

Re Liu and BMO

IN THE MATTER OF:

The Investment Dealer and Partially Consolidated Rules and the Dealer Member Rules

and

Yujie (Jared) Liu and BMO Nesbitt Burns Inc.

2024 CIRO 46

Canadian Investment Regulatory Organization
Hearing Panel (Ontario District)

Heard: March 28, 2024 in Toronto, Ontario via videoconference

Decision: March 28, 2024

Reasons for Decision: April 4, 2024

Hearing Panel:

Martin L. Friedland, C.C., K.C, Chair, Richard E. Austin and Christopher Hill

Appearances:

Sylvia Samuel, Senior Enforcement Counsel

Caitlin R. Sainsbury, Counsel for Yujie (Jared) Liu and BMO Nesbitt Burns Inc.

Yujie (Jared) Liu (present)

Valérie Quintal, Associate General Counsel, BMO Wealth Management

REASONS FOR DECISION

BACKGROUND

¶ 1 On August 21, 2023, the Canadian Investment Regulatory Organization (“CIRO”) announced that a hearing would be held on August 25, 2023, in Toronto to consider whether a hearing panel should accept a settlement agreement entered into by Enforcement Staff (“Staff”) and the Respondents, Yujie (Jared) Liu (“Liu”) and BMO Nesbitt Burns Inc. (“BMO NBI”). The hearing was held on August 25 and 29, 2023.

¶ 2 On November 22, 2023, that earlier panel issued reasons for rejecting the proposed settlement.

¶ 3 The present Panel was appointed to consider a subsequent and modified settlement agreement, dated March 25, 2024, between Staff and the Respondents (the “Settlement Agreement”). The hearing was held on March 28, 2024.

¶ 4 At the conclusion of the hearing, the March 25, 2024 Settlement Agreement was accepted by the Hearing Panel. These are our reasons for accepting the revised Settlement Agreement.

¶ 5 Mr. Liu was a Registered Representative with BMO NBI from about September 2006 until about July 9, 2021. He is currently employed with BMO NBI in a non-registered capacity. During the relevant period, Mr. Liu’s activities were supervised by two co-branch managers at BMO NBI.

¶ 6 BMO NBI was an IIROC Dealer Member and is now a CIRO-regulated Dealer Member.

¶ 7 In Brief, the Settlement Agreement addresses allegations that between December 2017 and May 2019,

- (a) Mr. Liu contravened Dealer Member Rules 1300.1(p) and (q) by failing to use due diligence to determine the suitability of an investment strategy in certain client accounts; and
- (b) BMO NBI contravened Dealer Member Rules 38.1 and 2500A by failing to implement a system of supervision and control in respect of the trading activity in certain client accounts, particularly with respect to the suitability obligations owing by it and its Registered Representative and in respect of the supervision of the client accounts.

¶ 8 Dealer Member Rule 1300.1(p) provides that, in the case of accepting an order, “each Dealer Member shall use due diligence to ensure that the acceptance of any order from a client is suitable for such client based on factors including the client’s current financial situation, investment knowledge, investment objectives and time horizon, risk tolerance and the account or accounts’ current investment portfolio composition and risk level.” Rule 1300.1(q) provides that similar due diligence is required when recommending to a client “the purchase, sale, exchange or holding of any security.”

¶ 9 Dealer Member Rule 38.1 provides: “A Dealer Member must establish and maintain a system to supervise the activities of each partner, Director, Officer, Registered Representative, Investment Representative, employee and agent of the Dealer Member that is reasonably designed to achieve compliance with the Rules of the Corporation and all other laws, regulations and policies applicable to the Dealer Member’s securities and commodity futures business.” The Rules go on to provide for minimum standards in certain cases.

¶ 10 Dealer Member Rule 2500 establishes industry standards for Retail Customer account supervision, stating in the introduction to the Rule: “This Rule establishes minimum industry standards for Retail Customer account supervision. These standards represent the minimum requirements necessary to ensure that a Dealer Member has in place procedures to properly supervise Retail Customer account activity.”

THE PRIOR HEARING

¶ 11 CIRO Rule 8215 relating to settlements and settlement hearings provides that, if a settlement agreement is rejected by a hearing panel, the parties may agree to enter another settlement agreement and the reasons for the earlier rejection should be made available to the new panel considering a subsequent settlement agreement, but “must not be made public or referred to in a subsequent disciplinary hearing.” Some reference to the prior hearing is, however, necessary to give some context to the subsequent hearing.

¶ 12 A recent Alberta panel (*Re Workun 2020 IIROC 21*) dealt with this issue by stating:

A prior settlement agreement relating to these same contraventions was rejected by a hearing panel on May 27, 2020, with careful reasons for their conclusion that ‘the proposed sanctions were not appropriate to the conduct of the Respondent.’ Those reasons shaped the Settlement Agreement that was presented to us, which contained increased sanctions and additional contextual information responding directly to concerns expressed by the previous panel. Both counsel emphasized, and this panel agreed, that the additional contextual information was crucial to our determination that the Settlement Agreement is acceptable.

¶ 13 The present Hearing Panel echoes what the Alberta panel stated. The unpublished reasons in the previous decision were carefully drafted and “shaped the Settlement Agreement that was presented to us, which contained increased sanctions and additional contextual information responding directly to concerns expressed by the previous panel.”

THE “STRATEGY” EMPLOYED BY MR. LIU AND BMO NBI’S CONDUCT

¶ 14 The “Strategy” employed by Mr. Liu as well as BMO NBI’s supervision of his conduct is complex and will not be set out in detail in these reasons. The attached Settlement Agreement, which can be examined by the reader, contains over 90 paragraphs relating to Mr. Liu’s activities and BMO NBI’s conduct relating to his

Strategy. Here are six of the paragraphs from the Settlement Agreement (paras. 4-9) under the heading “Overview”:

In or about 2015, when interest rates were low, Liu, an investment advisor at BMONBI, engaged in a trading strategy that involved clients investing in preferred shares. By May 2016, a significant portion of Liu's book was comprised of preferred shares, involving numerous client accounts.

The trading strategy evolved to a strategy of clients borrowing to invest in preferred shares. Instead of using conventional margin, this strategy involved short selling Government of Canada (‘GOC’) bonds – in many cases, 30-year bonds – and using the proceeds of shorting the GOC bonds to invest in preferred shares (generally, rate reset or floating rate) (the ‘Strategy’). By Liu's account, shorting bonds as part of the Strategy was aimed, in part, at reducing the cost of borrowing since the cost of shorting the GOC Bonds was lower than margin rates.

In employing the Strategy, Liu failed to adequately explain to clients the incremental risk created by shorting long-term GOC bonds and investing in preferred shares, each of which was interest rate sensitive. Further, when prevailing interest rates declined in October/November 2018, Liu failed to advise clients in a manner that was adequately responsive to the change in market conditions.

For its part, BMO NBI failed to maintain a system of supervision and control in respect of its supervision of certain client accounts [...] reasonably designed to achieve compliance with the rules of the Corporation.

BMO NBI permitted Client Accounts to be over-weighted in fixed income securities as compared to the asset allocation reflected on Know-Your- Client (‘KYC’) documents for those accounts. Further, BMO NBI failed to consider the risk of the portfolio as a whole, and failed to give due consideration to the increased risk associated with the combination of the two constituent elements of the Strategy.

In addition, BMO NBI's system allowed a significant buffer before requiring supervisory action.

¶ 15 The Respondents agree in paragraph 25 of the Settlement Agreement that the “shorting of long-term bonds to purchase floating rate or rate reset preferred shares was high risk.”

¶ 16 There were sixteen clients who engaged in the Strategy, ranging in age from 38 to 53 during the relevant period, with a net worth ranging from \$2 million to \$42 million. The know-your-client documents show a tolerance for high risk for fifteen of the clients as somewhere between 10 and 40%. The other client had a tolerance of 40% for part of the period and 45% for the rest of the period.

¶ 17 During the relevant period, the BMO NBI supervision system assigned a high-risk rating to all short positions.

¶ 18 Starting in or about October/November 2018, there was a decline in prevailing interest rates. With the decline in prevailing interest rates came a decline in the prices of the preferred shares held in the client accounts and an increase in the price of the GOC bonds that had been shorted in the client accounts. As a result, the cost of covering the short bond positions increased while the value of the long positions in preferred shares decreased.

¶ 19 Mr. Liu's supervisors were aware of Mr. Liu's use of the Strategy from as early as May 2016. The Respondents admit in paragraph 69 of the Settlement Agreement that the “increased shorting, particularly of long-term GOC bonds that occurred from January 2018 to early June 2018 was or ought to have been apparent to the supervisors from the daily reviews.

¶ 20 The client accounts experienced an aggregate decline in value of approximately \$40 million (\$39,773,181) from the end of October 2018 to May 2019.

¶ 21 Mr. Liu's supervisors or their delegates received and reviewed the monthly BMO NBI supervision system reports for the client accounts during the relevant period. Starting on or about May 31, 2018, the

supervisors expressed concern regarding Mr. Liu's use of the Strategy but did not implement any plan for dealing with the risks that were identified at the time. Mr. Liu did reduce his shorting of long-term GOC bonds to near zero after May 31, 2018, but did little about existing short GOC bond positions in the client accounts (paragraphs 70 and 71 of the Settlement Agreement).

¶ 22 Paragraph 85 of the Settlement Agreement states:

In short, BMO NBI failed to implement a system of supervision and controls in respect of the trading activity in the Client Accounts that was adequate:

- a. to detect, in a timely manner, suitability issues associated with the Strategy in the Client accounts, including those related to asset allocation and risk tolerance;
- b. to reasonably ensure that Liu and the Supervisors were adequately discharging their responsibilities under its policies and procedures with respect to suitability of the Client Accounts and otherwise as required;
- c. to ensure that its Supervisors adequately queried the Client Accounts and followed up on queries as appropriate; and
- d. to ensure that its Supervisors were adequately following up on red flags in the Client Accounts, including relating to leverage and asset allocation.

TERMS OF SETTLEMENT

¶ 23 The Respondents agreed to the following sanctions and costs:

(i) Liu:

- i. a fine of \$80,000;
- ii. disgorgement of fees and commissions in the amount of \$63,258;
- iii. successful completion of the Conduct and Practices Handbook Course before applying for registration and approval with CIRO; and
- iv. costs of \$5,000.

(ii) BMO NBI:

- i. a fine of \$1,500,000;
- ii. disgorgement of fees and commissions in the amount of \$146,876; and
- iii. costs of \$50,000.

ACCEPTANCE OF THE SETTLEMENT AGREEMENT

¶ 24 As stated above, the Hearing Panel accepted the terms of the Settlement Agreement. A panel can either accept or reject a settlement agreement. It cannot modify it.

¶ 25 The conduct in the present case is very serious. As noted above, the sixteen clients involved in the Strategy had losses of \$40 million in value.

¶ 26 In Mr. Liu's favour, he has not previously been the subject of IIROC or CIRO disciplinary proceedings. Moreover, as a result of his conduct, he lost his position as a Registered Representative and although still employed by BMO NBI, he is a salaried employee, bringing in less income than as a Registered Representative. He is eligible to become a Registered Representative again, but he would first have to successfully complete the Conduct and Practices Handbook Course before applying for registration and approval with CIRO.

¶ 27 Mr. Liu is also subject to a fine of \$80,000 and disgorgement of fees and commissions in the amount of \$63,258. Both are significant penalties.

¶ 28 As to BMO NBI, we are informed that there is no evidence of any former disciplinary action that is relevant to this proceeding.

¶ 29 Further, both Respondents cooperated with CIRO and by entering into the Settlement Agreement the Respondents have recognized the seriousness of their conduct and saved the CIRO the time, resources, and expenses associated with conducting a full hearing on the allegations.

¶ 30 At the time of the earlier hearing, it was not clear what compensation would be provided by BMO NBI as a result of civil lawsuits by 12 clients harmed by the Strategy. Even at the time the present Settlement Agreement was signed, the total compensation for all sixteen clients was not known. See paragraph 91 of the Settlement Agreement. We were told at the hearing that the sum provided by BMO NBI is \$27,676,198.50. This sum represents the total amount paid, inclusive of costs, to the 12 client account holders and their families or related corporate accounts who were part of the civil litigation or other resolution process described at paragraph 91 of the Settlement Agreement. This constitutes a significant portion of the clients' losses.

¶ 31 Moreover, major steps have been taken by BMO NBI to improve its procedures to help prevent a recurrence of the problems that occurred in the present case. These are set out in detail in paragraph 93 of the Settlement Agreement. Some of the steps were taken after the earlier hearing. The paragraph begins by stating: "BMO NBI has made revisions to its supervision systems since the Relevant Period, which have addressed the issues identified in the Settlement Agreement regarding exception reports and queries." The first and last of the five revisions are set out here to illustrate the scope of the changes.

¶ 32 The first revision states that BMO NBI "implemented a new regional supervision model resulting in supervisory functions previously performed by local branch management being migrated to a centralized team of supervisors and support staff solely focused on supervision related activities." The last revision states that BMO NBI has "revised its Margin Lending Operating Procedures to include shorting activities as a credit risk component."

¶ 33 The Terms of Settlement also call for disgorgement of fees and commissions by BMO NBI of \$146,876 and costs of \$50,000.

¶ 34 A penalty of \$1,500,000 is imposed on BMO NBI. This is a very significant monetary penalty.

¶ 35 The penalties imposed in the seven cases cited by counsel for CIRO were substantially lower than the penalties agreed to in the present case: see *Re Floyd* 2013 IIROC 27 (\$100,000); *Re Martens* 2013 IIROC 40 (\$50,000); *Re Carinci* 2013 IIROC 49 (\$40,000); *Re Husebye* 2016 IIROC 5 and 21 (\$20,000); *Re Scotia Capital Inc.* 2015 IIROC 27 (\$500,000); *Re Richardson GMP Ltd.* 2020 IIROC 41 (\$500,000); and *Re RBC Dominion Securities Inc.* 2021 IIROC 30 (\$350,000).

¶ 36 The monetary penalties to the Mr. Liu and BMO NBI provide a large measure of general and specific deterrence to the Respondents and the industry as a whole.

¶ 37 Hearing panels should respect settlements worked out by the parties. As the hearing panel stated in *Re Keshet* [2014] MFDA File No. 201419 at paragraph 7, to take one of many such cases: "It is well established that hearing panels should not interfere lightly in negotiated settlements and should not reject a settlement agreement unless it views the proposed penalty as clearly falling outside a reasonable range of appropriateness." There are many similar statements by MFDA and IIROC panels, stemming from the leading decision of *Re Milewski* [1999] I.D.A.C.D. No. 17, which stated:

A District Council considering a settlement agreement will tend not to alter a penalty that it considers to be within a reasonable range, taking into account the settlement process and the fact that the parties have agreed. It will not reject a settlement unless it views the penalty as clearly falling outside a reasonable range of appropriateness.

¶ 38 The penalty and the costs agreed to in this case clearly fall within "a reasonable range of appropriateness."

¶ 39 For the above reasons, the Hearing Panel accepted the Settlement Agreement.

DATED at Toronto, Ontario this 4th day of April 2024.

"Martin Friedland" _____

Martin L. Friedland, Chair

“Richard Austin”

Richard Austin, Member

“Christopher Hill”

Christopher Hill, Member

**Appendix “A”
Settlement Agreement**

IN THE MATTER OF:

The Investment Dealer and Partially Consolidated Rules and the Dealer Member Rules

and

Yujie (Jared) Liu and BMO Nesbitt Burns Inc.

SETTLEMENT AGREEMENT

PART I – INTRODUCTION

¶ 1 The Canadian Investment Regulatory Organizationⁱ (“CIRO”) will issue a Notice of Application to announce a settlement hearing pursuant to sections 8215 and 8428 of the Investment Dealer and Partially Consolidated Rules (the “Investment Dealer Rules”) to consider whether a hearing panel should accept this Settlement Agreement between Enforcement Staff and Yujie (Jared) Liu (“Liu”) and BMO Nesbitt Burns Inc. (“BMO NBI”) (collectively, the “Respondents”).

PART II – JOINT SETTLEMENT RECOMMENDATION

¶ 2 Enforcement Staff and the Respondents jointly recommend that the hearing panel accept this Settlement Agreement in accordance with the terms and conditions set out below.

PART III – AGREED FACTS

¶ 3 For the purposes of this Settlement Agreement only, the Respondents agree with the facts as set out in Part III of this Settlement Agreement.

Overview

¶ 4 In or about 2015, when interest rates were low, Liu, an investment advisor at BMO NBI, engaged in a trading strategy that involved clients investing in preferred shares. By May 2016, a significant portion of Liu's book was comprised of preferred shares, involving numerous client accounts.

¶ 5 The trading strategy evolved to a strategy of clients borrowing to invest in preferred shares. Instead of using conventional margin, this strategy involved short selling Government of Canada (“GOC”) bonds – in many cases, 30-year bonds – and using the proceeds of shorting the GOC bonds to invest in preferred shares (generally, rate reset or floating rate) (the “Strategy”). By Liu's account, shorting bonds as part of the Strategy was aimed, in part, at reducing the cost of borrowing since the cost of shorting the GOC Bonds was lower than margin rates.

¶ 6 In employing the Strategy, Liu failed to adequately explain to clients the incremental risk created by shorting long-term GOC bonds and investing in preferred shares, each of which was interest rate sensitive. Further, when prevailing interest rates declined in October/November 2018, Liu failed to advise clients in a manner that was adequately responsive to the change in market conditions.

¶ 7 For its part, BMO NBI failed to maintain a system of supervision and control in respect of its supervision of certain client accounts (the “Client Accounts” as further defined below) reasonably designed

to achieve compliance with the rules of the Corporation.

¶ 8 BMO NBI permitted the Client Accounts to be over-weighted in fixed income securities as compared to the asset allocation reflected on Know-Your-Client (“KYC”) documents for those accounts. Further, BMO NBI failed to consider the risk of the portfolio as a whole, and failed to give due consideration to the increased risk associated with the combination of the two constituent elements of the Strategy.

¶ 9 In addition, BMO NBI's system allowed a significant buffer before requiring supervisory action.

Background

¶ 10 At all material times, BMO NBI was an IIROC Dealer Member.

¶ 11 Liu was a Registered Representative with BMO NBI from about September 2006 until about July 9, 2021.

¶ 12 During the Relevant Period (as defined below), Liu's activities were supervised by two co-Branch Managers at BMO NBI (the “Supervisors”).

¶ 13 Liu is currently employed by BMO NBI but not in a registered capacity.

Evolution and Expanded Use of the Strategy

¶ 14 In 2015, Liu began recommending buying preferred shares in the secondary market to a small group of clients.

¶ 15 Liu subsequently introduced short selling GOC bonds as part of the Strategy.

¶ 16 More specifically, Liu recommended short selling GOC bonds and purchasing preferred shares with the proceeds, and several of Liu's clients did. By Liu's account, the Strategy was intended to be a long-term strategy.

¶ 17 In the beginning, the clients bought rate reset preferred shares. Later, they started selling some rate resets and buying floating rate preferred shares.

¶ 18 In short, the Strategy included two elements: (i) short selling GOC bonds, principally long-term bonds at the height of the Strategy, and (ii) purchasing preferred shares, principally floating rate and rate resets.¹

¶ 19 Over time, Liu recommended the Strategy to a number of clients. The exposure to short GOC bonds in Liu's book increased significantly between 2016 and 2018, and ultimately peaked in October 2018. In particular, there was a significant increase in the shorting of long-term GOC bonds in 2017 and the first half of 2018.

Risks of the Strategy

¶ 20 The preferred shares recommended by Liu as part of the Strategy were generally of well-established issuers, which limited credit risk, but other risks that are associated with holding preferred shares remained.

¶ 21 As with short selling more generally, the short selling element of the Strategy was premised on a decline in the price of the GOC bonds.

¶ 22 Prevailing interest rates in the economy can greatly influence a bond's price. When prevailing interest rates rise, the price of bonds in the market fall. When prevailing interest rates fall, the price of bonds in the market rise.

¶ 23 Both elements of the Strategy involved interest rate sensitivity and in the same direction, thereby increasing the overall risk of the Strategy.

¹ In certain cases, clients would also use the proceeds from short selling the GOC bonds for other purposes, e.g., investing in real estate.

¶ 24 Further, as longer-term bonds are more price-volatile in response to changes in interest rates than bonds with a shorter time to maturity, the risk was increased for those accounts shorting long-term bonds.

¶ 25 The shorting of long-term bonds to purchase floating rate or rate reset preferred shares was high risk.

The Client Accounts

¶ 26 Between December 2017 and May 2019 (the “Relevant Period”), the following sixteen client accounts (the “Client Accounts”) were among the accounts that engaged in the Strategy. The individual clients holding the Client Accounts ranged in age from 38 to 53 during the Relevant Period, with a net worth ranging from \$2,000,000 to \$42,000,000.

1.	W.D.
2.	P.L. & Y.J.
3.	H.G.
4.	M.L. & Y.S.
5.	Y.L. & H.C.
6.	Y.L. & M.X.
7.	F.L. & M.Z.
8.	M.I. Inc.
9.	M.T. Ltd.
10.	J.S. & W.L.
11.	C.S. & Z.S.
12.	S.H.C. Ltd.
13.	J.W. & L.
14.	Y.W. & Q.L.
15.	H.Z.
16.	J.Q.

KYCs of the Client Accounts

¶ 27 With the exception of two accounts, the KYC documents for the Client Accounts had a tolerance for high risk of either 20%, 30% or 40% between December 2017 and March 2019, with the remaining risk tolerance allocated to medium risk. One of the remaining two accounts had a high risk tolerance of 10% until April 2018 when it was updated to 30%, and the other account had a high risk tolerance of 40% until March 2019 when it was updated to 45%.

¶ 28 At the start of the Strategy, all Clients Accounts were documented as having a time horizon of “10 years and more.”

Holdings in Client Accounts

¶ 29 The Client Accounts all held short GOC bond positions and preferred shares, generally rate reset or floating rate.

¶ 30 The aggregate exposure to rate reset or floating rate preferred shares in the Client Accounts increased from approximately \$35.3MM in December 2017 to approximately \$114.7MM in October 2018.

¶ 31 Fifteen of the Client Accounts were short at least \$2MM of GOC bonds as of October 31, 2018, in all cases, representing at least 40% of the market value of the account.

¶ 32 Fourteen of the Client Accounts exceeded their high-risk target by at least 20% in October 2018.

Decline in Prevailing Interest Rates and Client Accounts' Values

¶ 33 Starting in or about October/November 2018, there was a decline in prevailing interest rates.

¶ 34 With the decline in prevailing interest rates came a decline in the prices of the preferred shares held in the Client Accounts and an increase in the price of the GOC bonds that had been shorted in the Client Accounts. As a result, the cost of covering the short bond positions increased while the value of the long positions in preferred shares decreased.

¶ 35 The Client Accounts experienced an aggregate decline in value of approximately \$39.7MM from October 2018 month end to May 2019.

Supervision Tools, Policies, and Procedures

¶ 36 BMO NBI's account supervision system (the "BMO NBI Supervision System") rated securities, triggered exception codes, and produced exception reports to identify accounts that were not aligned with their risk tolerance and asset allocation targets.

BMO NBI Supervision System Security Classification and Risk Rating

¶ 37 The BMO NBI Supervision System relied on a securities rating system that assigned a risk rating to each individual security or position and characterized securities by asset class - as either cash and equivalents, fixed income, or equities.

¶ 38 The preferred shares held in the Client Accounts were all rated as medium risk on the BMO NBI Supervision System and classified as fixed income, although preferred shares have characteristics of both fixed income and equities.

¶ 39 During the Relevant Period, the BMO NBI Supervision System assigned a high risk rating to all short positions. As a result, the short GOC bond positions held in the Client Accounts were classified as high risk on the BMO NBI Supervision System.

¶ 40 Liu and his Supervisors adopted the BMO NBI Supervision System risk ratings assigned to the preferred shares and the short GOC bond positions held in the Client Accounts.

BMO NBI Supervision System Exception Codes

¶ 41 Exceptions were assigned one of three categories of reason codes related to risk tolerance (R), fixed income holdings (F), or equity holdings (E), and identified the degree to which any these was not aligned with account targets.

¶ 42 The exception codes varied somewhat depending on whether the account was opened before November 2015, in which case exceptions were based on investment objective ranges, or whether the account was opened (or updated) after November 2015, in which case exceptions were based on specific risk tolerance or asset allocation targets. Two of the Client Accounts were opened before November 2015 and were updated to the specific targets during the Relevant Period, and one Client Account was opened before November 2015 and remained under the objective ranges throughout the Relevant Period.

¶ 43 Notably, for the three Client Accounts opened with investment objective ranges, exceptions were not triggered when account holdings exceeded fixed income targets during the period the KYCs continued to have investment objective ranges rather than specific risk tolerance or asset allocation targets.

¶ 44 Accounts with specific risk tolerance and asset allocation targets could trigger two additional

exception codes as follows:

- a. E-25% would be triggered where equity holdings were under target by 25% or more for six consecutive months; and
- b. F-25% would be triggered where fixed income holdings were under target by 25% or more for six consecutive months.

BMO NBI Supervision System Exception Reports

¶ 45 The BMO NBI Supervision System produced daily and monthly reports that were issued to investment advisors and supervisors respectively, listing exceptions that were triggered.

¶ 46 The Daily BMO NBI Supervision System Exception reports listed all accounts that were offside a client's target risk tolerance or asset allocation to any degree. All exception codes were included on daily reports, where applicable.

¶ 47 According to the BMO NBI Sales Administration Manual ("SAM") in effect from May 2016, there was no requirement for Branch Managers to review the Daily BMO NBI Supervision System Exception report, which was then considered an optional tool. The Branch Managers were the Supervisors during the Relevant Period.

¶ 48 The Monthly BMO NBI Supervision System Exception reports listed accounts that required review by a Supervisor.

¶ 49 The Monthly Activity Review section of the SAM in effect during the Relevant Period, provided as follows: "the [BMO NBI Supervision System] Monthly Exception report will identify and flag accounts requiring review."

¶ 50 Only accounts significantly offside their targets were displayed on the Monthly BMO NBI Supervision System Exception reports. The following exception codes appeared on Monthly BMO NBI Supervision System Exception reports, where applicable: E+3, R+3, F+3, E-25%, and F-25%.

¶ 51 This meant, for example, that the Monthly BMO NBI Supervision System Exception report only triggered a requirement for further review where an account using specific risk tolerance and asset allocation targets exceeded their high-risk tolerance by at least 20%.

¶ 52 Liu's Supervisors or their delegates received and reviewed the Monthly NBI Supervision System Reports for the Client Accounts during the Relevant Period.

BMO NBI Supervision System Asset Allocation Assessment

¶ 53 Using the asset classification assigned by the BMO NBI Supervision System, asset allocations were assessed by the BMO NBI Supervision System to determine whether account holdings were offside target asset allocations.

¶ 54 However, throughout the Relevant Period, the BMO NBI Supervision System exceptions for excessive fixed income were only triggered if fixed income holdings were above target fixed income allocations and the client's target equity allocation was zero and only for accounts using specific risk tolerance and asset allocation targets as opposed to ranges.

BMO NBI Supervision System Account Risk Assessment

¶ 55 The risk ratings assigned to individual securities or positions were used to determine whether account holdings were in line with the target risk tolerance.

¶ 56 In assessing the risk of an account, the BMO NBI Supervision System took the sum of each security of a particular risk rating expressed as a proportion of the account's "market exposure" and then compared the result with the target risk tolerance.

¶ 57 Using the BMO NBI Supervision System methodology (preferred shares as medium risk and expressed

as a fraction of market exposure) and assuming the short GOC bonds as the only high-risk positions in the accounts, twelve of the sixteen Client Accounts exceeded their high-risk exposure target by 10% or more at some point during the Relevant Period.

¶ 58 BMO NBI's policies and procedures allowed a buffer of up to 19.99% (9.9% when investment objective ranges used) above an account's high-risk tolerance before requiring action.

¶ 59 Further, the BMO NBI Supervision System only considered each individually rated security in the account, rather than the risk of the account as a whole.

Other Supervision Tools - SAM Concentration and Margin Guidelines

¶ 60 Liu and his Supervisors ought to have considered risk in the Client Accounts beyond those matters flagged on the BMO NBI Supervision System Exception reports, including the excessive use of leverage, but failed to do so.

SAM Margin Guidelines

¶ 61 The "Suitability for Margin Accounts" section of the SAM in effect during the Relevant Period contained guidelines relating to borrowing, including for assessing the suitability of leverage and margin, and was prefaced by the following:

The appropriateness of margin should be assessed on a client-by-client basis. The following guidelines are to aid you in your assessment and should any of these factors raise a red flag, there is an increased chance that a leveraging strategy may be unsuitable for your client. [Emphasis added]

¶ 62 The SAM margin suitability guidelines included the following cautions in connection with leverage loans as it relates to a client's net worth and income:

Net worth – caution should be taken in the cases where a loan exceeds 30% of client's net worth and 50% of client's liquid assets

Client's income – caution should be taken in the cases where debt payments exceed 35% of the client's gross income, not including the income generated from the leveraged investments

Risk Tolerance – medium or higher (should be high for short-selling)

¶ 63 Notwithstanding the cautions in the SAM, the Client Accounts were permitted to use leverage (in the form of short GOC bond positions) in amounts well in excess of the limits cautioned against.

¶ 64 Each of the Client Accounts exceeded at least one of the net worth or income guidelines for multiple months during the Relevant Period, and, in some cases, throughout the Relevant Period.

¶ 65 Liu did not consider the cautions regarding leverage in the SAM in his assessment of the suitability of the Strategy. In fact, Liu did not perform any calculations to determine how the holdings in the Client Accounts compared with the leverage guidelines cautioned against in the SAM.

¶ 66 Neither the Supervisors nor their delegates performed calculations to determine the suitability of leverage in the Client Accounts or other accounts using the Strategy.

¶ 67 In at least ten instances, the Supervisors approved KYC updates for Client Accounts while the account's holdings exceeded at least one of the leverage ratios that the SAM cautioned against exceeding.

Supervision Failures

¶ 68 Liu's Supervisors were aware of Liu's use of the Strategy from as early as May 2016.

¶ 69 The increased shorting, particularly of long-term GOC bonds that occurred from January 2018 to early June 2018, was or ought to have been apparent to the Supervisors from the daily reviews.

¶ 70 Starting on or about May 31, 2018, the Supervisors expressed concern regarding Liu's use of the

Strategy. Their queries reflected concern over the rationale for short selling long-term GOC bonds; a client's possible need to liquidate prior to the bonds' maturity and attendant market and interest rate risks; and the dramatically increased risk to Liu's portfolio as a result of shorting long-term GOC bonds. The Supervisors did not implement any plan for dealing with the risks that were identified at that time.

¶ 71 Following the Supervisors' queries, Liu reduced his shorting of long-term GOC bonds to near zero after May 31, 2018. However, he did little about existing short GOC bond positions in the Client Accounts.

¶ 72 On or about June 7, 2018, one of Liu's Supervisors questioned Liu about his plan to "shorten the duration" of the short GOC bond holdings in client accounts, but failed to follow up appropriately at that time.

Monthly Supervision – Asset Allocation

¶ 73 Prior to March 2019, fifteen of the sixteen Client Accounts were consistently overweighted in fixed income securities by more than 20% compared to the account's targets.

¶ 74 Prior to March 2019, although E-25% exceptions appeared on monthly reports, they were not adequately queried by the Supervisors.

¶ 75 In those instances that resulted in queries, after Liu responded to the risk tolerance issue, the Supervisor noted that the equity allocation was off target but made no further queries.

¶ 76 By ignoring the E-25% exceptions in the Client Accounts, the Supervisors effectively did not query the over-weighting in fixed income that was generally the trigger for the E-25% exceptions on the Monthly BMO NBI Supervision System Exceptions reports in the Client Accounts.

Monthly Supervision - Risk Tolerance

¶ 77 Even while using the Monthly BMO NBI Supervision System Exception reports as the basis of their monthly reviews, the Supervisors did not adequately query R+3 exceptions (greater than 19.99% offside risk tolerance for accounts using specific risk tolerance target or 9.9% for the Client Accounts that used objective ranges) that appeared on the Monthly BMO NBI Supervision System Exceptions reports.

¶ 78 As of September 2018, there were increased risk-related queries sent to Liu, and by the end of September 2018, the Supervisors discussed among themselves advising Liu that his use of the Strategy should be limited to shorter term bonds and discussed alternative financing options to shorting.

¶ 79 However, it was March 7, 2019 before a Supervisor advised Liu that absent management approval, his short bond sales would be limited to those with a "duration of less than 5 years."

¶ 80 Also in March 2019, the Supervisors began sending queries as part of what they indicated was a broader review of Liu's clients' short positions. The queries included concerns regarding under-investment in equities and suitability of shorting long-term bonds.

¶ 81 The queries culminated in an email dated March 25, 2019, requiring that Liu produce an action plan to reduce the exposure to short long-term GOC bonds and "aggressively" reduce his book's concentration in floating rate preferred shares.

¶ 82 By mid-May 2019, progress on the proposed action plan had slowed, but apart from continuing to monitor the progress of the action plan, sending a May 17, 2019 email requesting that Liu "continue to de-lever" his book, and reviewing and approving the KYC updates, the Supervisors did not take additional steps to follow up.

¶ 83 At about the time of increased supervision queries in March 2019, thirteen of the sixteen Client Accounts had KYC updates that resulted in high risk tolerance and fixed income allocation being increased.

¶ 84 Generally, the KYC updates matched the account risk tolerance or objectives to the actual portfolio compositions.

¶ 85 In short, BMO NBI failed to implement a system of supervision and controls in respect of the trading

activity in the Client Accounts that was adequate:

- a. to detect, in a timely manner, suitability issues associated with the Strategy in the Client Accounts, including those related to asset allocation and risk tolerance;
- b. to reasonably ensure that Liu and the Supervisors were adequately discharging their responsibilities under its policies and procedures with respect to suitability of the Client Accounts and otherwise as required;
- c. to ensure that its Supervisors adequately queried the Client Accounts and followed up on queries as appropriate; and
- d. to ensure that its Supervisors were adequately following up on red flags in the Client Accounts, including relating to leverage and asset allocation.

Volatility and Client Harm

¶ 86 The following summarizes key account details in respect of the Client Accounts during the Relevant Period, including high-risk tolerance and losses between October 2018 and May 2019.

Name	Market Value (\$) at October 2018	Loss (\$) October 2018 to May 2019	Loss (October 2018 to May 2019) as % of Market Value (October 2018)	KYC Allocation to High Risk (October 2018)
W.D.	2,005,829.47	(1,161,951.11)	-57.9%	Growth*
P.L. & Y.J.	3,045,478.86	(958,847.82)	-31.5%	30%
H.G.	2,117,118.06	(1,172,494.48)	-55.40%	30%
M.L. & Y.S.	4,612,546.68	(2,904,294.19)	-63.0%	20%
Y.L. & H.C.	5,135,333.65	(3,576,738.74)	-69.6%	40%
Y.L. & M.X.	3,009,456.26	(2,001,291.06)	-66.5%	30%
F.L. & M.Z.	1,593,104.84	(820,256.70)	-51.5%	30%
M.I. Inc.	3,193,508.40	(1,860,689.53)	-58.3%	20%
M.T. Ltd.	1,287,793.97	(591,944.68)	-46.0%	30%
J.S. & W.L.	4,337,608.87	(2,781,253.02)	-64.1%	30%
C.S. & Z.S.	3,098,906.50	(1,183,309.12)	-38.2%	20%
S.H.C. Ltd.	7,402,979.98	(5,908,865.70)	-79.8%	20%
J.W. & L.	4,037,222.80	(1,925,918.78)	-47.7%	40%
Y.W. & Q.L.	26,943,798.86	(9,343,148.03)	-34.7%	20%
H.Z.	4,937,353.66	(2,404,156.13)	-48.7%	30%
J.Q.	3,139,647.10	(1,178,022.87)	-37.5%	20%
TOTAL	79,897,687.96	(39,773,181.96)		

¶ 87 The extent of the decline over a period of roughly six months illustrates the volatility of the Strategy.

Financial Benefit to Liu, BMO NBI

¶ 88 Fourteen of the Client Accounts were fee-based accounts. These Client Accounts paid a total of

\$660,918.35 in fees from the time they implemented the Strategy to May 31, 2019.

¶ 89 The remaining two Client Accounts were in transactional commission arrangements and paid a total of \$91,425.84 (\$65,700.84 from fixed income securities) in commissions.

¶ 90 During the Relevant Period, the Client Accounts paid BMO NBI borrow fees on the short GOC bond positions totaling \$461,358.

¶ 91 Holders of twelve of the Client Accounts have received compensation from BMO NBI for their losses as part of the settlement of civil litigation or other resolution process, in amounts sufficient to cover a significant portion of their capital losses along with the fees (including borrow fees) and commissions paid by those Client Accounts.

¶ 92 The disgorgement amount set out below includes the fees (including borrow fees) and commissions paid by the clients holding the four Client Accounts that did not file complaints or commence litigation and therefore did not receive compensation.

Additional Factors

¶ 93 BMO NBI has made revisions to its supervision systems since the Relevant Period, which have addressed the issues identified in this Settlement Agreement regarding exception reports and queries. In particular, BMO NBI:

- a. implemented a new regional supervision model resulting in supervisory functions previously performed by local branch management being migrated to a centralized team of supervisors and support staff solely focused on supervision related activities;
- b. improved its account supervision system from a paper-based reporting system to an electronic alert system that prioritizes alerts for review (including accounts with multiple alerts) and facilitates the issuance of electronic queries, with evidence of each review and query being retained electronically in a centralized system. The electronic alert system is meant to facilitate a risk-based approach and to target a supervisor's review to accounts that present greater risks for the client. The electronic alert system differs from the reporting system in place during the Relevant Period as follows:
 - i. over 25 electronic filters are available for categories such as age, short positions, pro-trading, etc.;
 - ii. the range of alerts have been expanded and include asset allocation (i.e., where equity holdings are zero but there is an equity component to the account's asset allocation, or where there is excess cash held in the account), risk tolerance (i.e., where high risk holdings are zero or low risk is 100% but there is a high risk component to the account's risk tolerance), turn-over ratio, security concentration (single security, sector concentration, issue concentration); and
 - iii. reduced the buffer to 10% for the generation of an alert for accounts that exceed their targeted high risk tolerance;
- c. developed and launched a dashboard for supervisors that is updated weekly in order to identify and review investment strategies with characteristics that may increase the risk of the strategy, including margin borrowing and short selling. The dashboard lists the accounts with the highest prevalence of these activities in each region (and can further be filtered by branch, IA, and/or client objective) and for each activity also shows the percentage the activity represents in relation to the client's total net equity and the client's key KYC attributes, including age, investment experience, investment objectives, risk tolerance, liquid assets, and net worth;
- d. updated its policies and procedures to:

- i. incorporate an escalation process for unresolved queries, which enables supervisors to take actions regarding an account of concern, such as coding the account “no more business” or withholding fees/commissions until the query has been remediated, and requires that the issue be escalated to the National Director of Supervision; and
 - ii. incorporate a quarterly attestation process for regional branch supervisors, which documents completion of daily and monthly supervision activities within the required timelines, the issuance and remediation of queries regarding any concerns with a transaction or an account, and retention of evidence of these activities, followed by a review of the attestations by the National Director of Supervision; and
- e. revised its Margin Lending Operating Procedures to include shorting activities as a credit risk component.

¶ 94 Liu has never been the subject of any disciplinary proceedings commenced by the Corporation.

¶ 95 Liu was re-assigned to a non-registered and non-client facing role with a significant reduction in compensation.

¶ 96 The holders of the Client Accounts were corporations and individuals that were not considered vulnerable clients as that term is defined in section 3201 of the Investment Dealer Rules, namely they were not clients who had any illness, impairment, disability, or aging-process limitation.

¶ 97 While the Strategy resulted in increased volatility, given that it involved the shorting of GOC bonds, the risk of losses over the long term was accompanied by: (a) the certainty of the cost of borrowing, and (b) an understanding that the price of the shorted bonds would return to par at maturity.

¶ 98 Certain clients sought to engage in the Strategy for the tax efficient dividend income and/or to hedge against real estate investments.

PART IV – CONTRAVENTIONS

¶ 99 By engaging in the conduct described above, the Respondents committed the following contraventions of Corporation requirements:

Liu

- i. Between December 2017 to May 2019, Liu failed to use due diligence to determine the suitability of the Strategy as used in the Client Accounts, contrary to Dealer Member Rule 1300.1 (p) and (q).

BMO NBI

- ii. Between December 2017 and May 2019, BMO NBI failed to implement a system of supervision and control in respect of the trading activity in the Client Accounts, particularly with respect to the suitability obligations owing by it and its Registered Representative and in respect of the supervision of the Client Accounts, contrary to Dealer Member Rules 38.1 and 2500A.

PART V – TERMS OF SETTLEMENT

¶ 100 The Respondents agree to the following sanctions and costs:

(i) Liu:

- i. a fine of \$80,000;
- ii. disgorgement of fees and commissions in the amount of \$63,258;
- iii. successful completion of the Conduct and Practices Handbook Course before applying for registration and approval with CIRO; and

- iv. costs of \$5,000.
- (ii) BMO NBI:
- i. a fine of \$1,500,000;
 - ii. disgorgement of fees and commissions in the amount of \$146,876; and
 - iii. costs of \$50,000.

¶ 101 If this Settlement Agreement is accepted by the hearing panel, the Respondents agree to pay the amounts referred to above within 30 days of such acceptance unless otherwise agreed between Enforcement Staff and the Respondents.

PART VI – STAFF COMMITMENT

¶ 102 If the hearing panel accepts this Settlement Agreement, Enforcement Staff will not initiate any further action against the Respondents in relation to the facts set out in Part III and the contraventions in Part IV of this Settlement Agreement, subject to the provisions of the paragraph below.

¶ 103 If the hearing panel accepts this Settlement Agreement and the Respondents fail to comply with any of the terms of this Settlement Agreement, Enforcement Staff may bring proceedings under Investment Dealer Rule 8200 against the Respondents. These proceedings may be based on, but are not limited to, the facts set out in Part III of this Settlement Agreement.

PART VII – PROCEDURE FOR ACCEPTANCE OF SETTLEMENT

¶ 104 This Settlement Agreement is conditional on acceptance by the hearing panel.

¶ 105 This Settlement Agreement shall be presented to a hearing panel at a settlement hearing in accordance with sections 8215 and 8428 of the Investment Dealer Rules, in addition to any other procedures that may be agreed upon between the parties.

¶ 106 Enforcement Staff and the Respondents agree that this Settlement Agreement will form all the agreed facts that will be submitted at the settlement hearing, unless the parties agree that additional facts should be submitted at the settlement hearing. If any of the Respondents do not appear at the settlement hearing, Staff may disclose additional relevant facts, if requested by the hearing panel.

¶ 107 If the hearing panel accepts this Settlement Agreement, the Respondents agree to waive all rights under the Rules of the Corporation and any applicable legislation to any further hearing, appeal and review.

¶ 108 If the hearing panel rejects this Settlement Agreement, Enforcement Staff and the Respondents may enter into another settlement agreement or Enforcement Staff may proceed to a disciplinary hearing based on the same or related allegations.

¶ 109 The terms of this Settlement Agreement are confidential unless and until this Settlement Agreement has been accepted by the hearing panel.

¶ 110 This Settlement Agreement will become available to the public upon its acceptance by the hearing panel and the Corporation will post a copy of this Settlement Agreement on the Corporation website. The Corporation will publish a notice and news release of the facts, contraventions, and the sanctions agreed upon in this Settlement Agreement and the hearing panel's written reasons for its decision to accept this Settlement Agreement.

¶ 111 If this Settlement Agreement is accepted, the Respondents agree that neither they nor anyone on their behalf, will make a public statement inconsistent with this Settlement Agreement.

¶ 112 This Settlement Agreement is effective and binding upon the Respondents and Enforcement Staff as of the date of its acceptance by the hearing panel.

PART VIII – EXECUTION OF SETTLEMENT AGREEMENT

¶ 113 This Settlement Agreement may be signed in one or more counterparts which together will constitute a binding agreement.

¶ 114 An electronic copy of any signature will be treated as an original signature.

DATED this "25th" day of March 2024

"Witness"

Witness

BMO Nesbitt Burns Inc.
Per
"Kevin Barnes"

Name
I have authority to bind the corporation

"Witness"

Witness

BMO Nesbitt Burns Inc.
Per
"Bruce Ferman"

Name
I have authority to bind the corporation

DATED this "25th" day of March 2024

"Witness"

Witness

"Yujie (Jared) Liu"

Yujie (Jared) Liu

DATED this "25th" day of March 2024

"Ricki Ann Newmarch"

Witness

"Sylvia Samuel"

Sylvia Samuel
Enforcement Counsel on behalf of Staff of the
Enforcement Department of CIRO

The Settlement Agreement is hereby accepted this "28th" day of "March" 2024 by the following Hearing Panel:

Per: "Martin Friedland"

Panel Chair

Per: "Christopher Hill"

Panel Member

Per: "Richard Austin"

Panel Member

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ⁱ On January 1, 2023, IIROC and the MFDA were consolidated into a single self-regulatory organization recognized under applicable securities legislation.

The Canadian Investment Regulatory Organization ("CIRO") has adopted interim rules that incorporate the pre-amalgamation regulatory requirements contained in the rules and policies of IIROC and the by-law, rules and policies of the MFDA (the "Interim Rules"). The Interim Rules include (i) the Investment Dealer and Partially Consolidated Rules, (ii)

the UMIR and (iii) the Mutual Fund Dealer Rules. These rules are largely based on the rules of IIROC and the rules and certain by-laws and policies of the MFDA that were in force immediately prior to amalgamation. Where the rules of IIROC and the rules and by-laws and policies of the MFDA that were in force immediately prior to amalgamation have been incorporated into the Interim Rules, Enforcement Staff have referenced the relevant section of the Interim Rules. Section 1105 (Transitional provision) of the Investment Dealer and Partially Consolidated Rules sets out CIRO's continuing jurisdiction, including that CIRO shall continue the regulation of any person subject to the jurisdiction of the Investment Industry Regulatory Organization of Canada that was formerly conducted by the Investment Industry Regulatory Organization of Canada.