

Re Canaccord Financial

IN THE MATTER OF:

**THE DEALER MEMBER RULES OF THE
INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA**

AND

**CANACCORD FINANCIAL LTD.
(FORMERLY CANACCORD CAPITAL CORPORATION)**

2009 IIROC 56

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

Heard: December 21, 2009 at Vancouver B.C.

Decision: January 15, 2010

(46 paras.)

Hearing Panel:

John Rogers (Chair), Brian Field, Chris Lay

Appearances:

Tamara Brooks, Enforcement Counsel, for the Investment Industry Regulatory Organization of Canada
Donald J. Sorochan, Q.C., Miller Thompson LLP, Barristers & Solicitors, for the Respondent

REASONS FOR DECISION

¶ 1 A hearing panel of the Investment Industry Regulatory Organization of Canada (“IIROC”) was convened on December 21, 2009 in accordance with Rule 15 of the IIROC Dealer Member Rules of Practice and Procedure to review a settlement agreement (“Settlement Agreement”) dated December 16, 2010 negotiated between the Enforcement Department of IIROC and Canaccord Financial Ltd. (“Respondent”) in accordance with Rule 20.35 of Part 10 of the IIROC Dealer Member Rules (the “Rules”) and Rule 15 of the Dealer Member Rules of Practice and Procedure. A copy of the Settlement Agreement is attached to this decision.

Preliminary Application

¶ 2 At the commencement of the Settlement Agreement Hearing, Enforcement Counsel advised the Hearing Panel that similar proceedings to the matter at hand were being conducted across Canada. She confirmed that these other hearings related to matters referred to in the Settlement Agreement, matters which most likely the Canadian financial press would find of interest. In an attempt to coordinate the release to the public of the decisions resulting from this Hearing and the other hearings, Enforcement Counsel requested that we defer any decision that we might make in this matter until 2:00 PM Vancouver time.

¶ 3 The Respondent consented to this approach.

¶ 4 Therefore, following the submissions of counsel, the Settlement Agreement Hearing was adjourned until 2:00 PM Vancouver time when we delivered the decision below set out.

Statement of Facts

¶ 5 The Settlement Agreement contains certain facts agreed to by IIROC and the Respondent for the purpose of the Settlement Agreement. A summary of these facts are set out below.

The Asset Backed Commercial Paper Market

The Security

¶ 6 During 2006 and 2007 the Respondent offered for sale to its clients a security known as Asset Backed Commercial Paper (“ABCP”). ABCP is a short-term debt instrument with typical maturities of 30 to 180 days, offering a yield slightly better than the yield offered on short-term government debt, and backed by a pool of long term underlying financial assets. The security offered by the Respondent was issued by a trust which was established by a sponsor. The sponsor of a particular trust selected the underlying assets for the trust, administered these assets, and arranged for the sale of the ABCP securities. The Canadian ABCP market included two categories of ABCP securities: bank-sponsored and non-bank-sponsored (“third party”).

¶ 7 The pool of underlying financial assets included traditional financial assets such as consumer loans, credit card receivables and residential mortgages; however the pool might also include non-traditional more complex synthetic assets with a different risk profile such as collateralized debt obligations. There was no disclosure of the specific assets in the pool of assets held by the trust, with, in most cases, the general asset classes being the only information publicly disclosed.

Liquidity Agreements

¶ 8 As the underlying assets supporting the trust had a long term maturity and the maturity of the ABCP securities had a short term maturity, maturing ABCP securities of a particular trust were financed by the issuance of new short term ABCP securities by that trust. To safeguard against difficulty in financing the redemption of the ABCP securities upon their maturity, the issuing trust entered into an agreement with a liquidity provider to provide back up credit lines under certain conditions. These conditions included the requirement that specified “general market disruption events” had occurred and a credit rating affirmation before liquidity would be provided.

¶ 9 These liquidity agreements were subject to confidentiality provisions prohibiting disclosure of many of their terms, including disclosure of the definition of the general market disruption event condition.

Dominion Bond Rating Services Limited

¶ 10 Dominion Bond Rating Services Limited (“DBRS”), an approved credit rating organization, was the sole credit rating organization which rated the ABCP securities sold to the Respondent’s clients. These ABCP securities received from DBRS the highest credit rating available, being R-1 (high), and this credit rating remained in place until August 13, 2007.

¶ 11 On January 19, 2007, DBRS announced changes to its rating methodology. These changes included a new set of requirements for liquidity agreements for ABCP securities for which a DBRS rating was being sought. These changes did not apply to the issuance by trusts of new ABCP securities to finance the redemption of DBRS rated ABCP securities issued prior to January 19, 2007.

ABCP Over-the-Counter Market

¶ 12 Third party ABCP securities were distributed to investors through a dealer syndicate. One member of the dealer syndicate was appointed as the lead dealer whose duties included the allocation of the ABCP securities to dealer syndicate members and, in consultation with the sponsor, setting the yield on the securities offered.

¶ 13 The third party ABCP securities traded in an over-the-counter dealer market which was not transparent to investors. Participating investors were, therefore, reliant mainly upon the dealer syndicate for information relating to issues such as pricing, market depth and market volume. The primary information that dealers disclosed to investors was the yield and credit rating of the third party ABCP securities traded in that market.

The Market Freeze

¶ 14 On August 13, 2007, a number of Canadian trusts which had previously issued ABCP securities were unable to sell new ABCP securities to fund the repayment of their previously issued and maturing ABCP securities. In addition, many of the liquidity providers did not agree that the conditions for liquidity funding had occurred and refused to provide liquidity to fund this repayment.

Remedial Action

¶ 15 As a result of this market freeze, on August 16, 2007 a consortium representing banks, asset providers and major holders of ABCP securities agreed to take steps to establish normal operations in the ABCP market (the “Montreal Proposal”). Subsequently, a Pan-Canadian Investors Committee, including parties to the Montreal Proposal and other significant holders of ABCP securities, put forward a Plan of Compromise and Arrangement (the “Plan”). The Plan as eventually implemented on January 21, 2009 led to the exchanging of short term ABCP securities for ABCP securities of a longer term more closely matching the maturity dates of the underlying financial assets securing the ABCP securities.

The Respondent’s Involvement in the ABCP Market

¶ 16 The Respondent was a secondary dealer in both bank sponsored and third party ABCP securities. The Respondent relied primarily on another Member firm who was the lead dealer for the majority of the third party ABCP securities traded by the Respondent. As well, the Respondent was the carrying broker for a Member firm who also sold third party ABCP securities to its retail clients.

¶ 17 By August 2007, the Respondent’s retail clients represented approximately 11% of the retail holdings of third party ABCP securities in Canada.

¶ 18 In about 1998, the Respondent’s executive committee established the Respondent’s general criteria for the Respondent’s retail offerings of fixed income products. These criteria included the provision that such offerings be restricted to those fixed income products which carried a DBRS rating of R-1 (high). The bank sponsored and third party ABCP securities met this restriction.

Lack of Adequate Due Diligence

¶ 19 In the Settlement Agreement, the Respondent acknowledges that it did not perform adequate due diligence on the ABCP securities in which it traded. It relied primarily on the credit rating provided by DBRS and secondarily on corroborating information from the other Member firm who was the lead dealer for the majority of the third party ABCP securities supplied to the Respondent.

¶ 20 Specifically, the Respondent acknowledges that:

1. It did not learn and remain informed of the complexities of the ABCP securities and the consequent systemic risks arising from the manner in which the securities were rated by DBRS and the counterparty risks arising from the liquidity agreements;
2. It did not differentiate between bank sponsored ABCP securities and third party ABCP securities;
3. As the third-party ABCP securities met the executive committee’s basic criteria of the R-1 (high) rating by DBRS, they automatically became part of the Respondent’s pool of fixed income product offerings without further due diligence; and
4. It did not take steps to adequately ensure that its approved persons involved in the sale and distribution of third party ABCP securities to retail clients were trained in and understood the complexities of the ABCP product and the consequent risks related to these securities to make proper decisions involving suitability.

¶ 21 Consequently, without a full understanding of the ABCP securities being offered, the Respondent’s retail advisors were representing the ABCP securities to their clients as interest-rate sensitive investments with a credit rating identical to a government Treasury Bill, and as an alternative to a Guaranteed Investment Certificate or a term deposit.

The Respondent's Remedial Actions

¶ 22 Following the market freeze on August 13, 2007, the Respondent made significant efforts to assist its clients. The Settlement Agreement acknowledges that:

1. From the time of the market freeze, the Respondent assisted clients suffering hardship because their holdings of ABCP securities were frozen;
2. As a party to the Montreal Proposal and as a participant in the Pan-Canadian Investors Committee, it provided both financial and leadership support;
3. Complementary to and in support of the Plan of Compromise and Arrangement, the Respondent established the Canaccord Relief Program to assist eligible clients, paying out a total of \$152.2 million under this program in addition to unpaid interest and restructuring costs; and
4. For clients who were not eligible for the Canaccord Relief Program, the Respondent has made offers to assist them, substantially all of which offers have been accepted by such clients.

Contraventions

¶ 23 The Settlement Agreement contains the Respondent's admission that contrary to IIROC Dealer Member Rule 1300.1(a), in or about 2006 and 2007 it did not take adequate steps to ensure that its sales staff understood the complexities of the third party ABCP securities it offered for sale to retail clients and the consequent risks (including systemic risks and counterparty risks) related to these securities, and, in not taking these steps, it did not ensure that the purchase of third party ABCP securities was properly understood by its clients.

Terms of Settlement

¶ 24 In the Settlement Agreement, IIROC and the Respondent agree to the following terms of settlement:

1. That the Respondent will pay a fine in the amount of \$3,100,000 (inclusive of costs); and
2. That the Respondent will have an outside consultant undertake a compliance review of the Respondent's product due diligence practices insofar as such practices relate to the fixed income business of the Respondent, with the goal of this review to be remedial and preventive.

¶ 25 The complete terms of reference for the compliance review agreed to by the Respondent, together with the consultant's reporting obligations and the terms of the consultant's retainer, are more particularly set out in Schedule A of the Settlement Agreement.

¶ 26 Although not referred to in the Settlement Agreement, the parties confirmed at the Settlement Agreement Hearing that if the Settlement Agreement were accepted by the Hearing Panel, that the fine and costs agreed to by the Respondent were to be payable immediately.

Staff Commitment

¶ 27 The Settlement Agreement provides that if this Hearing Panel accepts the Settlement Agreement, that IIROC Enforcement Staff will not commence any proceeding under the Rules against the Respondent or any of its affiliates or their respective present or former directors, officers, employees or agents in relation to the facts set out in the Settlement Agreement.

¶ 28 This provision is also stated in the Settlement Agreement to bind the Ontario Securities Commission and Autorité des marchés financiers to prevent the commencement of any proceeding under their applicable legislation and rules.

¶ 29 The Hearing Panel was advised by Enforcement Counsel that although not referred to in the Settlement Agreement, that the British Columbia Securities Commission has, as well, agreed to be bound by this provision.

Decision

¶ 30 The Hearing Panel accepts the Settlement Agreement.

Reasons

¶ 31 Rule 20.36 empowers a Hearing Panel upon the conclusion of a settlement agreement hearing to either accept or reject the settlement agreement under consideration. Neither in Rule 20.36 nor elsewhere in the Rules is there guidance for what criteria a Hearing Panel should use in making this decision.

Appropriateness of Penalty

¶ 32 Past decisions of Hearing Panels determining whether or not to accept a settlement agreement are of assistance. In *Milewski* [1999] I.D.A.C.D. No. 17, Bulletin No. 2605, August 5, 1999, and *Clark* [1999] I.D.A.C.D. No. 40, Bulletin No. 2674, December 14, 1999 the test for a Hearing Panel to use in determining whether or not to accept a settlement agreement was defined as whether or not the settlement agreement reached between the respondent and IIROC Enforcement Staff includes a penalty which clearly falls outside a “reasonable range of appropriateness”. If in the opinion of the Hearing Panel the penalty falls outside this reasonable range, the Hearing Panel should not accept the settlement agreement. Otherwise it should do so. The rationale behind this approach is that a Hearing Panel should be cognizant of the settlement process and should not interfere in a negotiated settlement by attempting to substitute its discretion for that of the parties.

¶ 33 Further assistance as to what factors should be considered by a Hearing Panel in determining whether or not to accept that a settlement agreement containing an appropriate penalty was provided in *Derivative Services Inc.*, [2000] I.D.A.C.D. No. 26 at page 3. The decision lists five considerations of which a Hearing Panel should be cognizant in determining an appropriate penalty. These considerations are:

1. Protection of the investing public;
2. Protection of the IIROC membership;
3. Protection of the integrity of the IIROC hearing process;
4. Protection of the integrity of the securities markets; and
5. Prevention of a repetition of the conduct leading to the penalty.

¶ 34 The terms of settlement in the Settlement Agreement contain two elements – a monetary fine and an agreement to have an outside consultant conduct a compliance review. To deal firstly with the compliance review.

Compliance Review

¶ 35 The Respondent relied on the DBRS R-1 (high) rating as the sole and “automatic” criterion for including the ABCP securities as part of the Respondent’s pool of fixed income product offerings. In taking this approach, as Counsel for the Respondent candidly acknowledges, the Respondent “did not know what it did not know”.

¶ 36 The Respondent did not perform its own due diligence on the ABCP securities it offered to its clients in order to learn and remain informed about the complexities of the security. It did not properly understand the manner in which DBRS had rated the ABCP security or the risks involved if the liquidity providers failed to meet their contractual commitments or, indeed, the possibility of them failing to do so. Although the confidentiality restrictions governing the liquidity agreements might have prevented the Respondent from finding out these and other factors as part of a due diligence program, the Respondent did not attempt such a program. .

¶ 37 For product knowledge, the Respondent relied primarily on the credit rating provided by DBRS and secondarily on the corroborating information from the broker leading the syndicate. A situation the Respondent acknowledges in the Settlement Agreement was insufficient and which it has since taken steps to remedy.

¶ 38 Nor did the Respondent make an adequate effort to ensure that its approved persons understood and conveyed to their clients the complexities of the ABCP securities, the lack of transparency surrounding these financial products, and the consequent risks from purchasing these products.

¶ 39 We were advised by Respondent's Counsel that following the market freeze on August 13, 2007, the Respondent commenced and has followed through with changes to its due diligence program for its fixed income product offerings. These changes were undertaken to ensure that the new due diligence program is in compliance with appropriate regulatory standards for such practices and their implementation by secondary market dealers in Canada and the IIROC notice 09-0087 entitled Best Practices for Product Due Diligence.

¶ 40 The Settlement Agreement provides that this new due diligence program introduced by the Respondent will be reviewed by an outside consultant. This review will include an examination of the provisions in the program that relate to the Respondent's training of the Respondent's staff concerning fixed income securities and the Respondent's procedures regarding staff compliance with these changes. The consultant will report results of this review to both the Respondent and to IIROC.

¶ 41 We believe that this compliance review will confirm the effectiveness of the remedial actions undertaken by the Respondent and will deal with the concerns in regard to prevention and protection as set out in *Derivative Securities*. It is, therefore, clearly within the range of an appropriate penalty in accordance with *Milewski*.

Monetary Fine

¶ 42 In attempting to determine the reasonable range of appropriateness of the monetary fine, we are faced with a paucity of criteria against which to compare the fine negotiated by the parties.

¶ 43 There is reference to the fact that in August of 2007, the Respondent's clients represented approximately 11% of the retail holdings of third-party ABCP in Canada, but there is no indication of the total amount of these holdings.

¶ 44 The Settlement Agreement itself does not enumerate the criteria used by the parties in arriving at the fine inclusive of costs of \$3,100,000.

¶ 45 With respect to mitigating circumstances, we note:

1. The Respondent's role in the ABCP securities market was restricted to that of a secondary dealer relying on another Member firm to act as lead dealer;
2. From the commencement of the market freeze on August 13, 2007, Respondent made significant efforts to assist its clients and was an active participant in the Pan-Canadian Investors Committee providing both financial and leadership support;
3. Complementary to and in support of the Plan of Compromise and Arrangement, the Respondent established the Canaccord Relief Program to assist eligible clients, paying \$152.2 million under this program together with unpaid interest and restructuring costs;
4. For clients who were not eligible clients under the Canaccord Relief Program, the Respondent has made them offers, substantially all of which offers have been accepted by these non-eligible clients; and
5. The submission by IIROC Enforcement Counsel that the Respondent from the beginning of the market freeze accepted full responsibility and cooperated fully with IIROC officials and Enforcement Staff.

¶ 46 Based upon the above, it is obvious that the Respondent took immediate steps to assist its clients affected by the ABCP market freeze cooperating fully with IIROC officials and Enforcement Staff to work through what became a very difficult and financially challenging process. We see no reason to question the amount of the fine arrived at by the parties and find the amount arrived at by them within a reasonable range of appropriateness.

Dated at Vancouver, British Columbia, this 15th day of January, 2010.

John Rogers, Chair

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SETTLEMENT AGREEMENT

I. INTRODUCTION

1. The Enforcement Department Staff (“Staff”) of the Investment Industry Regulatory Organization of Canada (“IIROC”) has conducted an investigation (“the Investigation”) into the conduct of Canaccord Financial Ltd. (“the Respondent”).
2. The Investigation was commenced by Enforcement Department Staff (“IDA Staff”) of the Investment Dealers Association of Canada (“IDA”) prior to May 30, 2008. On June 1, 2008, IIROC consolidated the regulatory and enforcement functions of the Investment Dealers Association of Canada and Market Regulation Services Inc. Pursuant to the *Administrative and Regulatory Services Agreement* between IDA and IIROC, effective June 1, 2008, the IDA has retained IIROC to provide services for IDA to carry out its regulatory functions.
3. On or about December 1, 2009, Canaccord Capital Corporation changed its name to Canaccord Financial Ltd.
4. The Investigation discloses matters for which the Respondent may be disciplined by a hearing panel appointed pursuant to IIROC Transitional Rule No.1, Schedule C.1, Part C (“the Hearing Panel”).

II. Joint Settlement Recommendation

5. The Respondent consents to be subject to the jurisdiction of IIROC.
6. Staff and the Respondent consent and agree to the settlement of these matters by way of this settlement agreement (“the Settlement Agreement”) in accordance with IIROC Dealer Member Rules 20.35 to 20.40, inclusive and Rule 15 of the Dealer Member Rules of Practice and Procedure.
7. The Settlement Agreement is subject to acceptance by the Hearing Panel.
8. The Settlement Agreement shall become effective and binding upon the Respondent and Staff as of the date of its acceptance by the Hearing Panel.
9. The Settlement Agreement will be presented to the Hearing Panel at a hearing (“the Settlement Hearing”) for approval. Following the conclusion of the Settlement Hearing, the Hearing Panel may either accept or reject the Settlement Agreement.
10. If the Hearing Panel accepts the Settlement Agreement, the Respondent waives its right under IIROC rules and any applicable legislation to a disciplinary hearing, review or appeal.
11. If the Hearing Panel rejects the Settlement Agreement, Staff and the Respondent may enter into another settlement agreement; or Staff may proceed to a disciplinary hearing in relation to the matters disclosed in the Investigation.
12. The Settlement Agreement will become available to the public upon its acceptance by the Hearing Panel.
13. Staff and the Respondent agree that if the Hearing Panel accepts the Settlement Agreement, they, or anyone on their behalf, will not make any public statements inconsistent with the Settlement Agreement.
14. Staff and the Respondent jointly recommend that the Hearing Panel accept the Settlement Agreement.

III. Statement of Facts

(i) Acknowledgment

15. Staff and the Respondent agree with the facts set out in this Section III and acknowledge that the terms of the settlement contained in this Settlement Agreement are based upon those specific facts.

(ii) Factual Background

ASSET-BACKED COMMERCIAL PAPER (“ABCP”)

16. ABCP is a short-term debt instrument with typical maturities of 30 to 180 days. ABCP is backed by a pool of underlying assets and offers a yield slightly better than the yield offered on short-term government debt.
17. ABCP is issued by a special purpose vehicle (also referred to as a conduit). In Canada, the conduits are trusts established by sponsors. Sponsors generally select underlying assets, administer the assets and arrange for the sale of the ABCP notes. The Canadian ABCP market included two categories: bank-sponsored and non-bank-sponsored (or third party) ABCP.
18. As the underlying assets were long term and the ABCP notes were short term, there was a timing mismatch between the cash flowing from the assets and the cash needed to repay maturing ABCP. For many years, conduits met their obligations by selling newly issued ABCP, the proceeds of which were used to pay maturing ABCP. The liquidity of ABCP was an important characteristic for investors.
19. To safeguard against difficulty meeting maturity obligations, conduits entered into agreements with liquidity providers which provided credit lines under certain conditions. In general, there were two types of liquidity facilities: (1) general market disruption (“GMD”) and (2) global-style. GMD liquidity was also called “Canadian-style” since it was only used in the Canadian ABCP market. Unlike global-style liquidity facilities, Canadian-style liquidity facilities required specified “general market disruption” events and a credit rating affirmation before liquidity was provided.
20. Liquidity agreements were subject to confidentiality provisions. Many details of the pre-conditions required for liquidity support, including the definition of a “general market disruption event”, were not known to the public, to investors or to the distributors of ABCP who were not also liquidity providers. Conduits generally disclosed only the existence of their liquidity arrangements and disclosed that there were pre-conditions to draws.
21. As of September 2005, ABCP distributed in Canada was prospectus-exempt under the short-term debt exemption in section 2.35 of National Instrument 45-106 – *Prospectus and Registration Exemptions*, which provided an exemption for commercial paper with an approved credit rating from an approved credit rating organization.
22. Dominion Bond Rating Services Limited (“DBRS”), an approved credit rating organization, was the sole credit rating organization which rated third-party ABCP in Canada.
23. On January 19, 2007, DBRS announced changes to its rating methodology for certain new transactions entered into by ABCP issuers. The DBRS press release set out specific new rating criteria, including a requirement for global-style liquidity. These rating criteria were only applied prospectively in the marketplace.

THIRD-PARTY ABCP

24. ABCP has been in the Canadian marketplace for over a decade, and non-bank sponsors entered the marketplace in approximately 2000.
25. Historically, the assets underlying ABCP consisted of traditional assets such as consumer loans, credit card receivables and residential mortgages. Non-traditional complex synthetic assets, such as collateralized debt obligations, came into these structures over time.
26. Third-party ABCP was typically issued by a series of notes, the most common being Series “A” Notes and Series “E” Notes. The “A” Notes were supported by the Canadian-style liquidity facilities. “E” Notes were not, but could be extended up to 364 days after the original maturity date if certain

conditions were met, including that market conditions did not allow for “E” Notes to be sold at a specified spread.

27. The sponsors provided limited information regarding the underlying pool of assets in conduits issuing ABCP. Sponsors typically provided an information memorandum describing the basic elements of ABCP. In most cases, the general asset classes were the only information publicly disclosed; there was no disclosure of the specific assets.

COVENTREE INC.

28. At all material times, Coventree Inc. was the largest sponsor of third-party ABCP in Canada. Coventree Inc. also issued third-party ABCP through a subsidiary, Nereus Financial Inc. (“Nereus”).
29. At all material times, Coventree Inc. and Nereus (collectively, “Coventree”) sponsored the following third-party ABCP conduits: Apollo Trust, Aurora Trust, Comet Trust, Gemini Trust, Planet Trust, Rocket Trust, Slate Trust, Venus Trust, Structured Investment Trust III and Structured Asset Trust.
30. All Coventree conduits but one received an R-1 (high) rating (the highest credit rating available, equivalent to a “AAA” for long term debt) by DBRS, as did other Canadian third-party ABCP. This rating remained in place at all material times up to and including August 13, 2007.

THE DISTRIBUTION OF THIRD-PARTY ABCP

31. In general, third-party ABCP was distributed to investors through a dealer group (the “dealer syndicate”). Typically, one member of the dealer syndicate would be appointed as lead dealer. Some of the lead dealer’s daily duties included the allocation of ABCP notes to dealer syndicate members and setting the yield in consultation with the conduit sponsor.
32. The dealer syndicate members maintained trading lines, up to a credit limit, for third-party ABCP mainly to provide a market-making function. Dealer syndicate members would typically purchase third-party ABCP that was not sold at the end of a trading day. These positions were to be held on a short-term basis, typically overnight, until the notes could be sold to investors. Dealer syndicate members also purchased third-party ABCP from clients in the secondary market. While the dealer syndicate was under no obligation to purchase any third-party ABCP, they did so to provide a secondary market, maintain liquidity in the market and/or as a service to their clients. Dealer syndicate members other than the lead dealer also had the option to turn back ABCP to the lead dealer if they were unable to sell their daily allocation, but this was not their ordinary practice.
33. Third-party ABCP traded in a dealer market, also known as an over-the-counter (“OTC”) market. Unlike an auction market or exchange, the OTC market was not transparent to investors. As such, investors relied mainly upon the dealer syndicate for information relating to issues such as pricing, market depth and market volume.
34. The primary information that dealers disclosed to investors was the yield and credit rating of third-party ABCP.

THE MARKET FREEZE

35. On August 13, 2007, a number of Canadian third-party ABCP conduits including the Coventree conduits were unable to sell new ABCP to fund the repayment of maturing ABCP. Many of the conduits’ liquidity providers did not agree that the conditions for liquidity funding had occurred and refused to provide liquidity to the affected conduits.
36. As of August 13, 2007, the third-party ABCP market totaled approximately \$35 billion, with Coventree conduits representing approximately 46 percent of the value of the third-party ABCP market.
37. On August 16, 2007, a consortium representing banks, asset providers and major ABCP holders agreed to take steps to establish normal operations in the ABCP market. This agreement was known as the Montreal Proposal.

38. A Pan-Canadian Investors Committee, including investors who were signatories to the Montreal Proposal plus other significant holders, was established to oversee the restructuring of third-party ABCP. It put forward the Plan of Compromise and Arrangement (the “Plan”), which was implemented on January 21, 2009.
39. Pursuant to the Plan, holders of the eligible third-party ABCP had their short-term notes exchanged for longer term notes to match more closely the maturity dates of the underlying assets.

THE RESPONDENT’S OFFERING OF THIRD-PARTY ABCP

40. By August 2007, the Respondent’s retail clients represented approximately 11% of the retail holdings of third-party ABCP in Canada.
41. The Respondent was a secondary dealer in both bank-sponsored and third-party ABCP. The Respondent relied primarily upon another Member firm who was the lead dealer for the majority of the third-party ABCP supplied to the Respondent. In addition, the Respondent was the carrying broker for another Member firm that also sold third-party ABCP to its retail clients.
42. Approximately 80% of the third-party ABCP sold by the Respondent to its retail clients was Structured Investment Trust III (“SIT III”).
43. The Respondent’s criteria for approving fixed-income products in general was set out in or around 1998 by its executive committee. This committee, consisting of senior management including the CEO, restricted the Respondent’s retail offerings of fixed income products to those that were either rated R-1 (high) by DBRS Ltd (or an equivalent rating by another rating agency) or banker’s acceptances rated “AA” or better. Fixed-income products rated R-1 (high) included bank-sponsored ABCP, third-party ABCP and government bonds.
44. Since the third-party ABCP products selected by the Respondent met the executive committee’s basic criteria of R-1 (high) rating, they automatically became part of the Respondent’s pool of fixed-income product offerings.

PRODUCT KNOWLEDGE

45. The Respondent did not perform adequate due diligence on bank-sponsored and third-party ABCP in order to learn and remain informed about the complexities of the ABCP product and the consequent risks (including systemic risks and counterparty risks) related to the product. The Respondent relied primarily on the credit rating provided by DBRS and secondarily relied upon corroborating information from the other Member firm who was the lead dealer for the majority of the third-party ABCP supplied to the Respondent. The Respondent did not differentiate between bank-sponsored and third-party ABCP since all relevant information available to the Respondent was virtually identical – liquidity structures, ratings, selling process, yields and pricing. So long as third-party ABCP met the minimum credit rating threshold, the Respondent’s bond desk (“bond desk”) was permitted to include third-party ABCP as part of its fixed-income offerings to retail clients.
46. The bond desk did not conduct any meaningful review of the complexities of the ABCP product and the consequent risks (including systemic risks and counterparty risks) related to the product. The bond desk placed third-party ABCP as a product on the Respondent’s fixed-income offering sheet, providing only basic information about the credit rating, terms and return. The Respondent regularly circulated this offering sheet to its retail advisors. The Respondent also circulated DBRS rating reports that included a securitization report.
47. The Respondent did not take steps to adequately ensure its approved persons, including bond desk traders and retail advisors, involved in the sale and distribution of third-party ABCP to retail clients understood the complexities of the ABCP product and the consequent risks related to the product including but not limited to the following:

- The basic structure of ABCP and the roles of the various entities (Canadian and international banks, sponsors, issuer, trustee, asset providers);
 - The nature and composition of the underlying assets;
 - The lack of transparency relating to the providers of underlying assets;
 - The nature and limitations of the liquidity facilities;
 - The new ratings methodologies of DBRS and the fact that they were applied only prospectively; and
 - The lack of transparency relating to the identity of the liquidity providers.
48. Any queries about bank-sponsored and third-party ABCP from the Respondent's retail advisors or the Member firm with which it held a carrying broker arrangement were directed to the Respondent's bond desk. The bond desk in turn relied on answers it received from the lead dealer to respond to inquiries. The bond desk acted as a flow-through for information from the lead dealer and as such, it was overly reliant on that information and the DBRS rating.
49. The Respondent provided training to Approved Persons on matters generally restricted to the technical and mechanical aspects of trading these products. The information provided was insufficient given the complexities of the ABCP product and the consequent risks (including systemic risks and counterparty risks) related to the product.
50. Staff interviewed several of the Respondent's retail advisors who revealed that, except for basic information relating to term, return and rating, they knew very little about the complexities of the ABCP product and the consequent risks (including systemic risks and counterparty risks) related to the product. These advisors knew nothing about the issuer, the role of the issuer, the composition and structure of the product and its evolving characteristics. Consequently, advisors based suitability decisions on the rating, return and term of the product as well as any information they received from the bond desk.
51. The Respondent did not take steps to adequately ensure that its sales staff, including retail advisors, understood and appreciated the qualitative differences between the bank-sponsored and third-party ABCP and the other fixed income products it made available for sale to retail clients particularly as it related to the complexities of the ABCP product and the consequent risks (including systemic risks and counterparty risks) related to the product.
52. Without a full understanding of the complexities of the ABCP product and the consequent risks (including systemic risks and counterparty risks) related to the product, retail advisors were representing the product to their clients as an interest-rate sensitive investment with a credit rating identical to a government Treasury Bill, and as an alternative to a Guaranteed Investment Certificate or a term deposit.

CONTRAVENTION

53. In or about 2006 and 2007, the Respondent did not take steps to adequately ensure its sales staff understood the complexities of the third-party ABCP product it offered for sale to retail clients and the consequent risks (including systemic risks and counterparty risks) related to the product and, in not taking these adequate steps, did not ensure that the purchase of third-party ABCP was appropriately understood by its clients, contrary to Regulation 1300.1(a).

ADDITIONAL FACTORS

54. The Respondent made significant efforts to assist its clients after the market freeze. It was a party to the Montreal Proposal and, as a participant to the Pan-Canadian Investors Committee, provided both financial and leadership support.
55. Complementary to and in support of the Plan of Compromise and Arrangement, the Respondent established the Canaccord Relief Program to assist eligible clients. The total amount paid to eligible

clients under this program was \$152.2 million plus any unpaid interest and restructuring costs.

56. From the time of the market freeze, the Respondent also assisted clients suffering hardship because of their frozen ABCP holdings. Further, the Respondent has made offers to all its clients who are not eligible clients under the Canaccord Relief Program. Substantially all of these offers have been accepted by the clients.

VI. TERMS OF SETTLEMENT

57. IIROC and the Respondent agree to the following terms of settlement:

- (i) A fine in the amount of \$3,100,000 (inclusive of costs);
- (ii) The Respondent agrees to undertake a compliance review by an outside Consultant, as detailed in Schedule A.

VII. STAFF COMMITMENT

58. If the Hearing Panel approves this Settlement Agreement, Staff, the Ontario Securities Commission and Autorité des marchés financiers will not commence any proceeding under applicable legislation and rules against the Respondent or any of its affiliates or their respective present or former directors, officers, employees or agents in relation to the facts set out in Part III of this Settlement Agreement.

AGREED TO by the Respondent at the City of Vancouver in the Province of British Columbia, this 16th day of December, 2009.

“Witness signature”

Witness

“Martin L. MacLachlan”

Respondent

MARTIN L. MACLACHLAN

AGREED TO by Staff at the City of Toronto in the Province of Ontario, this 17th day of December, 2009.

“Witness signature”

Witness

“Tamara Brooks”

Tamara Brooks

Enforcement Counsel on behalf of Staff of the
Investment Industry Regulatory Organization of
Canada

“Witness signature”

Witness

“Elsa Renzella”

Elsa Renzella

Enforcement Counsel on behalf of Staff of the
Investment Industry Regulatory Organization of
Canada

ACCEPTED at the City of Vancouver in the Province of British Columbia, this 21st day of December, 2009, by the following Hearing Panel:

Per: “John Rogers”

Panel Chair

Per: “Chris Lay”

Panel Member

Per: “Brian Field”
Panel Member

SCHEDULE “A” – TERMS OF REFERENCE FOR COMPLIANCE REVIEW

A. Retention of the Consultant

Canaccord Financial Ltd. (the “Respondent”) agrees to retain a third-party independent Consultant to carry out a review and report concerning the Respondent’s due diligence practices and procedures relating to fixed income securities, subject to the terms set out below.

B. Terms of Reference for Engagement of the Consultant

1. The agreement with the Consultant (“Agreement”) shall provide that the Consultant will conduct a review of the current state of the Respondent’s product due diligence practices insofar as they relate to the fixed income business in the context of appropriate regulatory standards for such practices and their implementation by secondary market dealers in Canada and the IIROC notice 09-0087 entitled Best Practices for Product Due Diligence. The goal of the review is remedial and preventative.
2. The agreement with the Consultant (“Agreement”) shall provide that the Consultant examine the policies, procedures and effectiveness of the current state of the Respondent’s practices outlined in B(1) above insofar as they relate to:
 - a) The Respondent’s oversight of sales with respect to fixed income securities made available to clients pursuant to Dealer Member Rule 1300.1 and Dealer Member Rule 2500;
 - b) Any committees or other mechanisms established to review and approve new fixed income securities products made available to clients and changes to those securities and products;
 - c) The training of the Respondent’s staff concerning fixed income securities; and
 - d) The Respondent’s procedures regarding staff compliance with the foregoing.

(collectively the “Review”)

C. The Consultant's Reporting Obligations

1. The Consultant shall issue a draft report to the Respondent and IIROC within three months of appointment and in that regard will be provided the opportunity to present its report to the Board of Directors of the Respondent.
2. The Consultant shall engage with the Respondent in discussions regarding the draft report with a view to reaching consensus and finalizing the report within one month of the delivery of the draft report. If requested by the Consultant, the Consultant will be provided with an opportunity to present its final report to the Board of Directors of the Respondent and to explain any areas of disagreement with management of the Respondent.
3. The Consultant will deliver the final report to the Respondent and to IIROC.
4. The Consultant's draft and final reports shall include a description of the review performed, the conclusions reached, and the Consultant's recommendations for any changes or improvements to the Respondent's policies and procedures as the Consultant reasonably deems necessary to conform to regulatory requirements set out in Dealer Member Rule 1300.1, Dealer Member Rule 2500, and the IIROC notice 09-0087 entitled Best Practices for Product Due Diligence applicable to the subject matter of the Review in Section B(1) above.
5. The Respondent will, within 60 days after receipt of the Consultant’s report, advise IIROC of a

timetable to implement the recommendations contained in the report; however, in the event the Respondent disagrees with any of the recommendations, the Respondent shall so advise IIROC and provide its reasons for such position and, if applicable, any alternative actions, policies or procedures the Respondent intends to adopt.

6. Promptly following the implementation of those recommendations of the Consultant with which it did not disagree, the Respondent shall certify to IIROC, by certificate executed on its behalf by each of the President, the UDP and the CCO of the Respondent, that the Respondent has so implemented them.
7. For greater certainty, the terms of the Review do not limit in any respect the authority of IIROC to undertake, as part of their normal course audit activities, a review of all matters within the scope of the Review or any other aspect of the business of the Respondent.

D. Terms of the Consultant's Retention

1. The selection of the Consultant shall be made promptly following the approval of the Settlement Agreement, but in any event by no later than January 31, 2010, by mutual agreement between the Respondent and IIROC.
2. The Consultant shall enter into a confidentiality and non-disclosure agreement satisfactory to the Consultant, the Respondent and IIROC (all acting reasonably), and the Consultant shall then have reasonable access to all of the Respondent's books and records which reasonably relate to the scope of the Review and the ability to meet privately with the Respondent's personnel who are reasonably relevant to the Review. The Respondent shall instruct and otherwise encourage its officers, directors, and employees to cooperate fully with the Review conducted by the Consultant, and inform its officers, directors, and employees that failure to cooperate with the Review may be grounds for disciplinary action.
3. The Consultant shall have the right, as reasonable and necessary in his or her judgment, to retain, at the Respondent's expense, lawyers, accountants, and other persons or firms, other than officers, directors, or employees of the Respondent, to assist in the discharge of the Consultant's obligations. The Respondent shall pay all reasonable fees and expenses (as reasonably documented) of any persons or firms retained by the Consultant.
4. The Consultant shall make and keep notes of interviews conducted, and keep a copy of documents gathered, in connection with the performance of his or her responsibilities.
5. The Consultant's reasonable compensation and expenses shall be borne exclusively by the Respondent.

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