

Re Octagon Capital

IN THE MATTER OF:

**An Expedited Hearing Pursuant to Dealer Member Rule 20.42 of the
Investment Industry Regulatory Organization of Canada**

and

Octagon Capital Corporation

2016 IIROC 02

Investment Industry Regulatory Organization of Canada
Hearing Panel (Ontario District)

Heard: December 3, 2015 in Toronto, Ontario

Oral Decision: December 3, 2015

Written Reasons: December 17, 2015

Hearing Panel:

Mark Sandler, Chair; Daniel Iggers and Nick Savona

Appearances:

Elissa Sinha, Senior Enforcement Counsel

Charles Corlett, Senior Enforcement Counsel

David Hausman, counsel for Mr. Palumbo

REASONS FOR DECISION

Introduction

¶ 1 Dealer Member Rule 20.41 permits Staff of the Investment Industry Regulatory Organization of Canada (“IIROC”) to apply for an expedited hearing respecting a Dealer Member without notice in the circumstances prescribed in Rule 20.42.

¶ 2 One of those circumstances is where the Dealer Member is in such financial or operating difficulty that it cannot be permitted to continue to operate without risk of imminent harm to the public, other Dealer Members or IIROC: Rule 20.42(1)(d). Where a Hearing Panel determines that such a circumstance exists, it has the power to impose any of the penalties upon a Dealer Member set out in Rule 20.45, including suspension of Membership.

¶ 3 On December 3, 2015, we conducted an expedited hearing respecting Octagon Capital Corporation (“the Respondent”). Although Rule 20.41 permits an application for an expedited hearing to be held without notice to the Respondent, notice was, in fact, given to the Respondent here. Counsel for Mr. Palumbo, the Respondent’s Chairman and Chief Executive Officer, and its majority shareholder through a holding company, attended the hearing.

¶ 4 Staff relied upon the affidavit of Emily Pang, a Manager, Financial and Operations Compliance (“FINOPS”) of IIROC in support of its application for an expedited hearing and of the proposed Order it asked the Hearing Panel to make. Ms. Pang was not cross-examined on her affidavit. Nor was any other evidence tendered at the hearing. Based on her evidence, we were satisfied that the existing circumstances both supported the application for an expedited hearing and the proposed Order. Mr. Palumbo consented to the proposed Order as well. Accordingly, we signed the proposed Order at the conclusion of the hearing, for written reasons to

follow. These are our written reasons.

The Evidence

Background

¶ 5 The Respondent was admitted to Membership in IIROC as an Investment Dealer effective September 28, 2009. It was registered with IIROC's predecessor organization, the Investment Dealer's Association from 2003. Its only office is located in Toronto, Ontario.

¶ 6 The Respondent is a Type 4 Introducing Broker. It was primarily engaged in corporate finance and investment banking for institutional clients. It also maintained a limited retail business consisting primarily of the accounts of friends and family of its employees.

¶ 7 The Respondent's client accounts are carried by its carrying broker, Fidelity Investments Canada ("Fidelity"). As a Type 4 Introducing Broker, the Respondent is responsible for the daily funding requirements necessary to carry the client accounts. All of its clients' securities and assets other than cash are held with Fidelity. However, until very recently, unallocated client cash, also called "free credits", was held by the Respondent. The Respondent was permitted to use a portion of the free credits in its operations as long as it met IIROC's regulatory capital requirements.

Capital Deficiency

¶ 8 From November 12 to 24, 2015, FINOPS examiners conducted a routine annual examination of the Respondent's regulatory reporting infrastructure and operational controls.

¶ 9 In the course of the examination, FINOPS identified a receivable that had been incorrectly reported, thereby concealing a capital deficiency. This was a management fee receivable representing amounts owing to the Respondent from its parent company in the amount of \$690,000 (the "Management Fee Receivable"). It was reported on the Respondent's September 2015 Monthly Financial Report ("MFR") as a Client Balance instead of a Non-Allowable Asset.

¶ 10 The misclassification of the Management Fees Receivable resulted in the overstatement of the Respondent's Risk Adjusted Capital ("RAC") such that it avoided triggering IIROC's early warning tests and made it appear that the Respondent had satisfied its minimum capital requirements prior to the November 2015 audit. As well, the Respondent continued using client free credits in its operations when those credits should have been fully segregated based on the actual capital situation.

¶ 11 When the Management Fee Receivable was correctly reported as a Non-Allowable Asset, FINOPS determined that the Respondent was capital deficient in the amount of \$351,000.

¶ 12 Further, the Respondent had masked a significant debit in the trading account of its parent company, which consisted partly of a \$2.7 million sub-loan from the parent company to the Respondent with a guarantee by John Palumbo who used the balance in his trading account as collateral. However, the loan value of Mr. Palumbo's trading account was not sufficient to cover the debit balance. By masking the debit with an insufficient guarantee, the Respondent made its capital appear greater than it was.

¶ 13 On November 25, 2015, Ms. Pang contacted the Respondent's Chief Financial Officer, Mr. Everest, to discuss the capital deficiency. He was to speak to Mr. Palumbo immediately and call her back. As Ms. Pang did not hear from Mr. Everest, she contacted and met, later that day, with Mr. Palumbo together with Mr. Mirabella, Director, FINOPS. They advised him of the capital deficiency resulting from the Management Receivable Fee, the insufficient guarantee, and certain other accounting irregularities. Following the meeting, the Respondent was formally notified in writing of the capital deficiency. The notice also reflected that if the capital deficiency was not corrected by noon on the following day, the matter would be referred to IIROC's Enforcement Department.

¶ 14 On November 26, 2015, Mr. Palumbo advised IIROC that the Respondent did not intend to remedy the capital deficiency and preferred to wind up its operations in an orderly manner.

The Absence of an Active Qualified CFO

¶ 15 On November 27, 2015, Mr. Palumbo advised Ms. Pang by email that he assumed Mr. Everest would not return to work and that steps were being taken to remove him as a signing officer for the Respondent's bank accounts and deny him access to its accounts, email and payroll systems.

The Absence of Employees or Trading Activity

¶ 16 On November 30, 2015, the Respondent terminated its employees. Its Controller and Accounts Payable employee have been retained on contract to assist with administrative issues. The Chief Compliance Officer has agreed to remain involved for a short period of time. The Respondent cannot carry out its activities without employees and is not engaged in trading, other than accepting trade orders to liquidate from clients and communicating them to Fidelity for execution.

Client Free Credits

¶ 17 As already indicated, because the Respondent is a Type 4 Introducing Broker, client securities are held with Fidelity. However, client free credits (that is, cash) were controlled by the Respondent which held them in two bank accounts with the Bank of Montreal (the "BMO Accounts"). One is a U.S. Dollar account.

¶ 18 Once the Respondent's capital was deficient, it was not entitled to use any portion of the free credits in its operations, but was to segregate 100% of them.

¶ 19 FINOPS reviewed the client free credits reported on the Fidelity brokerage accounting system and the funds available in the BMO Accounts. It found a deficiency of approximately \$4.7 million. On November 30, 2015, the Respondent transferred the remaining client free credits in the BMO Accounts to Fidelity.

Mr. Palumbo's Position

¶ 20 Counsel for Mr. Palumbo advised the Hearing Panel that Mr. Palumbo does not necessarily agree with all of the facts put forward by Staff, but concedes that the circumstances justify the Order proposed by Staff.

Analysis

¶ 21 The evidence is overwhelming that the Respondent is in such financial or operating difficulty that it cannot be permitted to continue to operate without risk of imminent harm to the public, the IIROC membership and IIROC itself. It is not in compliance with IIROC's minimum capital requirements and does not have an active qualified Chief Financial Officer or employees to operate the business. Investigation revealed, among other things, that there is a deficiency of approximately \$4.7 million in client free credits. It cannot safely continue to operate in these circumstances.

¶ 22 We also observe that pursuant to Rule 20.42(1)(a), another circumstance that justifies an expedited hearing and related relief is when a Dealer Member makes a general assignment for the benefit of its creditors, makes an authorized assignment or proposal to its creditors; is declared bankrupt, or a winding-up order is made in respect of a Dealer Member or a receiver or other officer with similar powers is appointed in respect of all of any part of the undertaking and property of the Dealer Member. We were advised that insolvency proceedings were to commence in court following the expedited hearing in this matter, and would be concluded on consent. Although Rule 20.42(1)(a) is not triggered by insolvency proceedings not yet commenced, the fact that they are also imminent reinforces the need for our intervention.

¶ 23 Staff proposed that we order the following:

- The Respondent's Membership in IIROC is hereby suspended;
- The Respondent immediately cease dealing with the public;
- The Respondent shall comply with Dealer Member Rule 600 throughout the suspension period;
- The Early Warning Level 2 Restrictions and the Additional Business Restrictions imposed on the Respondent in IIROC's November 25, 2015 letter shall remain in place during the suspension period and until the Respondent's Membership in IIROC is terminated;

- The Respondent shall preserve all books and records, including all hard copy and electronic records in its possession or control, including without limitation, any and all computer servers, hard drives and any other electronically-stored records in any form (the “Records”), for a period of 7 years, and shall make the Records, or such part of them as is requested, available to Staff on demand;
- The Respondent shall pay any and all normal course outstanding IIROC and Canadian Investor Protection Fund fees;
- Upon determination of all client claims against the Respondent to the satisfaction of Staff, IIROC may move, without notice to the Respondent, for an order terminating its Membership in IIROC; and
- This Order shall come into effect immediately.

¶ 24 Rule 20.45 empowers a Hearing Panel, amongst other things, to suspend Membership, direct a Dealer Member to immediately cease dealing with the public, impose terms and conditions on a suspension of Membership or continued Membership or to facilitate the orderly transfer of client accounts from a suspended Dealer Member, and terminate the rights and privileges of Membership.

¶ 25 In our view, all components of the proposed Order fall within our powers pursuant to Rule 20.45 and are appropriate in the circumstances. Our direction that the Respondent immediately cease dealing with the public, together with suspension of the Respondent effective immediately protect the public and other Dealer Members from an ongoing risk of imminent harm. These measures also ensure that the public can be placed on notice that the Respondent is no longer a Dealer Member in good standing. Confidence in the industry and in IIROC as a regulator also demands no less. Other components of the proposed Order are designed to facilitate an orderly transition for clients and reduce potential prejudice to them and others. We recognize that several components of the proposed Order may impose requirements that survive beyond the Respondent’s suspension and ultimately, it’s Membership. In our view, these components nonetheless fall within the scope of Rule 20.45, particularly when it is also acknowledged that Dealer Members have various other obligations under IIROC’s regulatory regime that continue beyond the date that Membership formally ends.

Order

¶ 26 For these reasons, we made the proposed order. No costs were requested by IIROC. No costs are ordered. We are grateful to Ms. Sinha and Mr. Hausman for their assistance at the hearing.

Dated at Toronto this 17th day of December, 2015.

Mark Sandler, Chair

Daniel Iggers

Nick Savona

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