

# 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

**SCOTIA CAPITAL 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 Scotia Capital Inc. (the “Respondent” or “Scotia Capital”).
2. 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

3. 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 Rule 20.35-20.40, inclusive and Rule 15 of the Dealer Member Rules of Practice and Procedure.
4. The Settlement Agreement is subject to acceptance by the Hearing Panel.
5. The Settlement Agreement shall become effective and binding upon the Respondent and Staff as of the date of its acceptance by the Hearing Panel.
6. 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.

7. If the Hearing Panel accepts the Settlement Agreement, the Respondent waives its rights under IIROC rules and any applicable legislation to a disciplinary hearing, review or appeal and IIROC agrees not to initiate or continue any disciplinary proceedings against the Respondent or any of its current or former employees in connection with the same or similar facts as are set out in the Settlement Agreement.
8. 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.
9. The Settlement Agreement will become available to the public upon its acceptance by the Hearing Panel.
10. 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. Nothing in this section is intended to restrict the Respondent from making full answer and defence to any civil proceedings against it.
11. Staff and the Respondent jointly recommend that the Hearing Panel accept the Settlement Agreement.

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

#### **ACKNOWLEDGEMENT**

12. Staff and the Respondent agree with the facts set out in this Section for the purpose of this Settlement Agreement only and further agree that this agreement of facts is without prejudice to the Respondent or Staff in any other proceeding of any kind, including, but without limiting the generality of the foregoing, any proceedings brought by IIROC or any civil or other proceedings which may be brought by any other person or agency. No other person or agency may raise or rely upon the terms of this Settlement Agreement or any agreement to the facts stated herein whether or not this Settlement Agreement is approved by the Hearing Panel.

#### **OVERVIEW**

13. At all material times, the Respondent was a Member firm of the IDA, with its head office located in Toronto, Ontario. On June 1, 2008, the Respondent became a Member firm of IIROC.
14. On August 13, 2007, the Canadian non-bank sponsored asset-backed commercial paper (“ABCP” or “third-party ABCP”) market collapsed, leaving Canadian investors holding

illiquid investments that they could neither sell nor redeem.

15. The Respondent acted as a distribution agent for third-party ABCP.

#### **ASSET-BACKED COMMERCIAL PAPER**

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 held by conduits 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 maturity 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 along with credit ratings and yields.
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 available 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 for individual conduits, including the definition of a “general market disruption event”, were not known to the public, investors or to the distributors of ABCP who were not also the liquidity providers to those individual conduits. Conduits generally disclosed the existence of their liquidity arrangements and disclosed that there were pre-conditions to draws.
21. As of September 2005, ABCP was distributed in Canada pursuant to 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. The conduits issuing the ABCP were not reporting issuers under applicable securities laws and therefore were not required to provide continuous disclosure.
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, to be applied prospectively in the marketplace. No credit ratings on existing ABCP in the marketplace were affected by these changes.

### **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 issuance 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 held in the conduits or the terms of the liquidity agreements supporting the ABCP.

### **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 (“SIT III”) and Structured Asset Trust (“SAT”).
30. All Coventree conduits but one received an R1-(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. Coventree ABCP was rated by DBRS above the minimum “approved credit rating” required by NI45-106 at all material times.

### **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 previously issued third-party ABCP from clients. While the dealer syndicate was under no obligation to purchase any previously issued third-party ABCP, they did so from time to time 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 did not have a centralized quotation system.
34. Investors were provided with access by the conduit sponsors to information memoranda, conduit reports and other documentation prepared by the sponsors, and to DBRS reports. The information that ABCP purchasers typically requested of dealers and dealers provided was the name, yield, term 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. These new notes were issued by Master Asset Vehicles ("MAVs"). It is not currently possible to determine if any or all of the notes of the MAVs will mature at par value.

### **THE RESPONDENT'S ROLE IN SELLING THIRD PARTY ABCP**

40. The Respondent first started selling third-party ABCP market around 2002.
41. At all material times, the Respondent was a member of the dealer syndicates distributing all of the Coventree conduits. The Respondent acted as lead distribution agent for Coventree conduits SIT III and SAT.
42. The Respondent sold Coventree ABCP primarily to institutional investors that did not rely on the Respondent for advice. While five retail clients purchased Coventree ABCP through the Respondent prior to July, 2007, the Respondent did not market Coventree ABCP to retail clients.

### **EMERGING ISSUES**

#### ***(a) US Subprime Exposure***

43. During the period from March to June, 2007, increasing defaults in US subprime mortgages started to place strains on credit markets in the United States.
44. The Respondent first learned that some of the Coventree conduits may have contained United States (US) subprime mortgages in March 2007.
45. The Respondent and some of its clients attended a Coventree investor presentation in late April 2007. At the presentation, Coventree disclosed that the overall US subprime exposure in its conduits was 7.4 percent.
46. As a result of the widening spreads for fixed income securities during the summer of 2007, the Respondent's senior management required staff to manage down inventories, including commercial paper inventories.

47. During July 2007, the Respondent raised with Coventree the issue of the possible effects of US subprime on the credit markets and recommended in a July 20th email that Coventree provide full disclosure regarding US subprime in the individual conduits. The Respondent was concerned about the negative effect unwarranted rumours might have on the third-party ABCP market. The head of Coventree’s funding group responded to the email by stating that she agreed that Coventree should be proactive and disclose the exposure of its conduits.
48. On July 23, 2007, the Respondent authorized the purchase of \$38.9 million in Comet E notes from the CDPQ. The purchase of the Comet E position was contrary to management’s objective of managing down inventory levels. Upon learning of the Comet E purchase, management directed the sales staff to sell the position.
49. On July 24, 2007, Coventree sent an email (the “July 24<sup>th</sup> email”) to all of Coventree's syndicate members, including the Respondent, setting out information regarding US subprime exposure in Coventree conduits as of June 28, 2007. The US subprime content in each of the conduits was noted as follows:

<b>Conduits</b>	<b>Series A</b>	<b>Series E</b>	<b>Total ABCP</b>
Aurora Trust	0%	8%	3%
<b>Comet Trust</b>	0%	<b>42%</b>	16%
<b>Planet Trust</b>	<b>26%</b>	3%	17%
<b>Slate Trust</b>	0%	<b>16%</b>	13%
Apollo Trust			
Gemini Trust	0%	0%	0%
Rocket Trust			
Venus Trust			
SAT	0%	0%	0%
SIT III	1%	0%	1%
<b>TOTAL</b>	<b>3%</b>	<b>6%</b>	<b>5%</b>

50. The email included summary notes which stated, among other things, that all deals remained at AAA level, were performing as expected, there were minimal loss levels and that subprime exposure was to the more favourable pre-2006 vintages. The Respondent had not previously received such particulars on the subject of US subprime from

Coventree.

51. Coventree did not put any limitations on disclosure of the information contained in the July 24th email. Coventree expressly told the Respondent that it left it to the syndicate members to exercise their own judgement in deciding whether to distribute the information to clients.
52. The information communicated in the July 24th email concerning subprime content was not verifiable through publicly available sources. The Respondent, however, took steps to verify the information. Specifically, it confirmed with Coventree the fact that the subprime assets were of the more favourable pre-2006 vintage in addition to the fact that Coventree was rebalancing the subprime content of its conduits. The Respondent also confirmed with DBRS, who had full knowledge of the subprime content, that there was no threat of a ratings downgrade in any of the Coventree conduits and that the assets continued to be rated AAA notwithstanding the subprime content.
53. The Respondent encouraged Coventree to publicly disseminate the information with the necessary contextual information and interpretation.
54. The Respondent requested that DBRS provide further transparency on subprime exposure, stability cushions and downgrade remoteness, but DBRS did not do so. In addition, Coventree did not publicly disclose the information contained in the July 24th email.
55. In the weeks following the July 24th email, the Respondent came to believe that some of its clients had already learned of US subprime mortgage exposure in Coventree conduits. At the same time, one of the Respondent's other clients that was in receipt of the July 24th email was asking questions about US subprime content in third-party ABCP.
56. After the Respondent's management became aware of the July 24<sup>th</sup> email, it did not change the earlier direction to reduce inventories. From July 25 to August 1, 2007, the Respondent sold the Comet E position in seven trades to corporate/institutional purchasers who were previous purchasers of Coventree ABCP. The notes were to mature on August 21, 2007.

**(b) *Liquidity Issues***

57. Beginning in late July 2007, the ability to place Coventree paper was a concern for the Respondent although Coventree ABCP continued to roll up to August 13, 2007. The dealer syndicates including the Respondent offered higher yields in order to sell Coventree ABCP to investors. While the widening spreads were one indicator of liquidity issues that was apparent to investors, the Respondent, in its capacity as lead dealer, possessed additional information regarding the ability of Coventree's syndicates to roll over maturing ABCP and issue new ABCP. Some of the Respondent's clients did not have the ability to independently assess the liquidity in the market.
58. By late July, the Respondent began to collect information on the procedures to be followed to draw down liquidity from the liquidity providers. By August 3, 2007, the



Respondent was aware that liquidity issues may affect the Coventree ABCP market.

59. The Respondent continued to buy and distribute Coventree ABCP pursuant to its obligations in dealer agreements up to August 10, 2007. The Respondent's parent bank honoured its liquidity agreements on August 13, 2007 and the Respondent expected that other liquidity providers would also advance funds under their liquidity agreements. However, the Respondent did not have access to the liquidity agreements of other liquidity providers.

### **THE RESPONDENT'S RESPONSE TO EMERGING ISSUES**

60. Notwithstanding the events described above, the Respondent failed to fully assess the information in the July 24th e-mail in a meaningful way. The Respondent did not notify its Compliance Department ("Compliance") of the July 24th email or its contents until after August 13, 2007.
61. Notwithstanding its concerns about emerging market issues for Coventree ABCP, the Respondent failed to engage an adequate process to fully assess the impact of those concerns. The Respondent did not notify Compliance of its concerns.
62. Notwithstanding the emerging issues relating to the Coventree ABCP market as described above, the Respondent continued to sell Coventree ABCP to institutional clients, primarily by way of newly issued paper.
63. From July 25 to August 3, 2007, the Respondent sold Comet E from inventory, as noted in paragraph 56, and newly issued Planet A ABCP in the amount of \$35,400,000, to institutional clients who the Respondent was not aware had knowledge of the US subprime exposure.
64. On August 3 the Respondent sold \$28 million and from August 7 to 10 the Respondent sold \$235 million in newly issued Aurora A, SAT A, and SIT III A to institutional clients (excluding sales of ABCP that matured prior to August 13, 2007 and sales to the CDPQ and other certain professional counterparties).

### **THE RESPONDENT'S POSITION**

65. Upon the market disruption, the Respondent issued market disruption notices to the conduits. The Respondent's parent, Scotiabank, had entered into liquidity agreements with conduits with terms intended to ensure that in circumstances such as those that occurred, Scotiabank would advance funds to the conduits to enable them to repay investors whose paper was maturing. When the market disruption occurred, Scotiabank honoured its liquidity agreements paying out \$91 million in a timely manner that went to pay investors whose ABCP was maturing at that time.

66. In 2007, Scotiabank also led the restructuring of another non-Coventree third-party ABCP conduit that resulted in purchasers receiving back 98.7% of their principal.
67. At the request of the Pan-Canadian Investors' Committee, Scotiabank committed \$200 million to provide additional margin support for the restructured long-term notes issued in exchange for the outstanding third-party ABCP, which is to the benefit of investors.
68. In August, 2007, the retail brokerage division of the Respondent repurchased third-party ABCP from retail clients who purchased third-party ABCP through the Respondent.
69. Since August 2007, the Respondent has taken, and continues to take, steps which, directly or indirectly, will enhance compliance awareness among the Respondent's commercial paper personnel.
70. The Respondent fully cooperated with the regulatory investigation.

#### **IV. CONTRAVENTIONS**

71. The Respondent admits to the following contraventions of IIROC Rules, Guidance, IDA By-Laws, Regulations or Policies:

Between July 25 and August 10, 2007, the Respondent failed to adequately respond to emerging issues in the Coventree ABCP market insofar as it continued to sell Coventree ABCP without engaging Compliance and other appropriate processes for the assessment of such emerging issues, contrary to IDA By-law 29.1 (ii) (now Dealer Member Rule 29.1(ii)).

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

72. Based on these facts and admissions, Scotia Capital Inc. agrees to the following terms of settlement :
  - (a) Payment of \$28,950,000 pursuant to IIROC Dealer Member Rules, upon acceptance of the Settlement Agreement;
  - (b) Payment of investigation costs of \$320,000, upon acceptance of the Settlement Agreement; and
  - (c) The retention of an independent consultant to verify the remedial actions taken by the Respondent, in accordance with Schedule A of the Settlement Agreement.

**VI. STAFF COMMITMENT**

73. 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 Toronto in the Province of Ontario, this 17<sup>th</sup> day of December, 2009.

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

\_\_\_\_\_  
**RESPONDENT**

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

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

\_\_\_\_\_  
**ELSA RENZELLA**  
Enforcement Counsel on behalf of  
Staff of the Investment Industry  
Regulatory Organization of Canada

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

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

**ACCEPTED** at the City of Toronto in the Province of Ontario, this 21st day of December, 2009,  
by the following Hearing Panel:

Per: \_\_\_\_\_  
Mr. Frederick Webber, Panel Chair

Per: \_\_\_\_\_  
Mr. Donald (Sandy) Grant, Panel Member

Per: \_\_\_\_\_  
Mr. Guenther Kleberg, Panel Member

**SCHEDULE “A” – TERMS OF REFERENCE FOR  
COMPLIANCE VERIFICATION**

**A. Remedial Steps Taken by the Respondent**

1. After August 2007, the Respondent reviewed its policies and procedures in connection with the fixed income business and took the following remedial actions:

a.

**B. Retention of the Consultant**

2. The Consultant's compensation and expenses shall be borne exclusively by the Respondent.

3. The agreement with the Consultant ("Agreement") shall provide that the Consultant will conduct a verification of the implementation of the actions outlined in A above insofar as they relate to:

- a. The Respondent's compliance and oversight functions concerning its trading and sales functions with the fixed income department;
- b. any committees or other mechanisms established to review and approve new securities products in the fixed income department and changes to those products
- c. the Respondent's training of its staff concerning new securities products in the fixed income department, and changes to those products;
- d. the Respondent's training of its staff concerning the escalation of issues to compliance and engaging other appropriate processes;

(collectively, the “Review”).

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

4. The Consultant shall issue a draft report to the Respondent and IIROC within 3 months of appointment and in that regard will be provided the opportunity to present its report to the Board of Directors of the Respondent.

5. 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 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 may explain any areas of disagreement with management of the Respondent.

6. The Consultant will deliver the final report to the Respondent and to IIROC.
7. The Consultant's draft and final reports shall include a description of the verification review performed, whether the remedial action taken by the Respondent as it relates to 3(a-d) conforms to regulatory requirements, and, if not, the Consultant's recommendations for any changes to those remedial actions as the Consultant reasonably deems necessary.
8. 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.
9. The Respondent shall certify to IIROC, by certificate executed on its behalf by each of the CEO, the UDP, the CCO and the and the Chair of the Board of Directors of the Respondent, that the Respondent has implemented those recommendations of the Consultant which it had agreed upon, and will do so promptly following such implementation.
10. For greater certainty, the terms of this compliance 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

11. 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.
12. The Consultant shall have reasonable access to all of the Respondent's books and records. 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.
13. 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.