

Case Name:  
**Blair (Re)**

**IN THE MATTER OF the Securities Act, R.S.O. 1990,  
c. S.5, as amended  
AND IN THE MATTER OF (John) Blair Taylor  
Order  
(Subsection 127(1))**

2002 LNONOSC 425

Also reported at: (2002), 25 OSCB 4838

Ontario Securities Commission

**P. Moore, T. McLeod, and H. Hands**

Decision: July 18, 2002.

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ORDER:-- WHEREAS on July 16, 2002, the Ontario Securities Commission (the "Commission") issued a Notice of Hearing pursuant to subsection 127(1) of the Securities Act, R.S.O. 1990, c. S.5, as amended (the "Act") respecting (John) Blair Taylor ("Taylor");

AND WHEREAS Taylor entered into a Settlement Agreement in which he agreed to a proposed settlement of the proceedings, subject to the approval of the Commission;

AND UPON reviewing the Settlement Agreement and the Statement of Allegations of Staff of the Commission and upon hearing submissions from counsel for Taylor and from Staff of the Commission;

AND WHEREAS the Commission is of the opinion that it is in the public interest to make this Order pursuant to subsection 127(1) of the Act;

IT IS ORDERED THAT:

1. the attached Settlement Agreement executed July 17, 2002 is approved;
2. pursuant to subsection 127(1), paragraph 8 of the Act, Taylor is prohibited from becoming or acting as a director or officer of any issuer for two years commencing on the date of this Order; and

3. pursuant to subsection 127(1), paragraph 6 of the Act, Taylor is reprimanded.

P. MOORE  
T. McLEOD  
H. HANDS

\* \* \* \* \*

IN THE MATTER OF  
THE SECURITIES ACT,  
R.S.O. 1990, c. S.5, as amended

AND  
IN THE MATTER OF  
(JOHN) BLAIR TAYLOR

SETTLEMENT AGREEMENT BETWEEN STAFF OF THE  
ONTARIO SECURITIES COMMISSION AND  
(JOHN) BLAIR TAYLOR

## I. INTRODUCTION

1. By Notice of Hearing, the Ontario Securities Commission (the "Commission") will convene a hearing to consider the approval of this proposed settlement between Staff of the Commission ("Staff") and the respondent (John) Blair Taylor ("Taylor") including the making of an Order pursuant to subsection 127(1) and section 127.1 of the Securities Act, R.S.O. 1990, c. S.5 (the "Act").

## II. Joint Settlement Recommendation

2. Staff agrees to recommend settlement of an intended proceeding respecting Taylor in accordance with the terms and conditions described below. Taylor consents to the making of an Order against him in the form attached as Schedule "A" based on the facts set out in Part III of this Settlement Agreement.

## III. STATEMENT OF FACTS

### Acknowledgement

3. Solely for the purposes of this proceeding, and of any other proceeding commenced by a securities regulatory agency, Staff and Taylor agree with the facts set out in paragraphs 4 through 46.

### Phoenix Research and Trading Corporation

4. Phoenix Research and Trading Corporation ("Phoenix Canada") is a company incorporated pursuant to the laws of Ontario. During the material time, Phoenix Canada was registered with the Commission as an investment counsel and portfolio manager pursuant to the Act. Phoenix

- Canada's registration was voluntarily suspended in May 2000 due to its difficulties in filing audited financial statements and maintaining insurance.
5. Phoenix Canada was a small company of approximately 14 employees. Ronald Mock ("Mock") was the CEO and President of Phoenix Canada. During the material time, Mock was registered with the Commission as an investment counsel and portfolio manager pursuant to the Act. Mock also was the company's registered supervisory procedures officer.
  6. Taylor is a chartered accountant. From July 1997 to October 1999, Taylor was Phoenix Canada's Director of Operations and Finance. In November 1999, he was appointed the CFO. Taylor never was a registered officer of Phoenix Canada.
  7. During the material time, Stephen Duthie ("Duthie") was a senior fixed income trader with Phoenix Canada. Duthie has never been registered with the Commission in any capacity.
  8. Mark Kassirer ("Kassirer") was the Chair of Phoenix Canada during the material time. Kassirer headed the equity arbitrage business of Phoenix Canada.

#### The Phoenix Group

9. Phoenix Canada formed part of the Phoenix Group of companies and limited partnerships. Unitholders invested in the Phoenix Fixed Income Arbitrage Fund Limited, the Phoenix Fund Limited, the Phoenix Equity Arbitrage Fund Limited and the Phoenix Alternative Strategies Fund Limited (collectively, the "Feeder Funds"). The Feeder Funds (and other investors) invested in units of the Phoenix Fixed Income Arbitrage Limited Partnership ("PFIA LP") and the Phoenix Equity Arbitrage Limited Partnership ("PEA LP"). The Phoenix Hedge Fund Limited Partnership, a TSE-listed hedge fund, also held units of PFIA LP and PEA LP.
10. Pursuant to a services agreement with Phoenix Research and Trading (Bermuda) Limited ("Phoenix Bermuda"), Phoenix Canada provided investment advisory and portfolio management services to the Feeder Funds, PEA LP and PFIA LP.

#### Overview

11. In early January 2000, PFIA LP collapsed when it sustained a loss in excess of US\$120 million. By this time, Duthie had accumulated a \$3.3 billion U.S. long position in 6% U.S. treasury notes due August 15, 2009 (the "UST Notes"). The UST Notes represented PFIA LP's entire U.S. dollar portfolio. The UST Notes were not hedged. The concentration, size and length of time this unhedged position was in place contravened PFIA LP's investment guidelines and restrictions. The UST Notes caused PFIA LP's collapse.
12. Duthie was authorized to engage in a matched book strategy of repurchase agreements ("repos") and open reverse repos. Phoenix Canada management operated on the basis that the UST Notes were the open

reverse repo leg of the matched book and thus, fell within PFIA LP's investment parameters.

13. In reality, Duthie had engaged in a strategy of purchasing long bonds financed by repos.
14. The Bank of New York informed Phoenix Canada on January 4, 2000 that the latter was in a significant overdraft position (in excess of US\$50 million). The UST Notes caused the overdraft position. As a result, Phoenix Canada liquidated all of PFIA LP's assets. A loss to PFIA LP of over US\$120 million was sustained due to the unhedged UST Notes.
15. Immediately on being informed of its overdraft position, Phoenix Canada attempted to contact Duthie. On January 5, 2000, Phoenix Canada confirmed that the UST Notes were in fact unhedged long bonds and contacted Staff. As a condition of its registration, Phoenix Canada promptly retained a forensic accounting firm to prepare a report respecting the UST Notes.

#### PFIA LP

16. PFIA LP was a hedge fund managed by Phoenix Canada. Its investment objective was to maximize returns by pursuing professionally-managed fixed income market neutral and arbitrage investment trading strategies. Such trading strategies are designed to reduce exposure to market direction.
17. Mock ran PFIA LP. In connection with this aspect of Phoenix Canada's fixed income arbitrage business, Mock's staff comprised 9 employees namely the Operations Group (Taylor, the Operations Manager and the Settlement Clerk), three fixed income advisors and traders, the Research and Risk Manager, the Systems Support Manager and an administrative assistant.
18. Taylor was the Director of Operations and Finance and then the CFO of Phoenix Canada. He was the most senior person in the Operations Group. Taylor's duties included the direct supervision of the Operations Manager and the Settlement Clerk.

#### PFIA LP's Acquisition of the UST Notes

19. PFIA LP held investments in U.S. dollars, Canadian dollars and Euros. From the fall of 1998 through early January 2000, Duthie was responsible for PFIA LP's U.S. dollar portfolio.
20. Phoenix Canada's management informs Staff that Duthie was authorized to engage in a low risk, matched book trading strategy of repos and open reverse repos in U.S. treasury benchmark issues. An open reverse repo is a type of reverse repo that has no termination date (ie terminable on demand by either party to the transaction).
21. The goal of a matched book trading strategy of repos and open reverse repos is to eliminate the risk of market fluctuations inherent in bond trading. In this type of strategy, the trader merely plays the interest rate

- spread between the borrowing rate (repo leg) and the lending rate (open reverse repo leg).
22. On the repo leg, monies are borrowed on the collateral of bonds. On the termination of the repo, the borrowed monies plus interest are paid in exchange for the return of the bonds. Simultaneously, on the open reverse repo leg, monies are lent on the collateral of bonds. On the termination of the open reverse repo, the lent monies are repaid with interest and the bonds are returned. Profits are incurred on this type of matched book strategy when the interest earned on the open reverse repo leg exceeds the interest expense paid on the repo leg, net of transaction costs.
  23. Duthie did not engage in such a trading strategy. Rather, Duthie accumulated the UST Notes, financing the leveraged position using repos.

#### Management's Failure to Detect the True Nature of the UST Notes

24. Management relied principally on Duthie's representations that the UST Notes (and other long bonds reported during the material time) were open reverse repos (the "purported open reverse repos") and thus, part of Duthie's authorized trading strategy (ie the open reverse repo leg of the matched book strategy).
25. Within one day of being informed by the Bank of New York that PFIA LP was in a significant overdraft position, Phoenix Canada was able to discern that the UST Notes were long bonds and not the purported open reverse repos. Duthie also confirmed that the UST Notes were a long bond position.
26. The purported open reverse repos fell outside the scope of controls and procedures then in place at Phoenix Canada. Phoenix Canada failed to:
  - (a) establish, implement and monitor appropriate alternative controls and procedures respecting the purported open reverse repos;
  - (b) maintain the books, records and other documents necessary for the proper recording of the purported open reverse repos transactions; and
  - (c) segregate duties relating to the purported open reverse repo transactions.

As a result of these failures, the true nature of the UST Notes was not detected by management.

#### (a) Trade Capture of the Purported Open Reverse Repos

27. Phoenix Canada's method of capturing Duthie's trades in the purported open reverse repos was flawed and thus, unreliable. Phoenix Canada's computer trading system ("Alydia") was not designed to capture open repos or open reverse repos. All trades by Duthie in the purported open reverse repos therefore were entered into the bond module of Alydia as long bonds. Phoenix Canada then made two manual adjustments to reflect what it believed the true nature of the transactions to be namely:

- (a) a manual adjustment to "correct" PFIA LP's value at risk ("VAR") report so that the VAR would be meaningful. This adjustment was based on Duthie's representations as to the existence of the purported open reverse repos and the length of time such repos would be held; and
- (b) a manual adjustment to "correct" income from the bond position which would be reflected in the general ledger and profit and loss statements. Duthie provided the information used to make this adjustment.

(b) Phoenix Canada's VAR Reports

- 28. Phoenix Canada prepared, on a daily basis, a VAR report. The VAR reports were Phoenix Canada's primary risk monitoring and management tool to ensure that investments were within the limits prescribed by PFIA LP. The information used to create the VAR report was pulled from the information inputted to Alydia. Phoenix Canada adjusted the VAR report program so that the purported open reverse repos (entered as long bonds) were treated as short term long bonds (which they were not) and their risk assessed accordingly.
- 29. The adjustments to the VAR report were unreliable because they were based solely on Duthie's representations as to the existence of the purported open reverse repos and the length of time such repos would be held. Phoenix Canada did not request nor maintain any documentation of the original trades of the purported open reverse repos to support or verify Duthie's representations.

(c) "Pricing" of the Purported Open Reverse Repos

- 30. The purported open reverse repos were entered incorrectly into the bond module of Alydia. Since there is no bond inventory associated with an open reverse repo, however, there is nothing to "price". Rather, the purported open reverse repos would earn interest income which ought to be recorded.
- 31. Taylor dealt with the purported open reverse repos based on Duthie's representations as follows: Duthie identified those bonds entered into the bond module which were the purported open reverse repos. He then assigned a "price" to the purported open reverse repos which would produce a capital gain figure on the general ledger equal to what he said was the interest earned on the purported open reverse repos. Phoenix Canada relied exclusively on Duthie to assign a "price" to the purported open reverse repos.
- 32. Taylor never reallocated the "capital gain" figure to interest income. Thus, the purported interest earned on the purported open reverse repos appeared on the general ledger as a capital gain. The "capital gain" was

then carried over to the profit and loss statement relating to Duthie's market neutral strategy.

33. This method of dealing with the purported interest income earned on the purported open reverse repos was fundamentally flawed. Further, since Phoenix Canada did not maintain or retain any documentation respecting the existence of the purported open reverse repos or the basis for Duthie's calculation of the adjusted "price", Taylor had nothing against which to check these transactions.

(d) Segregation of Duties

34. Phoenix Canada failed to segregate duties relating to the purported open reverse repos by:
  - (a) relying solely on the representations of Duthie to allocate PFIA LP's U.S. bond inventory between long bonds and the purported open reverse repos;
  - (b) permitting Duthie to execute trades on behalf of PFIA LP respecting the purported open reverse repos and make the "pricing" adjustment relating to interest earned on the purported open reverse repos; and
  - (c) permitting Duthie to access collateral by virtue of his participation in cash management activities while engaged in his own profit and loss activities.

As a result of these failures, the true nature of the UST Notes remained undetected by Phoenix Canada.

(e) Books and Records

35. Phoenix Canada did not maintain any books and records of the original trades of the purported open reverse repos. Taylor did not request or obtain any open reverse repo contracts. Further, there was no manual blotter or spreadsheet maintained for the purported open reverse repos.
36. Internal reports generated from the inadequate trade capture and accounting of the purported open reverse repos such as daily trade blotters, collateral reports, settlement reports and trial balances were flawed and unreliable. For example, the settlement report used to confirm and settle trades listed trades in the UST Notes. The collateral usage report did not reflect the purported open reverse repos. The Operations Manager and Settlement Clerk who used these reports were unaware that the long bonds listed were a proxy for the purported open reverse repos.

Incorrect Reporting

37. Phoenix Canada reported incorrect information respecting the purported open reverse repos to the Bank of Bermuda, Phoenix Bermuda and the beneficial owners of PFIA LP. Phoenix Canada consistently reported the

purported open reverse repos as long bonds and the interest income as capital gains.

38. At no time did Taylor inform the Bank of Bermuda that Phoenix Canada was engaged in a trading strategy of repos and open reverse repos. Phoenix Canada submitted trade blotters, trial balances and net asset value calculations to the Bank of Bermuda which consistently reported the purported open reverse repos as long bonds. Because Phoenix Canada did not notify the Bank of Bermuda that the long bond position was a proxy for the purported open reverse repos, the Bank was able to agree the trades reflected on the trade blotters to third party trade confirms.

#### Suitability

39. The accumulation of the UST Notes contravened PFIA LP's investment objectives and restrictions and thus, the Notes were not a suitable investment for PFIA LP.

#### Lack of Supervision

40. Taylor failed to provide his operations staff with sufficient information to carry out their responsibilities as it related to the purported open reverse repos. Among other things, because Taylor failed to inform the Settlement Clerk that the long bond position was a proxy for the purported open reverse repos, she was able to agree the trades reflected on the trade blotters to trade confirms.

#### Taylor's Misconduct Relating to the Purported Open Reverse Repos

41. As the Director of Operations and then CFO of Phoenix Canada, Taylor:
  - (a) failed to ensure that the books, records and other documents necessary for the proper recording of Phoenix Canada's purported open reverse repo transactions were maintained;
  - (b) failed to establish and implement appropriate controls and procedures for the accurate capturing, recording, accounting and reporting of Phoenix Canada's purported open reverse repo transactions; and
  - (c) failed to adequately supervise Phoenix Canada's accounting and operations staff.
42. This settlement agreement relates only to Taylor's conduct and failures vis-à-vis Phoenix Canada's open reverse repo transactions. Staff is not impugning any other aspect of Phoenix Canada's trade capture and financial accounting systems.
43. Taylor informs Staff that he relied upon internal and external controls in place at Phoenix Canada to indicate whether there existed any deficiencies in its accounting and financial management systems. Taylor acknowledges that it was not sufficient to rely on such controls.

44. Taylor informs Staff that throughout 1996 to 1999, Phoenix Canada did not receive any internal control memorandum from its auditors.

45. Taylor's conduct was contrary to the public interest.

46. Taylor co-operated with Staff's investigation concerning the UST Notes.

#### IV. TERMS OF SETTLEMENT

47. Taylor agrees to the following terms of settlement:

(a) The making of an Order:

- (i) approving this Settlement Agreement;
- (ii) prohibiting Taylor from becoming or acting as a director or officer of any issuer for 2 years;
- (iii) reprimanding Taylor; and

(b) Taylor will take and complete successfully, within 2 years from the date of an Order approving this Settlement Agreement, the Partners, Directors and Seniors Officers Qualifying Examination prepared and conducted by the Canadian Securities Institute; and

(c) Taylor will make a payment by certified cheque to the Commission in the amount of \$7,500 respecting the costs of the Commission's investigation.

#### V. STAFF COMMITMENT

48. If this settlement is approved by the Commission, Staff will not initiate any other proceeding under the Act against Taylor respecting the facts set out in Part III of this Settlement Agreement.

#### VI. APPROVAL OF SETTLEMENT

49. Approval of the settlement set out in this Settlement Agreement shall be sought at the public hearing of the Commission scheduled for July 18, 2002, or such other date as may be agreed to by Staff and Taylor (the "Settlement Hearing"). Taylor will attend the Settlement Hearing in person.

50. Counsel for Staff or for Taylor may refer to any part, or all, of this Settlement Agreement at the Settlement Hearing. Staff and Taylor agree that this Settlement Agreement will constitute the entirety of the evidence to be submitted at the Settlement Hearing.

51. If this settlement is approved by the Commission, Taylor agrees to waive his rights to a full hearing, judicial review or appeal of the matter under the Act.

52. Staff and Taylor agree that if this settlement is approved by the Commission, they will not make any public statement inconsistent with this Settlement Agreement.
53. If, for any reason whatsoever, this settlement is not approved by the Commission, or an order in the form attached as Schedule "A" is not made by the Commission;
  - (a) this Settlement Agreement and its terms, including all discussions and negotiations between Staff and Taylor leading up to its presentation at the Settlement Hearing, shall be without prejudice to Staff and Taylor;
  - (b) Staff and Taylor shall be entitled to all available proceedings, remedies and challenges, including proceeding to a hearing of the allegations in the Notice of Hearing and Statement of Allegations of Staff, unaffected by this Settlement Agreement or the settlement discussions/negotiations;
  - (c) the terms of this Settlement Agreement will not be referred to in any subsequent proceeding, or disclosed to any person except with the written consent of Staff and Taylor, or as may be required by law; and
  - (d) Taylor agrees that he will not, in any proceeding, refer to or rely upon this Settlement Agreement, the settlement discussions/negotiations or the process of approval of this Settlement Agreement as the basis of any attack on the Commission's jurisdiction, alleged bias or appearance of bias, alleged unfairness or any other remedies or challenges that may otherwise be available.

#### VII. DISCLOSURE OF SETTLEMENT AGREEMENT

54. Subject to paragraph 50 above, this Settlement Agreement and its terms will be treated as confidential by Staff and Taylor until approved by the Commission, and forever if, for any reason whatsoever, this settlement is not approved by the Commission, except with the written consent of Staff and Taylor, or as may be required by law.
55. Any obligations of confidentiality shall terminate upon approval of this settlement by the Commission.

#### VIII. EXECUTION OF SETTLEMENT AGREEMENT

56. This Settlement Agreement may be signed in one or more counterparts which together shall constitute a binding agreement.
57. A facsimile copy of any signature shall be as effective as an original signature.

(John) Blair Taylor

Staff of The Ontario Securities Commission

Per: Michael Watson

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