



**Mutual Fund Dealers Association of Canada**  
Association canadienne des courtiers de fonds mutuels

**IN THE MATTER OF A DISCIPLINARY HEARING  
PURSUANT TO SECTIONS 20 AND 24 OF BY-LAW NO. 1  
OF THE MUTUAL FUND DEALERS ASSOCIATION OF CANADA**

**Re: Farm Mutual Financial Services Inc.**

Heard: December 10, 2008  
Toronto, Ontario

**REASONS FOR DECISION**

Hearing Panel of the Central Regional Council:

Thomas J. Lockwood, Q.C.	Chair
Sandy Grant	Industry Representative
Guenther Kleberg	Industry Representative

Appearances:

Michelle Pong	)	for Mutual Fund Dealers Association
Charles Toth	)	of Canada

No one appearing for the Receiver of Farm Mutual Financial Services Inc.

## **Allegations**

1. By Notice of Hearing, dated June 2, 2008, the following allegations were made against Farm Mutual Financial Services Inc. (“Respondent”):

**Allegation #1:** Between June 2003 and April 2007, the Respondent approved and allowed the sale of debentures (the “Debentures”) issued by FactorCorp Financial Inc. (“FactorCorp”) to approximately 680 of the Respondent’s clients without having conducted reasonable due diligence on the product and without having made reasonable inquiries to determine whether the product was suitable for sale to its clients, contrary to MFDA Rule 2.2.1(a), (b), (c) and (d) and MFDA Rule 2.1.1(c).

**Allegation #2:** Between June 2003 and April 2007, the Respondent approved and allowed the sale of the Debentures to approximately 680 of its clients without ensuring that:

- a) the investments were suitable for the clients and in keeping with the clients’ investment objectives, contrary to MFDA Rule 2.2.1(a), (b), ( c ) and (d) and MFDA Rule 2.1.1(c); and
- b) the clients qualified as accredited investors in accordance with Ontario Securities Commission Rule 45-501 and subsequently National Instrument 45-106, contrary to MFDA Rule 2.1.1(c), thereby engaging the jurisdiction of the Hearing Panel to impose a penalty on the Respondent pursuant to s. 24.1.2(n) of MFDA By-Law No. 1.

**Allegation #3:** Between June 2003 and September 2006, the Respondent failed to ensure that all sales of the Debentures to its clients were properly conducted through the facilities of the Respondent, contrary to MFDA Rule 1.1.1(a).

**Allegation #4:** Between June 2003 and April 2007, the Respondent failed to establish, implement and maintain policies and procedures to adequately and effectively supervise the sale of the Debentures to its clients, contrary to MFDA

Rules 2.5.1 and 2.1.1(c) and MFDA Policy No. 2.

**Allegation #5:** Commencing December 2003, the Respondent failed to establish, implement and maintain an adequate two-tier structure to supervise client account activity, and in particular failed to perform daily head office suitability reviews of trades conducted by its Approved Persons and/or failed to maintain evidence of such reviews, contrary to MFDA Rule 2.5.1 and Policy 2.

**Allegation #6:** Between May 2002 and May 2007, the Respondent failed to maintain adequate compliance staff to monitor adherence by the Member, and any person conducting business on account of the Member, to MFDA Rules, By-laws and Policies and applicable securities legislation requirements, contrary to MFDA Rule 2.5.1 and MFDA Rule 2.5.2(b).

### **Service**

2. On June 2, 2008, the Respondent was served with the Notice of Hearing in accordance with Rule 4.2(1)(c) of the MFDA Rules of Procedure.

### **History of Proceedings**

3. On June 27, 2008, the First Appearance took place, via teleconference, before the Hearing Panel.

4. At the First Appearance, counsel advised the Hearing Panel that the Respondent wished to bring a pre-Hearing Motion seeking an Order that the MFDA does not have jurisdiction to proceed against the Respondent in relation to Allegations #1, #2, #3 and #4, set out in the Notice of Hearing, on the basis that the Allegations “relate to activity carried out by the Respondent under its Limited Market Dealer Registration with the Ontario Securities Commission (“OSC”), a category of registration over which the MFDA does not have jurisdiction.”

5. On June 27, 2008, after hearing submissions from the parties, the Hearing Panel

set September 9, 2008 as the date for the pre-Hearing Motion. Dates were established for the serving and filing by the parties of their respective Motion materials.

6. The Hearing Panel also scheduled the Hearing on the Merits to take place on December 8, 9 and 10, 2008, and made certain incidental Orders for the serving and filing of materials in respect of the Allegations which were not the subject matter of the pre-Hearing Motion.

7. By letter, dated August 6, 2008, the Respondent informed the MFDA that it intended to resign its Membership in the MFDA effective immediately. The reason given for this resignation was “insolvency and imminent bankruptcy”.

8. On August 7, 2008, the Respondent filed an assignment for the general benefit of its creditors with the Official Receiver pursuant to Section 49.1 of the *Bankruptcy and Insolvency Act (Canada)* appointing Soberman Tesis Inc. as its Trustee in Bankruptcy.

9. By Notice of Application, dated August 14, 2008, Staff of the MFDA brought an Application before the Hearing Panel seeking an Order suspending the rights and privileges of the Respondent. This Application was based on Section 24.3.2(a)(ii) and (xiv) of MFDA By-law No. 1.

10. On August 19, 2008, the Hearing Panel made an Order suspending the rights and privileges of Membership of the Respondent in the MFDA until further Order of a Hearing Panel.

11. Notwithstanding the above, the Respondent served and filed its Reply in respect of Allegations #5 and #6 in the Notice of Hearing in accordance with the June 27, 2008 Order of the Hearing Panel. The Respondent also served and filed, in a timely manner, its Notice of Motion and Motion Record with respect to the pre-Hearing Motion scheduled for September 9, 2008. MFDA Staff, also in a timely manner, filed a Responding Record with respect to the said Motion.

12. On September 9, 2008, at the commencement of the pre-Hearing Motion, Staff brought a preliminary Motion with respect to whether the Hearing Panel should, in light of certain circumstances, be considering the pre-Hearing Motion at all.

13. After hearing extensive submissions from counsel for both Staff and the Respondent, the Hearing Panel determined that it would reserve its decision on the preliminary Motion by Staff but proceed to hear arguments on the pre-Hearing Motion itself so that the Panel could deal, if necessary, with both matters at the same time.

14. The Hearing Panel then proceeded to hear submissions on the pre-Hearing Motion, at the conclusion of which it reserved its decision, providing the parties with a time-limited opportunity to file written submissions on a certain aspect of the jurisdiction argument.

15. On November 12, 2008, the Hearing Panel released its Decision and Reasons dismissing the pre-Hearing Motion of the Respondent, finding that the MFDA did have jurisdiction to bring all six of the Allegations in the Notice of Hearing before a Hearing Panel for determination.

### **Manner of Proceeding**

16. The Hearing on the Merits commenced on December 10, 2008. The Respondent did not appear.

Rule 13.5 of the MFDA Rules of Procedure provides as follows:

“(1) Where a Respondent, having been served with a Notice of Hearing, fails to attend the hearing of the proceeding on its merits, the Hearing Panel may proceed in accordance with Rule 7.3.”

Rule 7.3 provides that where a Respondent fails to attend the Hearing on the date and at the time and location specified in the Notice of Hearing, the Hearing Panel may:

“(a) proceed with the hearing without further notice to and in the absence of the Respondent; and

- (b) accept the facts alleged and conclusions drawn by the Corporation in the Notice of Hearing as proven and impose any of the penalties and costs described in sections 24.1 and 24.2 respectively of By-law No. 1.”

Enforcement Counsel advised the Hearing Panel that they wished to proceed with the Hearing in the absence of the Respondent but seek to prove the Allegations by means of admissible evidence. We agreed with that approach.

### **Presentation of Evidence**

17. The main evidence before the Hearing Panel with respect to this matter consisted of a lengthy and detailed Affidavit of Ian Smith (“Smith”), a Senior Investigator with the MFDA, who had been assigned to investigate the distribution of certain exempt securities by the Respondent.

18. Throughout his Affidavit, Smith made reference to and quoted from portions of interviews conducted during the course of the investigation with various employees of the Respondent. These interviews were conducted pursuant to Section 22.1 of By-law No. 1, which provides as follows:

“22.1 For the purpose of any examination or investigation pursuant to this By-law, a Member, Approved Person of a Member or other person under the jurisdiction of the Corporation pursuant to the By-laws or the Rules may be required by the Corporation:

- (a) to submit a report in writing with regard to any matter involved in any such investigation;
- (b) to produce for inspection and provide copies of the books, records and accounts of such person relevant to the matters being investigated; and (*sic*)
- (c) to attend and give information respecting any such matters;
- (d) to make any of the above information available through any directors, officers, employees, agents and other persons under the direction or control of the Member, Approved Person or other person under the jurisdiction of the Corporation;

and the Member or person shall be obliged to submit such report, to permit such inspection, provide such copies and to attend, accordingly. Any Member or person subject to an investigation conducted pursuant to this By-law may be invited to make submission by statement in writing, by

- producing for inspection books, records and accounts and by attending before the persons conducting the investigation. The person conducting the investigation may, in his or her discretion, require that any statement given by any Member or person in the course of an investigation be recorded by means of an electronic recording device or otherwise and may require that any statement be given under oath.”
19. Rule 1.6(1) of the MFDA Rules of Procedure provides, in part, that:
- “1.6 *Admissibility of Evidence*  
(1) Subject to sub-Rule (3), a Panel may admit as evidence any testimony, document or other thing, including hearsay, which it considers to be relevant to the matters before it and is not bound by the technical or legal rules of evidence.”
20. Rule 13.4 provides that:
- “13.4 *Evidence by Sworn Statement*  
(1) The Hearing Panel may allow the evidence of a witness or proof of a particular fact or document to be given by sworn statement unless an adverse party reasonably requires the attendance of the witness at the hearing for cross-examination.”
21. Accordingly, we marked as Exhibits the Smith Affidavit, as well as copies of the transcripts of the complete interviews with the various employees.

### **The Evidence**

22. The Respondent was registered in Ontario as a mutual fund dealer on July 2, 1997, and as a limited market dealer on July 7, 1999. The Respondent became a Member of the MFDA on May 10, 2002.
23. On July 12, 2005, the MFDA issued a mandatory questionnaire to its Members seeking information regarding the nature and extent of Member involvement in the sale of exempt securities, deposit instruments and referral arrangements.
24. The Respondent completed the questionnaire on August 19, 2005, and advised the MFDA that it had sold debentures issued by FactorCorp to its clients.
25. According to its Offering Memorandum, FactorCorp was in the business of

extending credit to companies which purchased accounts receivable from other companies at a discount and then attempted to collect the accounts in full.

26. FactorCorp offered an unlimited number of debentures at a fixed rate of interest of 6%, 7% or 8% based on one, two or three-year terms, respectively (“Debentures”). The Debentures were offered to investors in Ontario in reliance on the “accredited investor” exemption set out in section 2.3 of Ontario Securities Commission (“OSC”) Rule 45-501 and, subsequently, National Instrument 45-106.

27. On June 25, 2003, the Respondent entered into a distribution agreement with FactorCorp pursuant to which the Respondent agreed to promote and distribute the Debentures to its clients through its Approved Persons. Under the terms of the distribution agreement, FactorCorp agreed to pay the Respondent a monthly commission based on the total amount invested by the Respondent’s clients and any other individuals to whom its Approved Persons sold the Debentures.

28. On December 18, 2003, the Respondent entered into a second distribution agreement with FactorCorp containing, essentially, the same terms and conditions as the June 25, 2003 agreement.

29. On November 11, 2003, the Respondent’s Manager of Compliance and Auditing sent an e-mail message to all branch managers to, *inter alia*, clarify the definition of “accredited investor” in OSC Rule 45-501. She advised that all exempt products (which would include the Debentures) “fall into a high risk category” and “require extra due diligence in the supervision by the branch manager in reviewing and approving, first of all the account set up for the investor based on the KYC [Know Your Client] information and, secondly, the sale of the product supported by the information obtained by the associate [Approved Person] from the investor.”

30. MFDA Staff analyzed the data provided by the Respondent concerning the sale of the Debentures. A detailed chart was provided to the Hearing Panel, which showed that, between June 25, 2003 and April 1, 2007, 35 Approved Persons of the Respondent sold

\$51,931,347.00 of the Debentures to 680 of its clients. In that time frame, the Respondent received commissions from FactorCorp totaling \$2,141,113.93.

31. Between June of 2003 and September of 2006, none of the Debenture transactions were properly recorded on the Respondent's books and records.

32. There was evidence before us to indicate that, at the time the Debentures were sold, the clients of the Respondent were asked to complete a Farm Mutual new account application form, a FactorCorp Subscription Agreement, and a FactorCorp Accredited Investor Status Certificate (collectively, the "Sales Documentation"). Clients were directed to make all cheques payable to FactorCorp.

33. The Sales Documentation, along with the client's cheque, was provided to the Approved Person's branch manager, whose responsibility it was to ensure that the Sales Documentation was complete. The branch manager then forwarded the Sales Documentation, along with the client's cheque, directly to FactorCorp.

34. The evidence before us clearly established that the branch managers of the Respondent either did not conduct at all, or did not adequately conduct, first-tier reviews of these purchases upon receiving the Sales Documentation. In particular, the branch managers did not review either the suitability of the trades in the Debentures or ensure that, in fact, the clients qualified as "accredited investors".

35. The Respondent did not require the branch managers to forward copies of the Sales Documentation to its head office. The copies were retained at the branch office.

36. Each month, FactorCorp provided the Respondent with a list of all sales commissions payable in respect of the sales of the Debentures made by its Approved Persons. The list included the names of the purchasing clients, the dates of purchase, the amounts purchased, the term of each investment, the Approved Person of record and the commission payable on each transaction. At no time did the Respondent initiate or

conduct a second-tier suitability review at head office of any of the Debenture transactions.

37. Between June of 2003 and April of 2007, the Respondent did conduct various branch office audits. However, these audits did not include a review of whether the Debentures were suitable for the clients and in keeping with their investment objectives. They also did not seek to ascertain whether the clients qualified as accredited investors.

38. In May of 2007, FactorCorp suspended redemptions. On July 6, 2007, the OSC issued a temporary Cease Trade Order against FactorCorp. Approximately \$49 million of the Respondent's clients' Debentures remained outstanding and unredeemed at the time of this Order.

39. On October 17, 2007, KPMG Inc. ("KPMG") was appointed as receiver and manager of FactorCorp by the Ontario Superior Court of Justice. On March 25, 2008, KPMG was appointed as Trustee in Bankruptcy for FactorCorp.

40. MFDA Staff provided evidence to the Hearing Panel which established that the Respondent:

- (i) permitted 41 of its clients to invest over \$5 million in the Debentures before it had completed its due diligence of the product;
- (ii) failed to obtain and review the financial statements of FactorCorp on an on-going basis in order to assess its financial viability; and
- (iii) failed to develop and communicate guidelines or an investor profile to its Approved Persons to assist them in identifying clients for whom the Debentures might have been a suitable investment and to identify investors for whom the Debentures would not be suitable.

41. A review of the Debentures transactions revealed that only 22 of the 680 clients of the Respondent who purchased had a risk tolerance of "high" recorded on their Know Your Client ("KYC") information at the time of their initial purchases. Fifty-two clients had no risk tolerance information recorded. The remaining 606 clients had a risk

tolerance of less than “high” at the time of their initial purchase. Further, based on the KYC information, only 44 of the 680 clients met the income, net financial assets and/or net worth threshold necessary to qualify for the accredited investor exemption. The remaining 636 clients either did not meet the requirements or the Respondent failed to collect sufficient information to make that determination.

42. The evidence also made it clear that the Respondent failed to ensure that between, at least, June of 2003 and September of 2006, the sale of the Debentures were properly conducted through its facilities.

### **Compliance Structure**

43. On August 7, 2007, MFDA Staff issued a Compliance Examination Report dealing with a review of the Respondent’s head office. This was a follow up to a previous Compliance Examination Report, dated December 10, 2003.

44. The Review concluded that: “The Member’s current account supervision structure does not meet the minimum requirements established in MFDA Policy No. 2.”

45. Specifically, the examination found that the “head office review of Approved Person’s trades is not conducted on a daily basis.” A sample review of 40 trades identified 23 trades where there was “no evidence of trade supervision and suitability review as no trade blotter existed for these trades.” The review also found that the Respondent did “not have procedures in place to detect patterns of excessive trading, market timing or switching by Approved Persons.”

### **Compliance Staffing**

46. Commencing in 2001, the Respondent’s management and Board of Directors were advised, on numerous occasions, that the compliance department was under-staffed.

47. For example, in the Minutes of a “Monthly Update Meeting of July 26, 2001”, a copy of which was sent to the Chairman of the Board of Directors of the Respondent, the

sole compliance person in the company “indicated that she is getting very frustrated with the lack of solid administrative support that she is getting and all of the errors that are being made. The area of compliance is growing everyday and the demands on [her] time and resources are becoming more than can be handled by 1 person.”

48. It would appear that nothing was done, as over a year later, in the Minutes of a Monthly Update Meeting of December 4, 2002, a copy of which was sent to the new Chairman of the Respondent’s Board, it was indicated, again, that she “is not receiving the administrative support that is necessary to address the ongoing administrative needs in the compliance department . . .”

49. In the Minutes of an August 1, 2003, meeting, copied to the Board Chair, the compliance person again complained about the lack of support indicating that, as a result, she “is spending most of her time on administration and not able to address issues of compliance supervision and training that are presently lacking.”

50. Nothing was done and, after the passage of almost a further year, BDO, in July of 2004, provided the Respondent with a Report which stated, in part: “The compliance department consists of one individual and the level of activity is overwhelming in this area. . . . The Compliance Manager is currently overwhelmed and has been close to “burning out”. This function represents the most important risk area facing the organization. It is not acceptable to have this area understaffed as it represents one of the two key areas of support provided by the back office.”

### **The Law**

51. The Notice of Hearing alleges breaches of the following MFDA Rules:

1. 1.1.1(a);
2. 2.1.1(c);
3. 2.2.1(a), (b), (c) and (d);
4. 2.5.1; and
5. 2.5.2(b).

They provide as follows:

1.1.1 **Members** No Member or Approved Person (as defined in By-law 1.1) in respect of a Member shall, directly or indirectly, engage in any securities related business (as defined in By-law 1.1) except in accordance with the following:

- (a) all such securities related business is carried on for the account of the Member, through the facilities of the Member (except as expressly provided in the Rules) and in accordance with the By-laws and Rules, other than:
  - (i) such business as relates solely to trading in deposit instruments conducted by any Approved Person not on account of the Member; and
  - (ii) such business conducted by an Approved Person as an employee of a bank and in accordance with the *Bank Act (Canada)* and the regulations thereunder and applicable securities legislation.

2.1.1 **Standard of Conduct.** Each Member and each Approved Person of a Member shall:

- (c) not engage in any business conduct or practice which is unbecoming or detrimental to the public interest; and

## 2.2 **CLIENT ACCOUNTS**

2.2.1 **"Know-Your-Client"**. Each Member and Approved Person shall use due diligence:

- (a) to learn the essential facts relative to each client and to each order or account accepted;
- (b) to ensure that the acceptance of any order for any account is within the bounds of good business practice; and
- (c) to ensure that each order accepted or recommendation made for any account of a client is suitable for the client and in keeping with the client's investment objectives; and
- (d) to ensure that, notwithstanding the provisions of paragraph (c), where a transaction proposed by a client is not suitable for the client and in keeping with

the client's investment objectives, the Member has so advised the client before execution thereof.

## **2.5 MINIMUM STANDARDS OF SUPERVISION**

**2.5.1 Member Responsibilities.** Each Member is responsible for establishing, implementing and maintaining policies and procedures to ensure the handling of its business is in accordance with the By-laws, Rules and Policies and with applicable securities legislation.

### **2.5.2 Compliance Officer**

(b) **Responsibilities.** The compliance officer shall be responsible for monitoring adherence by the Member and any person conducting business on account of the Member to the By-laws, Rules and Policies, including, without limitation, standards of business conduct under Rule 2 and applicable securities legislation requirements. The compliance officer or the individual to whom the compliance officer reports is required to report on the status of compliance at the Member to the board of directors or partners of the Member as necessary, and at least on an annual basis. It shall be the responsibility of the board of directors or partners of the Member to act on the annual report and to rectify any compliance deficiencies noted in the report.

52. The Notice of Hearing, further, alleges a breach of MFDA Policy No. 2, which came into force on February 23, 2001, and which is entitled: "Minimum Standards for Account Supervision."

53. Allegations #1 and #2 also require a consideration of MFDA Member Regulation Notice – Know Your Product, dated October 31, 2005, MR-0048, which was issued during the time period covered by those allegations.

## **Findings**

### **Allegation #1**

54. The essence of Allegation #1 relates to what obligation, if any, does a Member have to perform due diligence on a product before it is approved for sale to clients. Secondly, and equally important, does the Member have any obligation to ensure that the product is specifically suitable for the individual client to whom it is intended to sell? Thus, could a product suitable for client “A” not be suitable for client “B”?

55. The basic answer to these questions is found in MFDA Rule 2.2.1(c), which requires Members to use due diligence to ensure that each order accepted or recommendation made for any account of any client is suitable for that particular client and in keeping with that client’s investment objectives. The Rule is client specific. The “know your client” requirement is a fundamental part of complying with basic suitability obligations.

56. In order to properly discharge this obligation, a Member, including its supervisory staff and Approved Persons, must also understand the product being recommended to clients. In our view, this is a fundamental component of complying with Rule 2.1.1 and discharging the obligation imposed by Rule 2.2.1(c).

57. On October 31, 2005, the MFDA issued Member Regulation Notice-0048 – Know Your Product, to “clarify” the obligations of Members and Approved Persons with respect to the approval and sale of investment products. In our view, it is no answer for the Respondent to say that certain of its actions with respect to the Debentures pre-dated this Notice, because Rules 2.1.1 and 2.2.1 were in force throughout the entire relevant period of time. In addition, there is no evidence before us that the Respondent took any different approach to the sale of the Debentures after October 31, 2005.

58. At a minimum, Members must have in place written policies and procedures that describe in detail the steps to be followed in the due diligence process. As indicated

above, the evidence before us was that the Respondent permitted 41 of its clients to invest over \$5 million in the Debentures without ever having a proper, documented due diligence process and even before it had performed even minimal due diligence.

59. In determining whether to approve a product for sale, Members should not merely rely on the representations of the issuer. In all cases, the approval process must be independent and objective. It is insufficient to simply make inquiries. Members must properly follow-up on any questions which they have raised until they are satisfied that they have a complete understanding of any products they propose to sell.

60. The “Know Your Product” Member Regulation Notice sets out a specific list of what the due diligence review process should involve. It is as follows:

- (a) a review of any offering documents;
- (b) a review of any marketing materials related to the product;
- (c) consideration of MFDA Rules and securities regulations that may apply in the sale of the product;
- (d) an assessment of the risks associated with the product;
- (e) an assessment of the costs associated with the product;
- (f) an assessment of the commissions and other compensation to be paid to the Member and Approved Person for selling the product, and consideration of potential conflict issues that may arise under the compensation structure;
- (g) consideration of competitive products that may be less costly or less risky;
- (h) an assessment of the investment objectives and any projected returns for the product and the likelihood that the investment will meet these objectives and projections;
- (i) a review of the issuer’s financial position and history;
- (j) an assessment of management qualifications and track records;
- (k) an assessment of any custodian, investment manager or guarantor associated with the product; and
- (l) maintaining a thorough written record of the results of the Member’s due diligence.

61. In the case before us, the Respondent fell woefully short of complying, in even a minimal way, with this due diligence review process. In addition to not having either written policies or a standardized process in place, the evidence established that:

(a) the Respondent failed to obtain and review the financial statements of FactorCorp in order to assess FactorCorp's financial position and history, and any investment risk this may have created for clients;

(b) the Respondent failed to develop and communicate guidelines or an investor profile to its Approved Persons to assist them in identifying clients for whom the Debentures might have been a suitable investment and to clearly identify investors for whom the Debentures would not be suitable;

(c) the Respondent failed to develop a process to supervise the sale of the Debentures to clients and make its own determination as to whether the sales were suitable and complied with the requirements of the accredited investor exemption;

(d) the Respondent relied upon FactorCorp to train its representatives without considering whether the training was adequate or developing a process to reassess training needs on a continuing basis; and

(e) the Respondent did not develop a post-sale process, among other things, to periodically reassess and monitor the sale of the Debentures.

62. The Debentures were not sold through a Prospectus but rather through an Offering Memorandum, relying on the "accredited investor" exemption in OSC Rule 45 501. This places an added burden of inquiry on the Member.

63. With exempt products, the Member must, after due inquiry, satisfy itself that the conditions of any exemption apply before trading in reliance on the exemption. Where there is uncertainty regarding the applicability of an exemption, the Member must take

appropriate measures, which may include consultation with the relevant securities regulatory authority or legal counsel.

64. Here, the evidence established that, according to the Respondent's own records, only 44 of its 680 clients to whom the Debentures were sold met the necessary thresholds to qualify for the accredited investor exemption. On the face of it, the remaining 636 clients should not have been sold the Debentures.

65. Furthermore, even if the client qualifies for the accredited investor exemption, the Member still has an obligation to ensure that the product is suitable and in accordance with the risk tolerance of the client. Here, the Respondent was aware that the Debentures were a high-risk investment. Yet, the evidence established that only 22 of the 680 clients who purchased the Debentures had a risk tolerance of "high" recorded on their Know Your Client information.

66. In our view, by approving and allowing the sale of the Debentures in the manner which it did, the Respondent clearly breached MFDA Rules 2.2.1(a), (b), (c) and (d) and 2.1.1(c). We find that Allegation #1 was established.

## **Allegation #2**

67. It is clear on the facts and Rules already referred to that, during the period in question, the Respondent approved and allowed the sale of the Debentures to 680 of its clients without ensuring that the investments were suitable for the clients and in keeping with the clients' investment objectives. It is, further, clear that the Respondent did not take appropriate steps to ensure that the clients qualified as accredited investors.

68. The Respondent took no steps to acquire, review or maintain complete information pertaining to the sale of the Debentures. The Respondent either failed to take steps to know the financial circumstances of its clients or, alternatively, it willingly ignored that information. In any event, the Respondent repeatedly, over a long period of

time, sold the Debentures to clients who were either not accredited investors or for whom the investments were not otherwise suitable or both.

69. We find that Allegation #2 has been established.

### **Allegation #3**

70. Rule 1.1.1(a) provides that, with certain exemptions which are not relevant to the case before us, all securities related business must be carried on for the account of the Member, through the facilities of the Member and in accordance with the MFDA By-laws and Rules.

71. In the present case, none of the Debenture sales between June of 2003 and September of 2006, were processed through the facilities of the Respondent. All Sales Documentation and client payments were delivered directly to FactorCorp by the Respondent's representatives. In fact, the head office of the Respondent did not even become aware that its clients had purchased the Debentures until FactorCorp provided it with monthly commission statements. The trades were never properly recorded on the books and records of the Respondent.

72. Allegation #3 has been established. In our view, Rule 1.1.1(a) is fundamental to the regulatory mandate of the MFDA to enhance investor protection and strengthen public confidence in the Canadian mutual fund industry. Its breach is serious.

### **Allegation #4**

73. Rule 2.5.1 provides that each Member is responsible for establishing, implementing and maintaining policies and procedures to ensure that the handling of its business is in accordance with the By-laws, Rules and Policies of the MFDA and with applicable securities legislation.

74. MFDA Policy No. 2, entitled "Minimum Standards for Account Supervision", makes it clear that these are minimum standards, that the Member is not precluded from

establishing a higher standard of review and that, in certain situations, a higher standard may be necessary to ensure proper supervision. Under the heading of “Branch Office Account Supervision”, Policy No. 2 stipulates that branch managers must:

1. Review and approve all new account applications no later than the next business day after the account is opened.
2. Review the previous day’s trading for unusual trading activity using any convenient means. This review should include, at a minimum, all trades in exempt securities.
3. Follow up on unusual trades identified by head office.

75. Here, the Respondent failed to ensure that its branch managers conducted first tier reviews of client purchases of the Debentures. The Branch Managers of the Respondent did not review the suitability of trades facilitated by Approved Persons under their supervision, nor did they review the Sales Documentation to ensure that clients who purchased the Debentures qualified as accredited investors.

76. We agree with the submission of Staff that, where, as here, the Respondent failed to establish, implement and maintain policies and procedures to adequately and effectively supervise the sale of exempt products (in this case the Debentures) to its clients, it has breached Rule 2.1.1(c) and has engaged in business conduct which is unbecoming and detrimental to the public interest.

77. We find that Allegation #4 has been established.

#### **Allegation #5**

78. Rule 2.5.1 requires each Member to establish, implement and maintain policies and procedures to ensure that the handling of its business is in accordance with the By-laws, Rules and Policies of the MFDA and with applicable securities legislation.

79. MFDA Policy #2 explicitly states that “a two-tier structure is required to adequately supervise client account activity.” The Policy further states that “head office

must conduct daily reviews of account activity” which should include criteria to detect, *inter alia*, “lack of suitability”.

80. Here, the Respondent did not conduct second-tier head office reviews either at the time the Debentures were sold to clients or when it received from FactorCorp the monthly reports summarizing the Debenture transactions. The Sales Documentation was sent directly to FactorCorp by the Approved Persons and Branch Managers, with no copies of same being required to be sent to head office. As a result, 680 clients purchased the Debentures without proper head office supervision by the Respondent as to whether these investments were suitable or otherwise permissible under the accredited investor exemption.

81. The policies were ignored by the Respondent. Its clients were left unprotected.

82. We find that Allegation #5 has been established.

#### **Allegation #6**

83. By MFDA Rule 2.5.2(b), the compliance officer is responsible for monitoring adherence by the Member, and any person conducting business on account of the Member, to the By-laws, Rules and Policies, including, without limitation, standards of business conduct under Rule 2 and applicable securities legislation requirements.

84. In order to properly perform its compliance function, the compliance department must be properly staffed. Here, the compliance department consisted of one person. Commencing in at least July of 2001, Management, as well as the Board of Directors of the Respondent, were repeatedly made aware that the compliance department was understaffed. Yet nothing was done, such that three years later, in July of 2004, BDO issued a Report stating that the Compliance Officer is “overwhelmed” and that “this function represents the most important risk area facing the organization.”

85. It would appear that by April of 2005, a temporary Compliance Officer had been

hired. However, in October of 2006, the Board of Directors was again warned that “more support is required in the Compliance Department to help with the ever changing regulations, training, recruiting and business building.”

86. It is clear that during a significant part, if not all, of the time frame referred to in Allegation #6, the Respondent failed to maintain adequate compliance staff to monitor its adherence to the MFDA Rules, By-laws and Policies and that the Respondent was, therefore, in breach of Rule 2.5.1 and 2.5.2(b).

### **Penalty**

87. Enforcement Counsel, in their written submissions, sought the following sanctions:

- (a) A termination of the Respondent’s Membership in the MFDA;
- (b) A fine of at least \$2.64 million; and
- (c) Costs in the amount of \$50,000.00.

88. Staff stated that the fine and costs were sought against the Respondent “for deterrence reasons and to reflect its general denunciation of the misconduct.” Staff, further, stated that, as the Respondent is bankrupt, it would not be filing a proof of claim in the bankrupt estate which would compete with the distribution of funds by the trustee in bankruptcy to any other creditors of the Respondent.

### **Factors to be Considered**

89. The primary goal of securities regulation is the protection of the investor.

*Pezim v. British Columbia (Superintendent of Brokers)*, [1994] 2 S.C.R. 557 at para. 59.

90. Past MFDA Hearing Panels have set out some of the factors which should be considered in determining the appropriate penalty. They include:

- (a) the protection of the investing public;
- (b) the integrity of the capital markets;
- (c) specific and general deterrence;

- (d) the protection of the MFDA's Membership; and
- (e) the protection of the integrity of the MFDA's enforcement processes.

*In the Matter of Robert Roy Parkinson*, [2005] MFDA File No. 200501, decision dated April 29, 2005 ("Parkinson") at p. 21.

*In the Matter of Arnold Tonnies*, [2005] MFDA File No. 200503, decision dated June 27, 2005 ("Tonnies") at p. 22.

91. Precedents also suggest that the Hearing Panel should consider the following specific factors:

- (a) the seriousness of the allegations proved against the Respondent;
- (b) the Respondent's past conduct, including prior sanctions;
- (c) the Respondent's experience in the capital markets;
- (d) the level of the Respondent's activity in the capital markets;
- (e) whether the Respondent recognizes the seriousness of the improper activity;
- (f) the harm suffered by investors as a result of the Respondent's activities;
- (g) the benefits received by the Respondent as a result of the improper activity;
- (h) the risk to investors and the capital markets in the jurisdiction, were the Respondent to continue to operate in capital markets in the jurisdiction;
- (i) the damage caused to the integrity of the capital markets in the jurisdiction by the Respondent's improper activities; and
- (j) previous decisions made in similar circumstances.

*Parkinson, supra* at p. 22.

*Tonnies, supra* at p. 23.

92. In our view, any penalty which we impose should communicate to the Respondent, the investing public and to the mutual fund industry as a whole that there will be serious consequences for the type of misconduct which we have found to be established in the case before us. In addition, the penalty should be of such a nature and

extent that it will deter others from engaging in similar misconduct. By taking this approach, we hope to strengthen public confidence in the self-regulatory system.

### **Determination**

93. Between June of 2003 and April of 2007, 680 clients of the Respondent purchased almost \$52 million worth of Debentures of FactorCorp through its Approved Persons. In July of 2007, the OSC issued a Cease Trade Order against FactorCorp. Approximately \$49 million of the Respondent's clients' investments remained outstanding and unredeemed. In March of 2008, FactorCorp went into bankruptcy.

94. The Debentures should have only been available to "accredited investors". The Respondent was aware of this. The Respondent was also aware that this was a "high risk" product. Yet the evidence clearly established that, at the time of purchase, only 44 of the 680 clients qualified as accredited investors and only 22 had a "high risk" tolerance recorded in their KYC. On the basis of the documentation in its own files, the Respondent should only have permitted the Debentures to be sold to those 22 clients and only if they were part of the 44 clients who qualified as accredited investors.

95. However, the Respondent, without either first or second-tier review of the product, facilitated its sale to its clients and earned \$2,141,113.93 in sales commissions from FactorCorp in doing so.

96. The MFDA system of By-laws, Rules and Policies was not deficient. They clearly showed what the Respondent should have done to protect its clients. The Respondent, over a lengthy period of time, repeatedly chose to ignore some of the most fundamental Rules and Policies of the organization of which it was a Member. This has resulted in untold harm to its clients, the very individuals these Rules and Policies were designed to protect.

97. We have found each of Allegations #1 to #4 to have been established. Whether you take these Allegations individually or collectively, the basic penalty that is warranted

is a termination of any and all of the rights and privileges of the Respondent's Membership in the MFDA, pursuant to section 24.1.1(d) of By-law No. 1 and we so order.

98. We impose this penalty, which is, arguably, the most severe penalty which we could impose, as, in our view, it is incumbent upon this Hearing Panel to communicate, not only to the Respondent, but also to the investing public and the mutual fund industry as a whole, that serious consequences will befall those who are engaged in activities similar to those of the Respondent.

99. A fine is appropriate where, as here, the Respondent received a financial benefit directly as a result of its misconduct. The financial benefit received through the sale of the Debentures was \$2,141,113.93. In our view, a fine, in like amount, is appropriate with respect to Allegations #1 to #4 and we so order pursuant to the provisions of section 24.1.2(b) of By-law No. 1.

100. Staff seeks a fine of at least \$500,000.00 with respect to Allegations #5 and #6. These Allegations relate to serious deficiencies in the Respondent's compliance policies and procedures.

101. We were provided with two precedent cases, namely: (1) *In the Matter of Sterling Mutuals Inc.* [2008] MFDA File No. 200820; and (2) *In the Matter of IQON Financial Inc.* [2007] MFDA File No, 200713. In these cases, MFDA Hearing Panels imposed fines of \$50,000.00 and \$100,000.00 respectively, as well as requiring the Members to resolve the compliance deficiencies.

102. We note that both of these cases were Settlement Agreements, which involved no client losses. We also note that, in both cases, the respondents co-operated with Staff, agreed to the appointment of monitors and had taken steps to correct the deficiencies by the time the matter came before the Hearing Panels.

103. In contrast, in the present case, there are, apparently, very significant client losses.

Also, this was a contested case, even after the Respondent filed for bankruptcy in August of 2008.

104. While we view this fine to be at the higher end of the range, taking all of the relevant factors into consideration, we are prepared to accede to Staff's suggestion and impose a fine of \$500,000.00, pursuant to section 24.1.2(b) of By-law No. 1 with respect to Allegations #5 and #6.

105. Section 24.2 of By-law No. 1 provides, in part, that "A Hearing Panel may in any case in its discretion require that the Member . . . pay the whole or part of the costs of the proceedings before the Hearing Panel . . . and any investigations relating thereto."

106. The investigation of the Respondent in this case was detailed and lengthy. The proceedings were contested. In our view, Staff's request for costs in the amount of \$50,000.00 is, in all of the circumstances, appropriate and we so order pursuant to section 24.2 of By-law No. 1.

107. In imposing the above penalties, we did take into consideration the fact that the Respondent has no discipline history with the MFDA.

### **Penalties Imposed**

108. In summary, the penalties which we impose on the Respondent are the following:
- (a) Termination of any and all of the rights and privileges of Membership in the MFDA;
  - (b) A fine in the amount of \$2,141,113.93 with respect to Allegations #1 to #4;
  - (c) A fine in the amount of \$500,000.00 with respect to Allegations #5 and #6; and

(d) Costs in the amount of \$50,000.00.

Dated at Toronto, this 24th day of April, 2009.

“Thomas J. Lockwood”  
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Thomas J. Lockwood, Q.C.  
Chair

“Sandy Grant”  
\_\_\_\_\_  
Sandy Grant  
Industry Representative

“Guenther Kleberg”  
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Guenther Kleberg  
Industry Representative