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**IN THE MATTER OF AN APPLICATION FOR A HEARING AND REVIEW OF  
A DECISION OF THE ONTARIO DISTRICT COUNCIL OF THE INVESTMENT  
INDUSTRY REGULATORY ORGANIZATION OF CANADA PURSUANT TO  
SECTION 21.7 OF THE *SECURITIES ACT*, R.S.O. 1990, c. S.5, AS AMENDED**

**- AND -**

**IN THE MATTER OF DISCIPLINE PROCEEDINGS PURSUANT TO DEALER  
MEMBER RULE 20 OF THE INVESTMENT INDUSTRY REGULATORY  
ORGANIZATION OF CANADA**

**BETWEEN**

**STAFF OF THE INVESTMENT INDUSTRY REGULATORY  
ORGANIZATION OF CANADA**

**- AND -**

**QUESTRADE INC.**

**REASONS AND DECISION  
(Section 21.7 and Subsection 8(3) of the Act)**

**Hearing:** December 15, 2010

**Decision:** March 1, 2011

**Panel:** James D. Carnwath - Commissioner (Chair of the Panel)  
Carol S. Perry - Commissioner

**Appearances:** Robert J. Brush - For Questrade Inc.  
Clarke Tedesco

Andrew P. Werbowski - For Staff of the Investment Industry  
Charles Corlett Regulatory Organization of Canada

Yvonne B. Chisholm - For Staff of the Commission  
Amanda M. Heydon

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## REASONS AND DECISION

### I. INTRODUCTION

[1] Questrade Inc. (“Questrade”) applies for a hearing and review by the Ontario Securities Commission (the “Commission”) of a decision of the Ontario District Council (the “District Council”) of the Investment Industry Regulatory Organization of Canada (“IIROC”) dated November 6, 2009 (the “Decision”).

[2] The allegations made against Questrade related to its online foreign exchange (“FX”) trading business during the period from December 2006 to the time of the District Council hearing in April 2009. Questrade offered FX contracts for difference referred to as “Spot FX” contracts, a derivative security that allowed Questrade clients to take long or short positions in various currencies.

[3] The Spot FX trades took place during the transition period whereby the Investment Dealers Association (the “IDA”) became part of IIROC. Although initial communications were between Questrade and IDA, the hearing was held before a panel of the IIROC District Council.

[4] Questrade’s grounds for review require us to decide the following issues:

- (a) Did the District Council err in law when it found that Questrade advertised margin rates below the minimum regulatory standards and failed to obtain the required margin from its clients in connection with trading in online FX contracts?
- (b) Did the District Council err in law when it concluded that Questrade’s conduct constituted conduct unbecoming a Member?

### II. BACKGROUND

#### *The Regulatory Regime*

[5] For an overview of the regulatory regime, we refer to the description found in the IIROC Notice of Hearing, as admitted by Questrade and quoted in the District Council’s Decision:

IDA By-law 17.11 (now IIROC Dealer Member Rule 17.11) provides that every Member shall obtain from clients and maintain in respect of its own account such minimum margin in such amount and in accordance with such requirements as the Board of Directors may from time to time by Regulation prescribe. Such minimum margin shall be used for calculations pursuant to Form 1.

Form 1 is the Joint Regulatory Financial Questionnaire and Report and is commonly referred to as “the Q”. It is a mandatory report that is utilized by Financial Compliance Staff to monitor the financial status of all Firms with financial reporting obligations.

IDA Regulation 11.2 (now IIROC Dealer Member Rule 100.2) deals, generally, with margin requirements and prescribes certain calculations which are to be utilized in various sets of circumstances.

Specifically, IDA Regulation 100.2(d) (now IIROC Dealer Member Rule 100.2(d)) deals with the margining of unhedged foreign exchange positions of a Member Firm or Dealer Member.

The purpose behind the setting of margin requirements and prescribing rates to particular financial products is to reflect the assessment of regulatory Financial Compliance Staff (“FC Staff”) of the inherent riskiness of that particular product. Margin is a charge against a firm’s financial statement capital and is utilized in the calculation of Risk Adjusted Capital (“RAC”). RAC, in turn, is measured to ensure the financial stability of firms and to prevent capital deficiencies or claims against the Canadian Investor Protection Fund (“CIPF”).

(Decision at para. 3)

### ***Questrade’s Online FX Trading Business***

[6] In May 2004, Questrade told the IDA that it was contemplating offering online FX trading as a service for its clients. As described in the Decision, online FX contracts “allow investors to speculate on underlying currency movements, without the need of ownership and

physical settlement of the underlying currency” (Decision at para. 7). Questrade’s Spot FX product involved contracts for the delivery of currency pairs at a spot price without physical delivery, so that the only asset exchanged was the difference in price between two contracts. The foreign exchange market is very speculative, and in May 2004, Spot FX was viewed as a new and complex financial product.

[7] Questrade discussed with staff of the IDA operational issues concerning the FX business, whether online FX trading constituted a “security” requiring registration, and the proper application of margin.

[8] In May 2005, the IDA issued Member Regulation Notice 0351 – Margin treatment of unhedged foreign exchange positions held in customer accounts (“MR Notice 0351”) and in response to a specific request from IDA staff, Questrade said it had been applying margin as per MR Notice 0351 since January 2005.

[9] IDA staff conducted two field examinations of Questrade, one in 2005 and the other in 2006. Following the second field examination, IDA staff wrote to Questrade on December 15, 2006, setting out the IDA’s finding as to “Online FX Client Margin”. IDA staff informed Questrade that:

- Questrade’s practice of extending leverage of up to 200 times a client’s account equity was not in compliance with minimum regulatory margin requirements for FX positions held by clients and effectively set “house margin” rates that were lower than prescribed IDA regulatory margin rates;
- Questrade’s client positions were undermargined based on regulatory FX margin rates (and the firm essentially provided client margin out of its own capital) and that such client accounts were not permitted to trade while undermargined.

The IDA’s finding required that Questrade comply with IDA margin requirements. The IIROC District Council concluded in its Decision that:

“In our view, it is from this point in December of 2006 that we should consider whether the Allegations set out in the Notice of Hearing have been established. It

is at this point that the regulatory Staff advised the Respondent not to engage in certain types of conduct.”

(Decision at para. 28)

[10] Following the IDA’s finding from its 2006 field examination, Questrade wrote to the IDA, causing the District Council to conclude: “From this letter, it appears clear that in January of 2007, Questrade was offering clients 200:1 leverage and was not collecting margin from clients but was instead reducing its risk adjusted capital for any margin deficiencies” (Decision at para. 32).

[11] There was further correspondence between Questrade and IDA staff and at least one meeting on February 9, 2007, at which the IDA requested a timeline for Questrade’s compliance.

[12] On March 7, 2007, the IDA put firms that offered online FX contracts on notice that all advertising must feature minimum regulatory margin rates and that they must obtain the minimum regulatory margin on the trade date and margin calls should be made and collected promptly if margin dropped below regulatory margin rates. The following day, Ciro Mirabella, Senior Manager, Financial Compliance at IDA wrote to Questrade’s CFO regarding margin requirements for online FX service providers.

[13] In response to Mr. Mirabella’s letter and previous IDA correspondence, Questrade’s CFO, Dean Percy, sent a “draft response” to the IDA on March 20, 2007. His response stated that the revised requirements would be so detrimental that if fully implemented, Questrade would effectively have to shut down its Spot FX business. Questrade requested a written explanation from the IDA if it still considered Questrade not in compliance. The IDA responded to Questrade on March 29, 2007, confirming its position:

...

To summarize, we have not in any way changed our fundamental position as previously communicated to you in applying IDA minimum FX margin rates for open FX customer positions, and requiring the collection of margin deposits from

clients upon entering into FX contracts, including the prompt collection of margin calls, as required, in the event of adverse market movements.

Please consider this e-mail as my response to Mr. Percy's letter and take it under "advisement".

(Decision at para. 44)

[14] Further correspondence followed between Questrade and the IDA in April 2007, which did not result in any changes to Questrade's margin collection practices. By the time of the IIROC hearing in April 2009, Questrade was the only Member Firm not complying with the request of the IDA regarding margin rates on FX spot contracts.

### **III. THE STANDARD OF REVIEW**

[15] This hearing and review is brought pursuant to s. 21.7 of the *Securities Act*, R.S.O. 1990, c. S.5, as amended (the "Act"), which gives the Commission the power to hold a hearing and review of a direction, decision, order or ruling of a recognized self-regulatory organization ("SRO"), such as IIROC. Upon a hearing and review, the Commission may confirm the decision of the SRO or make such other decision as it considers proper, as outlined in s. 8(3) of the Act. In the hearing and review, the Commission exercises jurisdiction akin to a trial *de novo*, broader in scope than an appeal (*Investment Dealers Assn. of Canada v. Boulieris* (2004), 27 O.S.C.B. 1597 (aff'd [2005] O.J. No. 1984 (Div. Ct.)) at paras. 29-30).

[16] Notwithstanding the Commission's broad powers of review, in practice it exercises a "restrained approach" to intervening in SRO decisions. When the decision deals with an issue squarely within the SRO's expertise or jurisdiction, greater deference should be accorded (*Re Berry* (2008), 31 O.S.C.B. 5441 at paras. 62-63).

[17] In this case, we accord a high degree of deference to the IIROC District Council's Decision, which considers issues within IIROC's expertise and involves an analysis of the very types of issues that IIROC is engaged in on a daily basis, including administering rules and monitoring Member compliance.

[18] The test for whether the Commission should intervene in an IIROC decision is set out in *Canada Malting Co.* (1986), 9 O.S.C.B. 3565, which states that the Commission may intervene in a decision of an SRO on the following five grounds:

1. the SRO has proceeded on an incorrect principle;
2. the SRO has erred in law;
3. the SRO has overlooked material evidence;
4. new and compelling evidence is presented to the Commission that was not presented to the SRO; or
5. the SRO's perception of the public interest conflicts with that of the Commission.

#### **IV. ANALYSIS**

##### **A. Did the District Council err in law when it found that Questrade advertised margin rates below the minimum regulatory standards and failed to obtain the required margin from its clients in connection with trading in online FX contracts?**

[19] Questrade submits that Spot FX trades have a unique risk profile and the characteristics of Spot FX trading do not fit within the traditional requirements for collection of margin from investors. It distinguishes Spot FX contracts as having no traditional settlement date because the contracts do not involve the actual purchase of currencies and the contracts "roll over" each day.

[20] On December 15, 2006 the IDA clearly informed Questrade that its practice of offering up to 200:1 leverage did not meet minimum regulatory margin requirements. Despite any characteristics that might be unique to Spot FX contracts, Questrade knew by this time that its online FX trading clients' positions were undermargined, from the IDA's perspective (see paragraph 9 of these reasons).

[21] It is clear on the evidence of Questrade that Questrade chose not to amend its business practice. It continued to advertise 200:1 leverage and did not collect margin from its online FX trading clients.

[22] The evidence of IIROC staff at the hearing before the District Council was that Questrade never had any intention to collect the required margin from clients. In this proceeding, Questrade takes no exception to the findings of the District Council that:

The process followed by [Questrade] was to determine, on a daily basis, the margin requirement for each FX client position in accordance with IDA Member Regulation MR0351 – Regulation 100.2(d). The margin requirement for each client was then summed up and compared to the balance of the client’s account to determine if the account was undermargined.

If the account was undermargined, Questrade provided, out of its own firm capital, the difference necessary to meet the minimum regulatory requirements. There was no attempt to collect the undermargined amount from the client. Instead, the firm took a ‘hit’ on its Risk Adjusted Capital.

In cross-examination ..., Mr. Percy agreed that this was a correct description of the process followed by [Questrade].

(Decision at paras. 63-65)

[23] We reject Questrade’s submission that Mr. Mirabella improperly gave expert evidence or that he should not have testified as a member of IIROC Staff. Mr. Mirabella’s evidence on Note 2 of MR Notice 0351 was properly accepted by the District Council, which came to its own decision regarding the rules on margin requirements. Mr. Mirabella was not offered or qualified as an expert witness, but properly testified based on his knowledge and experience as Director of Financial Compliance for IIROC.

[24] We also reject Questrade’s submission that companies involved in parallel operations escaped action by IIROC over a considerable period of time merely by agreeing to comply with margin requirements, but taking their time to do so. Questrade clearly expressed its intention not to comply with the IDA’s directions regarding obtaining margin from its online FX trading clients. As noted at paragraph 14, at the time of the IIROC hearing, Questrade was the only IDA Member Firm not complying with the IDA request.

[25] The District Council found that Questrade failed to comply with the rules when it made no attempts to collect the required margin from its online FX trading clients. Dealing with an issue that falls squarely within IIROC's expertise, the District Council concluded that Spot FX contracts are not exempt from regulatory margin requirements. The IIROC District Council made no error in law and proceeded on no incorrect principle; the decision of the District Council falls squarely within its area of competence and expertise.

**B. Did the District Council err in law when it concluded that Questrade's conduct constituted conduct unbecoming a Member?**

[26] Questrade submits that the District Council erred in law when it found Questrade's breaches of the margin rules to be conduct unbecoming. Questrade argues that its deliberate refusal to follow the IDA's interpretation of the rules is not a deliberate refusal to follow the rules themselves.

[27] In Questrade's submission, the IDA's findings, guidance or interpretations do not have the effect of a rule and were not binding on Questrade per se; Questrade's failure to follow the IDA's direction would not constitute conduct unbecoming. Questrade submits that the District Council is the only party with the ability to finally determine the rules, and IDA or IIROC staff's directions about how they interpret the rules cannot have the authority of a rule.

[28] Questrade also submits that the District Council erred by applying the wrong test for what constitutes conduct unbecoming a Member. According to Questrade's submissions, for the District Council to make a finding of conduct unbecoming, IIROC staff must prove that the conduct was done in bad faith or was in some way unethical. Questrade claims that this state of mind requirement for deliberate misconduct was not met in this case.

[29] We disagree with Questrade's submissions on both points.

[30] To pursue their position that the IDA's interpretation of margin requirements was incorrect, Questrade deliberately chose not to follow directions from the IDA. Rather, it continued to make no attempt to collect required margin from its online FX trading clients and, if an account was undermargined, Questrade provided out of its own capital the difference necessary to meet the minimum regulatory requirements. The District Council made no error in

concluding that Questrade's decision not to comply with IDA directions and proceed to a hearing was conduct unbecoming.

[31] The District Council made no error in law in the method it used in coming to this conclusion. We reject the submission that it was necessary for the District Council to find bad faith on the part of Questrade. Questrade deliberately refused to comply with IDA directions rather than amend its business practice and comply until the matter was heard and the decision of the District Council was rendered. The fact that other Member Firms may have taken their time in complying with IDA's directions does not lessen the unbecoming nature of Questrade's continuing refusal to follow directions from the IDA. The District Council's decision falls squarely within its area of competence and expertise.

## V. CONCLUSION

[32] We conclude that the IIROC District Council made no error in law and proceeded on no incorrect principle when it found that Questrade failed to comply with regulatory margin requirements in its Spot FX business and that its conduct was unbecoming a Member Firm. None of the factors in *Canada Malting Co.*, above, apply to the facts of this case.

[33] We see no reason to interfere with the District Council's decision. The application for hearing and review is dismissed.

Dated at Toronto this 1<sup>st</sup> day of March, 2011.

*"James D. Carnwath"*

*"Carol S. Perry"*

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James D. Carnwath

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Carol S. Perry