

# INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

IN THE MATTER OF:

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

AND

**THE BY-LAWS OF THE  
INVESTMENT DEALERS ASSOCIATION OF CANADA**

AND

**CREDENTIAL SECURITIES INC.**

## 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 Credential Securities Inc. (“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. 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

4. The Respondent consents to be subject to the jurisdiction of IIROC.
5. 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.

6. The Settlement Agreement is subject to acceptance by the Hearing Panel.
7. The Settlement Agreement shall become effective and binding upon the Respondent and Staff as of the date of its acceptance by the Hearing Panel.
8. 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.
9. 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.
10. 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.
11. The Settlement Agreement will become available to the public upon its acceptance by the Hearing Panel.
12. 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.
13. Staff and the Respondent jointly recommend that the Hearing Panel accept the Settlement Agreement.

### **III. STATEMENT OF FACTS**

#### **(i) Acknowledgment**

14. 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”)**

15. 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.

16. 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.
17. 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.
18. 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.
19. 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.
20. 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.
21. Dominion Bond Rating Services Limited (“DBRS”), an approved credit rating organization, was the sole credit rating organization which rated third-party ABCP in Canada.
22. 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**

23. ABCP has been in the Canadian marketplace for over a decade, and non-bank sponsors entered the marketplace in approximately 2000.

24. 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.
25. 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.
26. 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.**

27. 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”).
28. 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 (“SIT III”) and Structured Asset Trust (“SAT”).
29. 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**

30. 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.
31. 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.

32. 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.
33. The primary information that dealers disclosed to investors was the yield and credit rating of third-party ABCP.

### **THE MARKET FREEZE**

34. 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.
35. 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.
36. 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.
37. 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.
38. 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**

39. The Respondent is a registered dealer with a predominantly retail client base. The Respondent is not and never was a sponsor, ABCP syndicate member dealer, asset or liquidity provider, active trader or investor in ABCP or otherwise involved in the third-party ABCP market, other than in acting as dealer for clients who wished to invest in ABCP. As such, at the relevant time, the Respondent did not have access to or detailed knowledge of certain of the information regarding third-party ABCP discussed above, including the information in paragraphs 18, 19, and 22.

40. At all material times, the Respondent was an introducing broker and had a carrying broker agreement in place with another Non-syndicate Member firm that sold third-party ABCP. While the Respondent's money market activity was handled by the carrying broker's bond desk, the Respondent's decision to make products available to its retail clients remained with it.
41. The Respondent first made third-party ABCP available to its retail clients in or about June 2006.
42. The majority of third-party ABCP made available by the Respondent to its clients was SIT III. By August 2007, SIT III held only non-traditional assets.
43. The Respondent's Product Review Committee ("the Committee") was a subcommittee of its Investment Risk Committee. The Committee was made up of senior individuals including certain department heads. Included on the Committee were individuals with expertise in compliance and financial markets. The Committee had the responsibility to create guidelines for product approval based on risk criteria. During the material time, products that were rated by a recognized bond rating agency as investment grade BBB or better were pre-approved by the Committee for distribution.
44. Since third-party ABCP met the Respondent's product approved threshold, they automatically became eligible as part of the Respondent's pool of fixed-income products available for purchase by clients through the Respondent's Approved Persons.

## **PRODUCT KNOWLEDGE**

45. The Respondent did not use adequate due diligence in order to learn and remain informed that there were additional complexities relating to the third-party ABCP products that were made available to retail clients and the consequent risks (including systemic risks and counterparty risks) related to those products. The Respondent relied primarily on the credit rating provided by DBRS as the basis for making these products available.
46. More specifically, the Respondent failed to take adequate steps to ensure that its Approved Persons involved in the sale and distribution of third-party ABCP to retail clients understood the complexities and risks inherent in the product arising out of :
  - The basic structure of ABCP and the roles of the various entities (sponsors, issuer, trustee, asset providers);
  - The nature and composition of the underlying assets;
  - The lack of transparency relating to the underlying assets and liquidity agreements; and
  - The nature and limitations of the liquidity facilities.
47. Where Approved Persons had questions about third-party ABCP, they had access to the bond desk of the carrying broker through the internet, e-mail and in some circumstances

telephone. The Respondent relied upon the carrying broker for information relating to third-party ABCP.

48. 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. Advisors based their investment recommendations on the rating, return and term of the product as well as any information they received from the carrying broker's bond desk.
49. Without a full understanding of the complex nature of third-party ABCP, certain Approved Persons were representing the product to their clients as a safe and secure investment that was similar to a T-bill, Guaranteed Investment Certificate or a term deposit.
50. Under its relief program, the Respondent returned to the vast majority of its retail clients full face value plus interest and costs of up to \$1 million in exchange for the Notes issued following the restructuring of the third-party ABCP market.
51. Since the time when the issues surrounding the third-party ABCP became known, the Respondent proactively undertook an examination of and has instituted several changes to its procedures and systems to strengthen the review of complex fixed income securities that are traded by its retail clients and has made additions to its risk monitoring personnel. The Respondent is in the process of instituting additional training modules for its Approved Persons regarding due diligence practices, fixed income structured products and is taking other appropriate steps.

#### **IV. CONTRAVENTIONS**

52. In or about 2006 and 2007, the Respondent did not take adequate steps to ensure that its Approved Persons understood the complexities of the third-party ABCP product made available for purchase by its retail clients and the consequent risks (including systemic risks and counterparty risks) related to those products 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).

#### **V. TERMS OF SETTLEMENT**

53. IIROC and the Respondent agrees to the following terms of settlement:
  - (i) A fine in the amount of \$200,000 (inclusive of costs); and
  - (ii) The retention of an independent consultant in accordance with Schedule A of this Settlement Agreement.

54. Unless otherwise stated, any monetary penalties and costs imposed upon the Respondent are payable immediately upon the effective date of the Settlement Agreement.
55. Unless otherwise stated, any suspensions, bars, expulsions, restrictions or other terms of the Settlement Agreement shall commence on the effective date of the Settlement Agreement.

**VI. STAFF COMMITMENT**

56. 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 17th day of December, 2009.

Credential Securities Inc.  
**RESPONDENT**

\_\_\_\_\_  
**WITNESS**

Per: \_\_\_\_\_  
**DOCE TOMIC**  
President & Chief Executive Officer

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

\_\_\_\_\_  
**WITNESS**

\_\_\_\_\_  
**TAMARA BROOKS**  
Enforcement Counsel on behalf of  
Staff of the Investment Industry  
Regulatory Organization of Canada

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**WITNESS**

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**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 21<sup>st</sup> day of December, 2009, by the following Hearing Panel:

Per: \_\_\_\_\_  
Panel Chair

Per: \_\_\_\_\_  
Panel Member

Per: \_\_\_\_\_  
Panel Member

## **SCHEDULE “A” – TERMS OF REFERENCE FOR COMPLIANCE REVIEW**

Credential Securities Inc. (the “Respondent”) agrees to retain an independent third-party Consultant to carry out a verification review concerning the Respondent’s due diligence practices, policies and procedures relating to fixed income securities, subject to the terms set out below:

### **A. Remedial Steps Taken by the Respondent In Light of ABCP Market Disruption**

After August 2007, the Respondent reviewed its policies and procedures in connection with its fixed income business particularly in relation to third-party ABCP and took the following remedial actions:

- a. reviewed and revised its Product Review Policy, practices and systems;
- b. engaged additional personnel to assist with risk monitoring; and
- c. commenced development of additional training modules for advisors on due diligence practices and fixed income structured products.

### **B. Terms of Reference for Engagement of the Consultant**

1. The agreement between the Respondent and the Consultant (“Agreement”) shall provide that the Consultant will conduct a verification review of the implementation of the remedial actions outlined in A above insofar as they relate to:

- a. The Respondent’s compliance and oversight functions concerning its sales with respect to fixed income securities made available to clients;
- b. any committees or other mechanisms established to review and approve new fixed income securities made available to clients and changes to those securities;
- 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 “Verification Review”).

### **C. The Consultant's Reporting Obligations**

1. The Consultant shall issue a draft report concerning its Verification Review to the Respondent and IIROC within 3 months of its appointment. The Consultant may request the opportunity to present its draft 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 1 month of the delivery of its 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 may explain any areas of disagreement with management of the Respondent.

3. The Consultant will deliver its final report to the Respondent and to IIROC.
4. The Consultant's report shall include a description of the Verification Review performed and whether the remedial actions taken by the Respondent conforms with the applicable requirements of Dealer Member Rules 1300.1 and 2500, and IIROC notice 09-0087 entitled Best Practices for Product Due Diligence as those Rules and Notice apply to the subject matter of the Verification Review in Section B(1) above , and if not, the Consultant's recommendations for any changes to those remedial actions that the Consultant reasonably deems necessary.
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 Consultant's report, provided however, that in the event that the Respondent disagrees with or wishes to adopt other actions, policies or procedures in lieu of any of the Consultant's recommendations, the Respondent shall so advise IIROC and provide its reasons for its position and any alternative actions, policies or procedures the Respondent intends to adopt.
6. The Respondent shall certify to IIROC, by certificate executed on its behalf by each of the CEO, the UDP and the CCO of the Respondent and the Chair of the Board of Directors of the Respondent that the Respondent has implemented those recommendations of the Consultant or other actions, policies or procedures which it has agreed to adopt, promptly following such implementation.
7. For greater certainty, the terms of this Verification 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 Verification Review or any other aspect of the business of the Respondent.

D. Required Terms of Agreement with Consultant

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 have reasonable access to all of the Respondent's books and records and the ability to meet privately with the Respondent's personnel. The Respondent shall instruct and otherwise encourage its officers, directors, and employees to cooperate fully with the Verification Review conducted by the Consultant, and inform its officers, directors, and employees that failure to cooperate with the Verification Review may be grounds for disciplinary action.

3. 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, copies of which will be made available to the Respondent and IIROC.
4. The Consultant's reasonable compensation and expenses shall be borne by the Respondent.