IN THE MATTER OF
THE *SECURITIES ACT*, R.S.O. 1990, C.S.5, AS AMENDED (the "Act")

AND

IN THE MATTER OF
ARLINGTON SECURITIES INC. AND SAMUEL ARTHUR BRIAN MILNE

HEARING DATE:	February 4, 13 and June 4, 2002		
BEFORE:	H. I. Wetston, Q.C.	-	Vice-Chair
	H. L. Murphy, Q.C.	-	Commissioner
	R. W. Davis, FCA	-	Commissioner
COUNSEL:	M. Britton	-	For the Staff of the Ontario Securities Commission
	Unrepresented	-	For Arlington Securities Inc. and Samuel Arthur Brian Milne

REASONS FOR DECISION

Background

The Respondent, Arlington Securities Inc. was registered under Ontario securities law as a securities dealer. The Respondent Samuel Arthur Brian Milne was registered under Ontario securities law as an officer of Arlington. Mr. Milne is the President, Secretary, Compliance Officer, Branch Supervisor, and a director of Arlington. Mr. Milne is also a 51% owner of Arlington.

The Notice of Hearing was issued on October 11, 2001. The hearing was held on February 4 and 13, 2002. At the conclusion of the hearing the decision was reserved. The Commission requested on March 22, 2002 additional submissions with respect to the following four questions:

1. Can trading records in and of themselves be used as a basis for determining whether mark-ups are excessive?

2. Is the answer to Question 1 the same for companies that are in the quoted market as for companies in the reported market?

3. Staff submitted that there was little risk to Arlington in the sale of the securities at issue. Is the risk any different if the security is held in inventory for a period of time as opposed to being drawn down from options?

4. The trading records demonstrate that there were other dealers participating in the companies at issue. There is no evidence to suggest that these companies sold at prices other than between the bid and ask. In order to find conduct contrary to the public interest in these circumstances, is it necessary that there be evidence of inappropriate conduct?

Additional submissions on the four questions were made on June 4, 2002.

Mr. Milne represented himself and Arlington at the hearing. He and a friend, Mr. Peake, shared responsibility for making submissions to the Panel.

During the period from 1996 to 2000, all of Arlington's business consisted of principal trading. All of Arlington’s revenues were based on principal transactions and 92% of its revenues were derived from eight issuers, namely, Allegiance Equity Corporation (“Allegiance”), Beverly Glen Capital Corp (later known as Phonetime Inc.)(“Phonetime”), Biogenetic Technologies Inc. (“Biogenetic”), GoldMint Explorations Ltd. (later known as Caspian Oil Tools Limited)(“Caspian”), HPB Investments Inc. (“HPB”), Miltec Technology Inc. (“Miltec”), Ungava Minerals Corp. (“Ungava”); and Wavetech Networks Inc., (“Wavetech”). Stock of each of the eight companies was traded through the Canadian Dealing Network ("CDN") and, in the case of stock traded after October 2, 2000, through the Canadian Venture Exchange ("CDNX").

During the period from October 1, 1997 to December 31, 1999, Arlington purchased 166,650 shares of Allegiance at an average cost of $0.48 per share.

During this time, Arlington sold substantially all of its shares to its clients at an average price of $1.19 per share, generating a gross profit of approximately $0.4 million which was a mark-up of approximately 147%. As of September 19, 2001 the ask/bid for Allegiance shares was $.22/$.36.

During the period from January 28, 1998 to November 24, 1998, Arlington purchased 1,031,250 shares of Beverly at $0.65 per share. On or about December 12, 1997, Arlington commenced selling securities in Beverly to its clients at $1.70 per share. From approximately December 12, 1997 to December 31, 1999, Arlington sold substantially all of its shares to its clients at an average price of $1.27 per share, generating a gross profit of approximately $1.3 million which was a mark-up of approximately 245%. This issue last traded on April 4, 2001 at $0.05.

During the period from December 1, 1995 to April 30, 1999, Arlington purchased 2,842,006 shares of Biogenetic at an average price of $0.56 per share. During the period from

December 1, 1995 to April 30, 1999, Arlington sold substantially all of its shares to its own clients at an average price of $1.38 per share, generating a gross profit of approximately $2.3 million which was an average mark-up of 147%.

During the relevant time period, Arlington acquired 4,795,467 shares of Caspian (then known as GoldMint) at an average price of $0.36 per share. On or about August 8, 1996, Arlington commenced selling securities in GoldMint to its clients at $1.20 per share. Arlington sold substantially all of its shares to its clients at an average price of $1.18 per share, generating a gross profit of approximately $4.2 million which was at a mark-up of approximately 228%. GoldMint last traded on the CDN on February 2, 1999, at a price of $0.05 per share. It has not traded since that date.

During the period from May 1, 1999 to December 31, 1999, Arlington purchased 1,237,705 shares of HPB at an average price of $0.31 per share. On or about May 12, 1999 Arlington commenced selling securities to its clients at a price of $1.25 per share. During the period from May 1, 1999 to December 31, 1999, Arlington sold substantially all of its shares to its own clients at an average price of $1.31 per share, generating a gross profit of approximately $1.2 million which was a mark-up of approximately 318%. HPB last traded on October 13, 2000 at a price of $.01 per share.

During the period from September 1, 1998 to December 31, 1999, Arlington purchased 1,869,036 shares of Miltec at an average price of $0.27 per share. On or about October

21, 1998, Arlington commenced selling securities in Miltec at $1.00 per share. During the period from September 1, 1998 to December 31, 1999, Arlington sold substantially all of its shares to its clients at an average price of $1.18 per share, generating a gross profit of approximately $2.1 million which was a mark-up of approximately 338%. The last trade in Miltec shares prior to the cease trade order referred to above in paragraph 31, was on May 17, 2000, at $0.15 per share.

During the period from October 1, 1996 to December 31, 1999, Arlington purchased 727,884 shares of Ungava at an average price of $0.65 per share. During the period from October 1, 1996 to December 31, 1999, Arlington sold substantially all of its shares to its clients at an average price of $1.82 per share, generating a gross profit of approximately $0.8 million which was a mark-up of approximately 179%. The last trade of Ungava shares was on December 15, 2000 at a price of $0.125 per share.

During the period from March 1, 1999 to December 31, 1999, Arlington purchased 1,172,200 shares of Wavetech at an average price of $0.37 per share. During the period from March 1, 1999 to December 31, 1999, Arlington sold substantially all of its shares to its own clients at an average price of $1.54 per share, generating a gross profit of approximately $1.5 million which was a mark-up of approximately 319%. Wavetech last traded on February 15, 2001 at a price of $0.20 per share.

Arlington either held stock of these companies in its inventory or held options to acquire stock in them. In respect of several of the eight issuers, Arlington exercised options to acquire stock in them immediately prior to the commencement of principal trading in the stock with its clients.

The approximate percentages of trading in each of the companies that was accounted for by Arlington were as follows: Miltec Technology: 22%, HPB Investments: 21%, Wavetech Networks: 26%, Beverly Glen Capital: 17.5%, Goldmint Explorations: 59%, Ungava Minerals: 20%, Biogenetic Technologies: 72% and Allegiance Equity Corp: 39%. It is evident that in varying percentages, other dealers participated in each of these issuers. The gross profit generated on the trades during the relevant period by Arlington was over $13 million.

It is clear that five of the eight issuers had a market maker (Beverly Glen Capital, Goldmint Explorations, Ungava Minerals, Biogenetic Technologies and Allegiance Equity Corp.). According to Mr. Milne, Miltec Technology, HPB Investments and Wavetech Networks had indicated market makers. Every quoted CDN security is required to have at least one market maker.

On February 15, 2002 the prices of the shares of the companies that are still in operation ranged from one cent to twenty cents.

Staffs' Submissions

Staff submitted that the mark-ups in this case were excessive, that is, unjustifiably large. They adopt this position despite the absence of any policy or rule that determines excessiveness. Staff do not contend that the mark-ups were excessive because there were at times equal to or greater than mark-ups in three previous approved settlement agreements involving penny stock dealers (Gordon Daly, Gordon-Daly Grenadier Securities (August 9, 2000), A.C. MacPherson and Co. Inc. (April 6, 2000) and Price-Warner Securities Ltd. (August 3, 2000)). Staff do submit that in all the circumstances herein; the relationship of the parties, the nature of Arlington's business and the degree of risk involved, the mark-ups were excessive and therefore contrary to the public interest.

It was submitted that the privilege to be registered to sell securities carries obligations to act fairly in dealing with clients. This obligation is contained in rule 31-505, subsection 2.1(1) and 2.2(2). Arlington sold from a principal position and had an enhanced obligation to deal fairly, honestly and in good faith with their clients.

It was submitted that there is an inherent conflict between Arlington's business and the interests of its clients. While it is expected that losses will be incurred in the sale of speculative securities, it is submitted here that Arlington profited at the expense of its clients. It is further submitted that these losses flow, in this case, from the inherent conflict between the registrant and its clients.

Arlington accumulated, at modest prices, large quantities of shares either in inventory or by way of option agreements. It sold to its clients at high mark-ups which parallel the selling campaign. Prior to that trading was light. There was no real market for these stocks and, at the end of the promotion cycle, the prices fell to little or nothing.

Staff concede that high-risk can justify high mark-ups. However, the modest acquisition costs and the use of option agreements minimize Arlington's risk. Staff further contend that the respondent, Mr. Milne, authorized, permitted or acquiesced in the conduct of Arlington and thereby acted contrary to the public interest.

<u>The Respondents' Submissions</u>

Mr. Milne argued that there was no rule, policy statement or guidelines that indicated when mark-ups were excessive and therefore, it is not possible for a securities dealer to determine what level of mark-up would be excessive. He stated that it was difficult for registrants to govern their behaviour in the absence of greater certainty. It would be unfair to sanction him given this regulatory vacuum.

Mr. Peake submitted that Arlington was not the only dealer trading stocks of the eight issuers and that in fact there were many other dealers involved, and Arlington was not necessarily dominant. It was also submitted that Staffs' evidence was insufficient to establish that there was "no real market" for these shares and that once the campaign ended the prices collapsed.

Mr. Milne submitted that contrary to Staffs' position share prices "could" have gone up but called no evidence to support that assertion.

In response to Staffs' allegations, it was argued that at no time was Arlington in a position of conflict of interest with its clients since it did not act as a market maker. Moreover it was contended that there was no conflict in selling from a principal position. It was submitted that the prices at which Arlington sold stocks were determined independently by market forces and therefore Arlington could not be accused of "pumping up" stock prices. Furthermore, he submitted that according to CDN policy, in place at the time, Arlington was required to sell the stock to the public at a price between the bid and ask quoted by the market maker for an undisclosed number of board lots. Mr. Milne submitted that Arlington was independent of the market maker and always sold to clients between the market makers bid/ask.

Finally, it was contended that the settlement agreements reached between Commission staff and the other penny stock dealers were not binding on others. Moreover, Mr. Milne submitted that these settlements could be distinguished because there were conflicts of interest since the dealers appear to have also acted as market makers. He maintained that even if they were persuasive, the first one was reached on April 6, 2000. This was well after the relevant time at issue in this matter and thus it would be unfair to sanction the respondents retroactively on that basis.

The Respondents called no evidence other than recalling Staffs' only witness Mr. Cottrell, a senior staff forensic accountant.

<u>The CDN</u>

The CDN was established in 1991 to assume responsibility for over-the-counter equities trading in Ontario. It was a quotation and trade reporting system. Generally, over-the-counter equities markets involved junior issuers that do not have the secondary trading market liquidity required to sustain an order driven continuous auction securities market. Consequently, market makers are key players in the operation of an over-the-counter trading system. The intent is that investors should be able to buy or sell that security at the market maker's quoted bid and ask prices.

While CDN was a dealer market, only a registered dealer approved by CDN as a market maker for a particular security could post bid and ask price quotations on the CDN system for that quoted security. Other registered dealers using the CDN system and buying or selling as principal or agent directly and not through a market maker had to have regard to the market maker's posted bid and ask price quotations.

The CDN quotation and trade reporting system was governed by Part VI of the General Regulation to the *Securities Act* and CDN's published policy. The CDN Policy provided additional requirements and clarification in respect of matters covered by the Regulation and governed CDN's market operations.

Market makers applied to make a market in a particular security and their responsibility was to ensure that there will be a minimum level of liquidity for that security. However markets provided by approved market makers only had to be for at least one board lot. The CDN policy did not attempt to regulate the prices (commissions or mark-ups) that dealers may agree upon with their clients in CDN trades confirmed as principal. However, the dealer did have an obligation to charge a customer a commission or service charge which was fair and reasonable in all the circumstances.

All CDN trading took place by or through securities dealers. Individual investors bought or sold from securities dealers who either buy or sell as principal or agent. As indicated earlier, only a registered dealer approved by CDN as a market maker for a particular security could post bid and ask price quotations on the CDN system for that quoted security. Other registered dealers using the CDN system in buying or selling as principal or agent directly and not through a market maker must have regard to the market makers posted bid and ask price quotations for the purpose of meeting their obligations to obtain the best available price for their clients.

We have considered a number of Commission decisions including *Marchment & Mackay* (1999) 22 OSCB 4705; *E.A. Manning* (1995) 18 OSCB 5317 and the three settlement agreements (referred to above) involving activity on the CDN. These decisions reveal that the main activity generally followed a similar pattern. Trading in the stock of an issuer was typically dominated by dealers who were not members of the Investment Dealer's

Association. All dealers are now required to be members of the IDA. A dealer generally had options on the stock of the issuer(s) it traded in and drew them down as needed based on the sales activity. The trading activity was comprised almost exclusively of dealers selling stock as principal. A securities dealer would sell its inventoried stock at large mark-ups from its purchase price under the option agreements. Most of the trading activity was one-way, meaning that the selling securities dealer(s) sold stock to the public, but there was little or no trading activity from such public purchasers to any other dealer or among the public purchasers or any other secondary market purchaser. When securities dealers ran out of inventory, the market price of the security in question would collapse, as virtually the entire "market" demand for the stock was that generated by the sales of the securities dealers.

Analysis

The fundamental obligation of a registrant, whether as principal or agent, is to deal fairly, honestly and in good faith with its clients. This general duty is imposed by OSC Rule 31-105 Conditions of Registration. In addition, among other things, a registrant must disclose if selling from a principal position, its commissions and the risk associated with the purchase. Staff called no clients regarding the manner of the respondents' dealings with their clients. They only called Mr. Cottrell, a senior forensic accountant in the Enforcement Branch. The Respondents called no evidence (except recalling Mr. Cottrell) and introduced no evidence.

Rule 31-505 is as follows:

2.1 General Duties

> (1) A registered dealer or adviser shall deal fairly, honestly and in good faith with its clients.
>
> (2) A registered salesperson, officer or partner of a registered dealer or a registered officer or partner of a registered adviser shall deal fairly, honestly and in good faith with his or her clients.

As indicated previously, the Commission has approved settlements in other high mark-up cases. In Reasons for the Order in A.C. MacPherson, supra, the Commission found that dealers engaging in principal trades with their clients have an enhanced obligation flowing from their obligation to deal fairly, honestly and in good faith. These agreements provide some guidance to the Commission in assessing similar conduct which is alleged to be in violation of the public interest.

In this matter, the dealer was selling to clients from a principal position. In cases where there are excessive or high mark-ups our core regulatory concern is abusive sales practice. A marketplace conflict can occur where the interests of the seller are pitted against those of the buyer. Obviously selling activities in such an environment have become the focus of enforcement activity in recent years since unbridled business self-interest can conflict with the best interests of a firm's clients. While client diligence may be the best protection against potentially abusive sales practices, the nature of the relationship between a dealer as principal and a client in the OTC market can raise particular concerns.

Mr. Cottrell has been the primary investigator into the activities of ten penny stock dealers since July, 1999, including the Respondents. We accept Mr. Cottrell's evidence that, prior to the extensive selling during the relevant periods, these stocks traded lightly. Arlington sold these stocks to its clients at large mark-ups, from 146% to 338%. While other dealers were involved, in various percentages, this fact does not minimize Arlington's obligation to sell to clients in a fair manner. It is clear that once the selling cycle was complete, the prices of the securities collapsed.

In aggregate, the winner in these transactions was Arlington ($13.2 million gross profit) while the losers were its clients. This is not the market operating freely without conflict but rather registrants acting in their own self-interests not their clients. Moreover, we accept that there was little risk to Arlington since its acquisition costs were modest and option agreements were utilized.

While it would be preferable if there was a rule or policy with respect to high mark-ups, the fact that there is not, is not a justification for excessive mark-ups. After all we are not considering mark-ups of 5 or 10 or even 20%. Rather we are considering mark-ups of up to 338%. We agree with the opinion expressed in *In the Matter of Goldmack Securities Inc.*, [1966] OSCB 14 at p. 1920:

> "In Ontario the practice has not been to regulate the conduct of the affairs of registrants. The principle adopted has been that there is an implied standard of ethics which applies to all registrants, and it is the responsibility of each to

> know and observe this standard. This approach permits some leniency and discretion...It may at times, in particular situations, place a registrant in the position where he has to determine personally what is wrong without any specific guidelines. In such a situation he must apply the general ethical philosophy for the conduct of the securities business. The fact that no specific rule prohibits an act cannot be the test."

As indicated by Justice Iacobucci in Committee for Equal Treatment of Asbestos Minority Shareholders vs Ontario Securities Commission [2001] 2 S.C.R. 132 (SCC), The OSC has under S. 127, a broad discretion to intervene in Ontario capital markets if it is in the public interest to do so. The purpose of the sanctions are preventive, protective and prospective in nature. We must, on the basis of past conduct, prevent future conduct detrimental to the integrity of the capital markets.

It is apparent that Arlington places considerable reliance on the fact that it always sold shares to clients between the quoted bid and ask posted by the market maker. Moreover, Arlington never acted as a market maker. We have reviewed the trading records and conclude that the role of the market maker was not significant and rarely intervened to protect the price. Market makers need not reveal their board lots and need only quote a minimum board lot. It is our opinion that the trading in the shares herein was dominated by the stock promoters of which Arlington was one.

In conclusion, in all the circumstances of this case, i.e., the relationship of the parties, the nature of Arlington's business and the degree of risk involved we find that the mark-ups were "unjustifiably large". Principal trades are not unusual or necessarily problematic. However, Arlington's business and the interests of its clients were at odds. Arlington profited from the sale of speculative securities to the detriment of its clients who lost in the purchase of such securities.

Arlington failed to deal fairly, honestly and in good faith with its clients. It has not acted in the best interests of its clients and has acted contrary to the public interest. The Respondent, Mr. Milne, authorized, permitted or acquiesced in the conduct of Arlington and accordingly acted contrary to the public interest.

The following sanctions shall be imposed:

<u>Arlington Securities Inc.</u>

1. Arlington Securities Inc. shall be reprimanded.
2. Arlington Securities Inc. registration shall be terminated.
3. Arlington Securities Inc. shall permanently not have the benefit of any exemptions contained in Ontario securities law.

<u>Samuel Arthur Brian Milne</u>

1. Mr. Milne shall be reprimanded.
2. Mr. Milne shall cease trading in securities for three (3) years from the date of this Order.

3. Mr. Milne shall not have available for a period of three (3) years from the date of this Order any exemptions contained in Ontario securities law.

4. Mr. Milne shall resign for a period of three (3) years from the date of this Order one of more positions which he may hold as an officer or director of any issuer.

5. Mr. Milne shall for a period of three (3) years from the date of this Order not become or act as an officer or director of an issuer.

6. Mr. Milne shall pay costs of the investigation in the amount of $5,000.

DATED at Toronto this 25th day of June, 2002.

Howard I. Wetston H. Lorne Morphy

Robert W. Davis.