and we did not. For that reason alone, we would be reluctant to interfere with its conclusions about the reliability of his evidence. Moreover, there was no evidence from any of Lin's clients (none of whom were interviewed or called as witnesses), or from any other source, contradicting his evidence. We find that it was reasonable for the panel to accept Lin's evidence, which at the MFDA hearing was uncontradicted in any material respect.

¶ 37 The panel also rejected the evidence of David Sharpe, the MFDA's Director of Investigations, who testified at the MFDA hearing that, among other things, switch fees were not commonly charged in the mutual fund industry. His evidence was opinion evidence about usual practices and procedures in the mutual fund industry. Sharp did not testify as an expert. He was also an active participant in the investigation of Lin's trading, and so was not independent. We find that it was reasonable for the panel not to rely on his evidence.

Disclosure and client consents

¶ 38 The MFDA says that Lin's conduct falls into the category of conduct described under the heading "Prohibited Trading Activity" in MR-0065. It says that because Lin's conduct is prohibited, client consent is not a defence to an allegation of excessive trading.

¶ 39 That argument fails to the extent it depends on the language in MR-0065 purporting to prohibit conduct of the type engaged in by Lin. As noted above, a member regulation notice cannot impose prohibitions.

¶ 40 The MFDA also says that consent is not a vitiating factor for a trading recommendation that is not in the best interest of the client.

¶ 41 It is not necessary to consider the validity of that submission, because the MFDA hearing panel considered whether the impugned trades were in the best interests of the 8 clients and found there was insufficient evidence that the impugned trades were not in the best interests of the clients.

¶ 42 The panel also considered whether the disclosure Lin and Leaders made to the 8 clients was adequate, and whether and it was reasonable for them to rely on the clients' consents. It found that the disclosure was adequate, and that it was reasonable for Lin and Leaders to rely on the clients' consent.

¶ 43 In making these findings, the panel considered these factors:

- its acceptance of Lin's explanation for recommending the commission arrangement to the 8 clients;
- its acceptance of the evidence supporting Lin's statement that the 8 clients were given a choice between paying switch fees and reinvesting on a DSC basis;
- the 8 clients had previously purchased mutual funds from Lin on a DSC basis, and all of them were provided with written disclosure specifically addressing the redemption fee schedules;
- the disclosure language contained in the consents the clients signed (both the version prepared by Lin and the later version prepared by Leaders) was adequate – the later version prepared by Leaders "more closely" reflecting the type of disclosure recommended in MR-0065;
- the clients signed trade tickets before the transactions and signed consents after them; and
- there was no evidence the clients were harmed by the trades.

¶ 44 Viewed in isolation, the impugned trades have the appearance of excessive trading. However, it is not appropriate to view them in isolation. The evidence is that Lin processed hundreds of switches for his clients for years without compensation. He decided he no longer wished to process switches without getting paid for it. He put a proposition to his clients that would allow him to be compensated for this work and they agreed. Their consent was in writing, and informed.

¶ 45 We agree with the conclusion of the MFDA hearing panel that there was insufficient evidence to conclude that the trades were not in the best interests of the 8 clients. In these circumstances, the trades, in our opinion, did not constitute excessive trading, and in processing those trades Lin did not engage in business conduct that was unbecoming or detrimental to the public interest under Rule 2.1.1.

¶ 46 To address the conflict of interest inherent in the proposal he made to his clients, Lin disclosed it and obtained the consent of his clients. It would have been more sound administrative practice had Lin obtained the clients' consents before the transactions. However, after the first one, he did not do so at the direction of his firm's compliance officer. In any event, we agree with the conclusion of the MFDA hearing panel that the disclosure to the clients was adequate and that it was reasonable for Lin to have relied on the clients' signatures on the trade tickets as their consents. In our opinion, Lin dealt with the conflict of interest in a manner which, in the circumstances, met the requirements of Rule 2.1.4.

¶ 47 We find that the MFDA hearing panel's finding that there was insufficient evidence that Lin contravened Rules 2.1.1 and 2.1.4 was reasonable and made in accordance with the law, the evidence, and the public interest. We confirm the panel's finding.

IV Decision

¶ 48 We find the MFDA hearing panel erred in law in its interpretation and application of Rule 2.1.1 as it relates to the relevant regulatory principles about excessive trading. We find that its interpretation would also not be in the public interest. We set aside that aspect of the panel's decision.

¶ 49 We confirm the MFDA hearing panel's decision that there was insufficient evidence to find that Lin engaged in excessive trading and in so doing contravened MFDA rules 2.1.1 and 2.1.4.

¶ 50 The MFDA asked us to determine certain conduct to be contrary to MFDA rules and to the public interest and therefore not permitted. We are not making that determination. In our opinion, it is preferable for securities regulators to set policy through the transparent process of publishing proposals for comment, and to adopt rules and interpretation with the benefit of that comment, rather than through the opinions of a panel of three individuals, be they an MFDA panel or a panel of the Commission.

¶ 51 We do not have the jurisdiction under the Act to order costs as requested by the MFDA, and in any event, given our decision, it is not necessary for us to consider the matter.

¶ 52 April 21, 2011

¶ 53 **For the Commission**

Brent W. Aitken
Vice Chair

Bradley Doney
Commissioner

Don Rowlatt
Commissioner