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Citation: *Pro-Financial Asset Management et al*, 2017 ONSEC 9
Date: 2017-04-20

IN THE MATTER OF
THE *SECURITIES ACT*, RSO 1990, c S.5

- AND -

IN THE MATTER OF PRO-FINANCIAL ASSET MANAGEMENT INC.,
STUART MCKINNON and JOHN FARRELL

REASONS AND DECISION

Hearing: April 11-15, 18, 20-22, 25-29, June 13, 15-16 and September 15, 2016

Decision: April 20, 2017

Panel:	Christopher Portner	-	Commissioner and Chair of the Panel
	Judith N. Robertson	-	Commissioner
	AnneMarie Ryan	-	Commissioner
Appearances:	Derek Ferris Catherine Weiler Alexandra Matushenko	-	For Staff of the Commission
	Alistair Crawley Michael L. Byers	-	For Stuart McKinnon

No one appeared on behalf of Pro-Financial Asset Management Inc.

TABLE OF CONTENTS

REASONS AND DECISION

I. INTRODUCTION

A. Overview

[1] This proceeding involves allegations that Pro-Financial Asset Management Inc. ("**PFAM**"), Stuart McKinnon, PFAM's President and Chief Executive Officer ("**McKinnon**"), and John Farrell, PFAM's Chief Compliance Officer ("**Farrell**"), committed numerous breaches of Ontario securities laws. Such alleged breaches include numerous administrative, accounting, compliance and oversight failures. In addition, there are numerous allegations of failures relating to nine series of principal protected notes ("**PPNs**") distributed on behalf of two banks by PFAM, which failures resulted in a deficiency of $1,222,549.45 (the "**PPN Deficiency**") owing to holders of the PPNs (the "**Noteholders**").

[2] This proceeding was initiated by a Notice of Hearing dated December 9, 2014 which was issued by the Ontario Securities Commission (the "**Commission**") and named PFAM, McKinnon and Farrell as the respondents, and by a Statement of Allegations dated December 8, 2014 (the "**Statement of Allegations**") issued by Staff of the Commission ("**Staff**").

[3] Farrell settled the allegations against him by entering into a Settlement Agreement with Staff which was approved by the Commission on June 26, 2015. Neither the terms of the Settlement Agreement nor any admissions by Farrell may be used in this proceeding.

B. The Respondents

[4] The following is a brief description of PFAM and McKinnon, the remaining respondents (together, the "**Respondents**") following Farrell's settlement with Staff.

1. Pro-Financial Asset Management Inc.

[5] PFAM was incorporated in Ontario on November 6, 2002 under the name Pro-Hedge Funds Inc. which was changed to Pro-Financial Asset Management Inc. on January 17, 2006. PFAM was registered as:

(a) A limited market dealer from January 21, 2004 until September 28, 2009;

(b) An investment counsel and portfolio manager from October 19, 2005 to September 28, 2009; and

(c) An exempt market dealer ("**EMD**") from September 28, 2009 until May 17, 2013 when its registration as an EMD was suspended on consent.

[6] PFAM was also registered as an adviser in the category of portfolio manager and acted in that capacity for certain managed accounts until February 27, 2015 when this registration was also suspended. As of February 2015, PFAM no longer carried on any registrable activity.

[7] Prior to October 28, 2010, the date on which the McKinnon Family Trust entered into a Share Purchase Agreement with the Butler Family Trust,[1] the McKinnon Family Trust owned all of the issued and outstanding shares of PFAM.

2. Stuart McKinnon

[8] McKinnon graduated from the University of Western Ontario with a degree in Economics in 1986 and started his career as an equity trader on the floor of the Toronto Stock Exchange. McKinnon was the indirect owner, President, Chief Executive Officer and a director of PFAM from the date of its incorporation and has been registered with the Commission in various capacities since 1987 including as an officer and director of PFAM, as a registered dealing representative and as PFAM's Ultimate Responsible Person ("**URP**") and Ultimate Designated Person ("**UDP**").

[9] McKinnon also owned and controlled Legacy Investment Management Inc. ("**Legacy**"), a financial services firm which was registered as a mutual fund dealer and limited market dealer. Legacy and PFAM shared offices and accounting personnel and some of PFAM's personnel also performed duties for Legacy.

[10] In late 2013, McKinnon caused Legacy to transfer its assets and advisers to De Thomas Financial Corp. ("**De Thomas**"), a mutual fund and exempt market dealer. McKinnon continued to be a shareholder, officer, director, UDP and dealing representative of Legacy in the categories of EMD and mutual fund dealer until November 29, 2013.

[11] McKinnon's registrations as a dealing representative and UDP and his approval as an officer and director of PFAM were suspended on February 27, 2015 following the suspension of PFAM's registration by the Commission on May 17, 2013. A Notice of Reinstatement was filed on January 17, 2014, however, the reinstatement of McKinnon's registration was not approved. An application for Reactivation of Registration with De Thomas, which was filed on behalf of McKinnon on June 12, 2015, remains pending.

C. The Allegations

[12] In the Statement of Allegations, Staff alleges that, during the material time between May 2003 and August 2014:

(a) PFAM failed to deal fairly, honestly and in good faith with its clients in breach of its obligations under subsection 2.1(1) of OSC Rule 31-505 – *Conditions of Registration* ("**Rule 31-505**");

(b) PFAM failed to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances and, in doing so, breached the standard of care for investment fund managers under subsection 116(b) of the *Securities Act*, RSO 1990, c S.5 (the "**Act**");

(c) PFAM failed to maintain the minimum working capital required of a registered firm and failed to report its capital deficiency contrary to section 12.1 of National Instrument 31-103 - *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**");

[1] As contemplated by the Share Purchase Agreement, Anthony Cox also purchased PFAM common shares, however, the agreement relating to such purchase was not entered into evidence. See also Footnote 2.

(d) PFAM failed to keep satisfactory books, records or other documents contrary to subsection 19(1) of the Act and sections 11.5 and 11.6 of NI 31-103;

(e) PFAM failed to establish, maintain and apply policies and procedures that establish an adequate system of controls and supervision contrary to section 11.1 of NI 31-103 and subsection 32(2) of the Act;

(f) McKinnon, as an officer and director of PFAM, authorized, permitted or acquiesced in the beaches by PFAM set out in paragraphs [12](a) to (e) above and is thereby deemed to have breached subsection 2.1(1) of Rule 31-505, subsection 116(b) of the Act, sections 11.1 and 12.1 of NI 31-103, subsections 19(1) and 32(2) of the Act and sections 11.5 and 11.6 of NI 31-103 pursuant to section 129.2 of the Act; and

(g) McKinnon breached his obligations as URP and UDP of PFAM contrary to former subsection 1.3(2) of Rule 31-505 and, on and after September 28, 2009, contrary to section 5.2 of NI 31-103.

[13] Staff also alleges that PFAM's and McKinnon's foregoing conduct was contrary to the public interest.

[14] In response to Staff's allegations, McKinnon submits, among other things, that:

(a) The PPNs are excluded from the definition of a security within the meaning of the Act and, even if the PPNs were securities, section 8.5 of NI 31-103 provides that trades of the PPNs would be exempt if made through a registered dealer;

(b) PFAM's activities with respect to the PPNs were not registrable conduct and did not involve dealings with clients within the meaning of Rule 31-505;

(c) Staff's allegations amount, at the most, to negligence on the part of PFAM and do not rise to the threshold of intentional misconduct necessary to find liability under section 2.1 of Rule 31-505;

(d) PFAM was not a party to any contract with the Noteholders and any acts or omissions it may have made did not affect the rights of the Noteholders to full payment by the issuing banks;

(e) In his capacity as the Chief Executive Officer of PFAM, McKinnon was not personally responsible for record-keeping and the documentary evidence substantiates that he endeavoured to ensure that PFAM's physical and electronic records were safely and securely stored;

(f) He made *bona fide* efforts to ensure that PFAM's compliance systems were in accordance with industry standards; and

(g) If Staff cannot demonstrate that the conduct of the Respondents violated any of the specific provisions alleged, it would be inappropriate to find that such conduct was contrary to the public interest.

D. Merits Hearing

[15] The merits hearing in this matter (the "**Hearing**") was conducted over 17 days commencing on April 11, 2016 and concluding on June 16, 2016. Following the filing of their written submissions, the parties made oral submissions to the Panel on September 15, 2016.

[16] McKinnon was represented by counsel throughout the Hearing. PFAM was not represented and did not participate, provide evidence or make submissions at the Hearing.

E. Witnesses Called

[17] Staff called the following 13 witnesses:

(a) Employees of the Commission

(i) Michael Denyszyn, a senior legal counsel in the Commission's Compliance and Registrant Regulation Branch (the "**CRR Branch**");

(ii) Estella Tong, a senior accountant in the CRR Branch;

(iii) Susan Thomas, a senior legal counsel in the Commission's Investment Funds and Structured Products Branch (the "**IF Branch**"); and

(iv) Michael Ho, a senior forensic accountant in the Commission's Enforcement Branch ("**Ho**" and the "**Enforcement Branch**", respectively).

(b) Issuing Banks for the PPNs

(i) Paul Drumm, a Managing Director of BNP Paribas (Canada) ("**Drumm**" and "**BNP**", respectively); and

(ii) Diletta Prando, a Managing Director, General Counsel and Corporate Secretary of Société Génerale (Canada) ("**Prando**" and "**SGC**", respectively).

(c) Former employees of PFAM

(i) Michael Butler, PFAM's former President ("**Butler**")[2];

(ii) Anthony Cox, PFAM's former Chief Financial Officer ("**CFO**") and Chief Operating Officer ("**Cox**");

(iii) Ralph Bozzo, PFAM's former Manager of Operations ("**Bozzo**");

(iv) Milind Jog, PFAM's former Director of Sales and National Sales Manager ("**Jog**"); and

(v) Zora Atlija, PFAM's former Director of Finance ("**Atlija**").

[2] Butler became the President of PFAM on November 1, 2010 and remained in that position for just over five months until his employment was terminated by McKinnon on April 14, 2011. Cox became the Chief Financial Officer and Chief Operating Officer of PFAM on November 1, 2010 and resigned on April 15, 2011. Both Butler, indirectly through the Butler Family Trust, and Cox remained shareholders of PFAM after they ceased to be employed by PFAM.

(d) Service providers to PFAM

(i) David Chan, a representative of The Investment Administration Solution Inc., PFAM's record-keeper ("**Chan**" and "**IAS**", respectively); and

(ii) Dawn Bell, a representative of Concentra Trust, the trustee and escrow agent for the PPNs ("**Bell**" and "**Concentra**", respectively).

[18] McKinnon testified on his own behalf and called Samantha Pinto, PFAM's former CFO ("**Pinto**"), as a witness. PFAM did not participate in or call any witnesses at the Hearing.

II. PRELIMINARY MATTERS

A. Standard of Proof

[19] Commission proceedings apply the civil standard of proof on a balance of probabilities. It is not disputed that this civil standard of proof applies to this proceeding. In *F.H. v McDougall* [2008] 3 SCR 41 ("***McDougall***"), the Supreme Court of Canada stated that proof on a balance of probabilities requires the trier of fact to decide whether it is more likely than not that an alleged event occurred.[3] In making such a determination, the evidence must be sufficiently clear, convincing and cogent to satisfy the balance of probabilities test.[4]

B. Admission of Hearsay Evidence

[20] Some of the evidence tendered by the parties at the Hearing was hearsay. Hearsay evidence is admissible in hearings before the Commission pursuant to section 15 of the *Statutory Powers Procedure Act*, RSO 1990, c S.22. Hearing panels have broad discretion to admit evidence at a hearing including any oral testimony and any document or other thing relevant to the subject matter of the proceeding. A panel can rely on hearsay evidence that is corroborated or consistent with other documentary evidence.[5]

C. Assessment of Credibility

[21] Credibility is an important issue in this proceeding. Some of McKinnon's testimony conflicts in material respects with the testimony of Staff's witnesses or is inconsistent with the documentary evidence. In his written submissions dated August 19, 2016 ("**McKinnon's Written Submissions**"), McKinnon submits that, when weighing and considering the evidence, the Commission should consider that five of Staff's witnesses, namely, Prando, Bell, Chan, Butler and Cox, are involved in litigation with McKinnon and/or PFAM, either personally or through their employer or a corporation. McKinnon also notes that Bozzo was in litigation with PFAM prior to the dismissal of his grievance against PFAM and is now employed by IAS. McKinnon submits that Bozzo's evidence is fundamentally unreliable and that we should ascribe no weight to any of his uncorroborated evidence. McKinnon also submits that the testimony of each of Chan, Butler and Cox is not reliable as it is motivated by self-interest.

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[3] *McDougall*, para 44.
[4] *McDougall*, para 46.
[5] *Maple Leaf Investment Fund Corp* (2011), 34 OSCB 11551, para 47.

[22] In *Springer v Aird & Berlis LLP* (2009), 96 OR (3d) 325, Mr. Justice Newbould of the Ontario Superior Court of Justice cited with approval O'Halloran J.A.'s statement in *R v. Pressley* (1948), 94 CCC 29 (BCCA) that the most satisfactory judicial test of truth lies in its harmony with the preponderance of probabilities disclosed by the facts and circumstances in the conditions of a particular case.

[23] In assessing a witness's credibility, the trier of fact may consider:

> (a) an assessment of the witness' general integrity, powers of observation, capacity to remember and the accuracy of statements of the witness;
>
> (b) the extent to which the witness' evidence is internally consistent;
>
> (c) the extent to which the witness' evidence is consistent with other proven or undisputed facts; and
>
> (d) in the rarest of cases, the demeanour of the witness.
>
> (*North American Financial Group Inc.* (2013), 36 OSCB 12095 at para 258)

[24] In cases where there is conflicting testimony and where the trier of fact is deciding whether a fact occurred on a balance of probabilities, finding the evidence of one party credible may well be conclusive of the result because that evidence is inconsistent with that of the other party. In such cases, believing one party will mean explicitly or implicitly that the other party was not believed on the important issue in the case.[6]

[25] Disbelief of a witness's evidence on one issue may well taint the witness' evidence on other issues, but an unfavourable credibility finding against a witness does not, of itself, constitute evidence that can be used to prove a fact in issue.[7] In assessing McKinnon's credibility and that of other witnesses, we have carefully considered whether their evidence is in harmony with the preponderance of probabilities disclosed by the facts and circumstances of this proceeding and have made reference to the issue of credibility where relevant.

III. THE PPNs - DID PFAM FAIL TO DEAL FAIRLY, HONESTLY AND IN GOOD FAITH WITH ITS CLIENTS?

A. Background and Submissions

[26] Staff alleges that PFAM engaged in improper conduct which resulted in or contributed to the PPN Deficiency and is the basis of the allegation that PFAM failed to deal fairly, honestly and in good faith with its clients in breach of its obligations under subsection 2.1(1) of Rule 31-505. A representative of a registered dealer or a registered adviser is also required to deal fairly, honestly and in good faith with his or her clients under subsection 2.1(2) of Rule 31-505.

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[6] *McDougall*, at para 86.
[7] *McDougall*, at para 95.

[27] As the phrase "fairly, honestly and in good faith" is not defined in the Act, Staff points to the following definitions of "fairly" and "honest" found in *Webster's Encyclopaedic Dictionary*[8] and the definition of "good faith" found in *Black's Law Dictionary*[9] which provide a useful context for the discussion which follows:

> **Fairly:** in a just and equitable manner.
>
> **Honest:** never deceiving, stealing or taking advantage of the trust of others; sincere, truthful.
>
> **Good faith:** a state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage.

[28] In response, McKinnon acknowledges PFAM's shortcomings in relation to the PPNs, however, he asserts that "…Staff's allegations amount, at most, to negligence and do not rise to the threshold of intentional misconduct necessary to find liability under s. 2.1 of Rule 31-505."[10] McKinnon submits that the responsibility for the failures that caused the PPN Deficiency is shared with other parties and that the Noteholders ultimately received payment of the amount of the PPN Deficiency from the Banks.

[29] McKinnon also submits that PFAM's management of the PPNs was outside the scope of subsection 2.1(1) of Rule 31-505 as (i) the PPNs were not securities; (ii) PFAM's conduct in relation to the PPNs was more analogous to that of a back office entity and did not constitute registrable activity; and (iii) the Noteholders were not clients of PFAM within the meaning of subsection 2.1(1) of Rule 31-505.

[30] We will first review the issues raised by McKinnon and summarized in paragraph [29] above and, in the final part of this section, will return to the question of whether PFAM breached its obligation to deal fairly, honestly and in good faith with its clients.

B. Overview of the Principal Protected Notes

[31] Prando and Drumm, respectively, Managing Directors of SGC and BNP (together, the "**Banks**") testified that a PPN is an investment product which promises to repay, at a minimum, the capital invested if the note is held to maturity. Principal protected notes are usually issued by banks and the returns are linked to some other investment such as a fund or a basket of securities. At maturity, the noteholder receives the capital invested plus a return, if any, on the referenced fund or basket of securities.

[32] Prando and Drumm also testified that the Noteholders could sell their respective PPNs before maturity (an early redemption) on a secondary market provided by the Banks and

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8 *Webster's Encyclopaedic Dictionary,* Canadian ed. (New York, NY: Lexicon Publications Inc., 1988), pp. 338 and 465.

9 *Black's Law Dictionary*, 9th ed. (St. Paul, MN: West Publishing Co., 2009), p. 762.

10 McKinnon's Written Submissions, para 128.

at a price determined by the Banks. The price received for early redemptions might be less than the capital invested and might be subject to an early termination fee.[11]

[33] PPNs having an aggregate value of approximately $95 million were sold through PFAM to the Noteholders between 2003 and 2006. The PPNs were sold in nine series and 13 tranches, with maturity dates between December 31, 2010 and December 12, 2016.

[34] Of the nine series of PPNs sold through PFAM, three were issued by BNP and six were issued by SGC. The first two series issued by SGC were sold through Legacy, however, PFAM assumed responsibility for these series when Legacy withdrew from its involvement with the PPNs in 2005.

[35] PFAM entered into agreements with each of the Banks (collectively, the "**Bank Agreements**") pursuant to which PFAM agreed to provide advisory, distribution and other services in relation to the PPNs and for which PFAM was paid fees at closing and through the term of the respective series of PPNs. PFAM's role was essentially the same for all of the PPNs although each of the Banks described its agreements differently.[12]

[36] Pursuant to the Bank Agreements, PFAM undertook, among other things, to maintain the books and records relating to the PPNs, communicate with the Noteholders, provide marketing services and assist the Banks in the identification of sales channels, receive funds from the Noteholders and transfer the funds to the Banks on closing, act as a conduit for early redemption orders and transfer the proceeds from early redemptions and/or maturities from the Banks to the Noteholders.

[37] Both Prando and Drumm testified that PFAM was engaged to provide the retail distribution network that the Banks lacked. PFAM engaged directly with the Noteholders through its own salesforce and used its network of other dealers for such purpose. Prando testified that, during the distribution phase, PFAM was selling and marketing the PPNs and, as it was not merely a passive receiver of purchase orders, it was paid a selling fee. PFAM also received fees through the term of the PPNs as compensation for its on-going duties in the administration of the PPNs, including early redemptions and maturities.

[38] PFAM represented and warranted to each of the Banks that it was either registered as a dealer under the laws of each jurisdiction in which such registration was required and in which PFAM sold or procured purchasers in respect of the PPNs or that it held all material licences, permits, registrations and approvals necessary to perform its obligations under the relevant Bank Agreement.

[39] PFAM engaged IAS as record-keeper, and Concentra was engaged by PFAM and the Banks as trustee and escrow agent, to assist PFAM in fulfilling its responsibilities under the Bank Agreements. As the principal intermediary between the Banks and the Noteholders, PFAM was required to maintain the books and records, including the details

[11] The agreements, which are described in paragraph [35], provide that an affiliate of BNP and SGC would facilitate a secondary market under certain circumstances and purchase the PPNs from the Noteholders. While the secondary market theoretically included both sales and purchases, in practice, it was mainly used to allow the Noteholders to sell their investments prior to maturity. Accordingly, the practice became known at PFAM as early redemptions, however, the PPNs were not actually redeemed but were purchased by a Bank affiliate. We have adopted the PFAM convention of using the term early redemption for secondary market sales.

[12] PFAM also acted as Investment Advisor/Manager for six of the series of PPNs, however, its conduct as Investment Advisor/Manager was not at issue in this proceeding.

of the Noteholders and their investments, necessary to effect the initial investment and all early redemptions or payments on maturity. The PFAM records, as reflected on the IAS system, reflected the individual Noteholder positions (even when there was another dealer acting for that Noteholder). The Banks had no information relating to individual Noteholders. The records of the Banks and Concentra were maintained at the PPN level, i.e., the Banks recorded the initial funds received from PFAM and made adjustments to the global notes outstanding as early redemptions were processed in bulk. Any changes in ownership of the PPNs as a result of purchases or early redemptions would be recorded at the Noteholder level by PFAM on the IAS system.

[40] On the first maturity of the PPNs in December 2010, the amount received by PFAM from SGC was $197,031 more than the amount that was required to be remitted to Noteholders. On the second maturity of the PPNs in December 2011, the amount received by PFAM from SGC was $114,803 less than the amount that was required to be remitted to Noteholders. In both cases, PFAM paid Noteholders on the basis of the records maintained on the IAS system and did not inform SGC, Concentra or IAS of the discrepancies.[13]

[41] On the third maturity date in December 2012, PFAM estimated that there would be a large shortfall of over $500,000.[14] Subsequent analysis revealed a total estimated shortfall of approximately $1.9 million across all of the outstanding PPNs. At that time, there was also approximately $750,000 in the PFAM trust account for the PPNs which, when offset against the estimated maturity shortfalls, resulted in the PPN Deficiency of approximately $1.2 million.

[42] In their testimony, the representatives of BNP, SGC, IAS and Concentra were consistent in asserting that there should be no variance between the records of the Banks, the trustee and the record-keeper with respect to the units held by the Noteholders. They testified that routine and frequent reconciliations are the industry method for the early identification and correction of any errors which could give rise to such discrepancies and that the revelation of the PPN Deficiency was without precedent.

C. Legal Issues

1. Are the PPNs Securities Within the Meaning of Subsection 1(1) of the Act?

(a) Background and Submissions

[43] Subsection 1(1) of the Act provides that a "security" includes:

> (e) a bond, debenture, note or other evidence of indebtedness or a share, stock, unit, unit certificate, participation certificate, certificate of share or interest, preorganization certificate or subscription other than,
>
> …

[13] In some cases, these funds were not transferred to Noteholders immediately and remained in the PFAM trust account pending receipt of client instructions.

[14] Pinto advised the Commission in a telephone conversation on December 19, 2012 that there was a large difference of under $1.0 million, however, Pinto confirmed in her testimony that she could have calculated a $508,127 shortfall with the information she had on December 12, 2012. Butler and Cox estimated a shortfall of approximately $660,000 based on the information provided to them by Bozzo in November 2012.

> (ii) evidence of a deposit issued by a bank listed in Schedule I, II or III to the *Bank Act* (Canada), by a credit union or league to which the *Credit Unions and Caisses Populaires Act, 1994* applies, by a loan corporation or trust corporation registered under the *Loan and Trust Corporations Act* or by an association to which the *Cooperative Credit Associations Act* (Canada) applies. [Emphasis added.]

[44] Although the parties agree that the PPNs were issued by banks listed in Schedule II to the *Bank Act* (Canada)[15] (the "**Bank Act**"), McKinnon submits that the PPNs, which he states are also known as deposit notes, are excluded from the definition of "security" because the PPNs were evidence of bank deposits and therefore benefitted from the exemption in subsection 1(1)(e)(ii) of the Act set out in paragraph [43] above.

[45] To support his position, McKinnon refers to the information statements of the Banks which stated that each PPN was a direct, unsecured deposit obligation of the applicable Bank and that amounts owing under the PPNs were unconditionally guaranteed by the parent company of the applicable Bank.

[46] McKinnon also submits that PPNs are federally regulated by the *Principal Protected Notes Regulations*, SOR/2008-180 (the "**PPN Regulations**"), which were enacted under the Bank Act, the *Cooperative Credit Associations Act*[16] and the *Trust and Loan Companies Act*[17]. He further submits that compliance with the PPN Regulations is enforced by the Office of the Superintendent of Financial Institutions ("**OSFI**") and that OSFI may intervene if assets are not satisfactorily accounted for or a regulated entity is committing an unsafe or unsound practice.

[47] Finally, McKinnon submits that the thorough review of the Canadian PPN market between 2006 and 2012 conducted by the Canadian Securities Administrators (the "**CSA**") did not result in any provincial PPN legislation or regulations.

[48] Staff submits that the following characteristics of the PPNs are consistent with the definition of a "security" under subsection 1(1)(e) of the Act, namely, that: (i) the PPNs were marketed and sold as investments through registered dealers;[18] (ii) global certificates evidencing the total subscriptions of each series of PPNs were issued in registered form to The Canadian Depository for Securities Limited ("**CDS**") and deposited with CDS; (iii) the PPNs were subscribed for and redeemed through FundSERV; (iv) each PPN series was assigned a mutual fund order code; (v) the Banks made a secondary market available to the Noteholders; (vi) the financial terms of the PPNs were complex and structured more like derivative securities than deposits; (vii) sales and trailer commissions were paid on sales of the PPNs; (viii) the Banks did not consider the PPNs as deposits of the Banks insured under the *Canada Deposit Insurance Corporation Act*[19] (the "**CDIC Act**"); (ix) the Noteholders had the potential to earn gains

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[15] SC 1991, c 46.
[16] SC 1991, c 48.
[17] SC 1991, c 45.
[18] See for example, Exhibits 13, 19 and 24 at p.1.
[19] RSC 1985, c C-3.

based on the performance of the basket of securities underlying the PPNs; and (x) some of the information statements represented to the Noteholders that "No securities commission or similar authority in Canada has in any way passed upon the merits of the securities offered hereunder."[20]

[49] Staff submits that the Banks relied on the specified debt exemption under subsection 73.1(1) of the Act[21] in order to be exempt from the prospectus requirements of the Act. In this regard, in separate letters to the Commission from Jog and Pinto dated April 23, 2013 and September 30, 2013, respectively, PFAM stated that the distributions of PPNs "were effected by the issuers in reliance on the 'specified debt' exemption which is available for distributions of certain debt securities issued by banks."[22]

[50] In response to McKinnon's position with respect to the information statements described in paragraph [45] above, Staff notes that the information statements explicitly state that the PPNs will not constitute deposits that are insured under the CDIC Act and, in the case of the PPNs issued by BNP, the information statements also provide that the PPNs were not deposits under any other insurance regime.

[51] In response to McKinnon's submissions relating to the PPN Regulations, Staff submits that the PPN Regulations impose disclosure obligations on the issuers of PPNs but do not govern the activities of a registrant of the Commission acting in the role of a market intermediary.

[52] In response to McKinnon's submissions relating to the CSA review of the Canadian PPN market, Staff submits that the notices issued by the CSA with respect to its review of PPNs clearly demonstrate that the CSA views some PPNs as securities and points to CSA Multilateral Staff Notice 46-303 – *Principal Protected Notes* ("**CSA Notice 46-303**") which states, among other things, that "Any registrant that sells a security, including a PPN that is sold under a prospectus and registration exemption, must comply with the know your client (KYC) and suitability obligations."[23]

(b) Analysis and Findings

[53] It is clear from the evidence, including the characteristics of PPNs described in paragraph [49] above, that the PPNs are securities within the meaning of subsection 1(1) of the Act, and that all parties to the PPN transactions to which this proceeding relates, including PFAM, which had the benefit of legal advice, and the Banks, treated the PPNs as securities governed by the securities laws of Ontario.

[54] McKinnon's submissions relating to the applicable regulatory regime are substantially based on his analysis of the PPN Regulations and his assertion that the CSA review of the Canadian PPN market did not result in any provincial PPN legislation or regulations. In our view, and consistent with the submissions of Staff, the PPN Regulations do no more than establish certain disclosure obligations relating to PPNs and neither establish, nor purport to establish, rules governing PPNs. It follows that we reject McKinnon's

[20] Exhibit 2, p. 1.
[21] Subsection 73.1(1) of the Act provides that the prospectus requirement does not apply to a distribution of a debt security that is issued or guaranteed by a bank listed in Schedule I, II or III to the Bank Act.
[22] Exhibit 49, p. 1; Exhibit 380, p. 1.
[23] CSA Notice 46-303, p. 2.

submission that subsections 645(1) and 648(1)(d) of the Bank Act provide the basis for OSFI to intervene in any matter relating to a breach of the PPN Regulations which is clearly not provided or contemplated by the PPN Regulations and would be totally inconsistent with the well-established regulatory regime relating to securities.

[55] For the foregoing reasons, we find that each of the PPNs issued to the Noteholders was a "security" within the meaning of subsection 1(1) of the Act.

2. Was PFAM's Role Relating to the PPNs Registrable Conduct?

(a) Background and Submissions

[56] Prior to September 28, 2009, subsection 25(1)(a) of the Act provided that no person or company shall trade in a security unless the person or company was registered as a dealer or as a salesperson, partner or officer of a registered dealer. Since that date, subsection 25(1) of the Act provides that, unless exempt, a person or company shall not engage in or hold himself, herself or itself out as engaging in the "business of trading" in securities unless the person or company is registered in accordance with Ontario securities laws.

[57] As detailed in Staff's written submissions dated August 5, 2016 ("**Staff's Written Submissions**"), the requirement that someone be "in the business" before the dealer registration requirement is engaged is referred to as the "business trigger" which came into effect on September 28, 2009 with the amendment to subsection 25(1) of the Act, as noted above, and the adoption of NI 31-103.

[58] Staff submits that Legacy and PFAM were market intermediaries in 2003 and 2004, respectively, and, as a result, did not have an exemption from registration available for their activities relating to the PPNs. As a result and as required, both Legacy and PFAM became registered as dealers in the category of limited market dealers.

[59] Subsection 1.1(2) of OSC Rule 14-501 – *Definitions* provides that:

> "market intermediary" means a person or company that engages or holds himself, herself or itself out as engaging in Ontario in the business of trading in securities as principal or agent…[and] includes a person or company that engages or holds himself, herself or itself out as engaging in the business of,
>
> (a) entering into agreements or arrangements with underwriters or issuers, in connection with distributions of securities, to purchase or sell such securities,
>
> (b) participating in distributions of securities as a selling group member,
>
> (c) making a market in securities, or
>
> (d) trading in securities with accounts fully managed by the person or company as agent or trustee,

whether or not the person or company engages in trading in securities purchased for investment only.

[60] Section 1.3 of Companion Policy 31-103CP - *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103CP**") sets out a number of concepts that form the basis of the registration regime including the requirement to register, the business trigger for trading and registration, and fitness for registration. The section describes the following non-exhaustive list of factors that the Commission considers relevant in determining whether an individual or firm is trading or advising in securities for a business purpose and would therefore be subject to the dealer or adviser registration requirement:

(a) Engaging in activities similar to a registrant;

(b) Intermediating trades or acting as a market maker;

(c) Directly or indirectly carrying on the activity with repetition, regularity or continuity;

(d) Being, or expecting to be, compensated; and

(e) Directly or indirectly soliciting.

[61] Staff cites *Momentas Corp.* (2006), 29 OSCB 7408 ("***Momentas***") in which the Commission acknowledged that, traditionally, the term "market intermediary" has been "an individual or company who is interposed between the issuer and the investing public". The Commission also noted that receiving compensation from the proceeds of an offering is indicative of being a market intermediary.[24]

[62] Staff submits that, in respect of PFAM's activities in the marketing, distribution, sales and redemptions of PPNs, PFAM clearly acted as a market intermediary and engaged in the business of trading in securities, both before and after September 28, 2009, and relies in this regard on the following:

(a) PFAM's and Legacy's registration as dealers in the category of limited market dealer which enabled them to trade in prospectus-exempt securities such as the PPNs;

(b) The Agency Agreements with SGC pursuant to which PFAM agreed to act as SGC's agent and offer the PPNs for sale and assist in marketing and selling PPNs to investors through its relationships with various dealers;

(c) The representations by PFAM in the Agency Agreements that it was registered as a dealer under the laws of each jurisdiction in which such registration was required and in which PFAM sold or procured purchasers in respect of the PPNs;

(d) PFAM's facilitation of secondary market trading of PPNs pursuant to the Escrow and Administration Agreements with the Banks;

(e) As required by SGC, the provision by PFAM of an opinion from its legal counsel that PFAM was registered as a limited market dealer which Prando testified was

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[24] *Momentas*, paras 53 and 62.

"in keeping with the requirement that our agents be registered in some fashion, be subject to the jurisdiction of a Securities Commission, be subject to conduct, business conduct and financial requirements that go with such registration.";[25]

(f) The Marketing Services and Administration Agreements with BNP pursuant to which PFAM agreed to assist BNP in selling PPNs to investors through its relationships with various dealers;

(g) The collection by PFAM of subscription proceeds for the PPNs electronically through FundSERV and manually by cheque payable to PFAM, the proceeds of which would be forwarded to Concentra;

(h) The payment of sales commissions to PFAM on closing, consistent with PFAM being engaged in registrable conduct, and the receipt by PFAM of trailer and agency fees for its services;

(i) The receipt by PFAM of secondary market sales requests from dealers through the IAS system which were forwarded on an aggregated basis for each series of PPNs to the Banks;

(j) The receipt and payment of redemption proceeds for PPNs;

(k) Seven of the eight PFAM compliance manuals included sections entitled "Market Intermediary Activities" which described PFAM's policies and procedures for deposit notes or PPNs issued by the Banks; and

(l) Descriptions in PFAM's compliance manuals of conduct relating to PPNs which would amount to acts in furtherance of trades including the provision of information statements and subscription agreements to investors, establishing a secondary market price and receiving cheques from clients payable to PFAM.

[63] McKinnon submits that, even if the PPNs were securities, PFAM's activities in relation to the PPNs did not require registration. Although PFAM made representations in the Bank Agreements that it was registered under securities legislation, no evidence was adduced that such registration was necessary. In this regard, McKinnon points to Prando's testimony that she did not recall if there was a legal requirement to be registered to distribute the PPNs and Drumm's testimony that he had no direct knowledge as to whether or not registration would be required. McKinnon also relies on subsection 8.21(2)(e) of NI 31-103 which provides that "The dealer registration requirement does not apply in respect of a trade in…a debt security issued by or guaranteed by a Canadian financial institution or a Schedule III bank..."

[64] McKinnon submits that, even if registration may have been required to distribute the PPNs (which he disputes), that is a matter that is distinct from whether or not PFAM's activities in the secondary market required registration. He notes that the issues which arose with respect to the PPNs did so because of early redemptions of the PPNs by Noteholders, which were not solicited by PFAM and with respect to which they would have been advised by their investment advisers. McKinnon submits that PFAM's conduct with respect to the PPNs was more analogous to that of a back-office entity (that processes trades through registrants) which qualifies for this exemption, rather than to a

[25] Hearing Transcript, April 13, 2016, p. 59.

registrant which owes specific duties to its investing clients related to its provision of investment advice. McKinnon relies on section 8.5 of NI 31-103 which provides that trades will be exempt if made through a registered dealer, in this case the registrants in PFAM's dealer network, and not PFAM.

(b) Analysis and Findings

[65] In our view, the list of factors set out in paragraph [60] above, which the Commission considers relevant in determining whether a firm is trading or advising in securities for a business purpose and which trigger the requirement to comply with the registration regime, clearly apply to PFAM and establish that PFAM was acting as a market intermediary. The same is true of PFAM's activities in the marketing, distribution and sale of PPNs and in the secondary market for PPNs described in paragraph [62] above, a fact reflected in PFAM's own Policy and Procedures Manuals.[26]

[66] It is clear from the evidence that PFAM's responsibilities were extensive, as detailed above, and, accordingly, we reject McKinnon's submission that PFAM's conduct in respect of the PPNs was analogous to that of a back-office entity. The existence of another registrant in a chain of securities transactions does not change the character and nature of the role and responsibilities of PFAM as a market intermediary. We also note that there were many instances in which PFAM or Legacy were the only dealers of record.

[67] In exactly the manner described in *Momentas*, PFAM was interposed between the issuer banks and the investing public, either directly or indirectly through another registrant. Accordingly, for the foregoing reasons, we find that PFAM was acting as a market intermediary with respect to the distribution and sale of the PPNs to the Noteholders and with respect to its role in the secondary market for the PPNs and its activities in that regard were clearly registrable.

3. Were the Noteholders Clients of PFAM?

(a) Background and Submissions

[68] Staff submits that, in *Sextant Capital Management Inc.* (2011), 34 OSCB 5863 ("***Sextant***") and *Norshield Asset Management (Canada) Ltd.* (2010), 33 OSCB 7171 ("***Norshield***"), the Commission took a broad view of who can be considered a client within the meaning of section 2.1 of Rule 31-505. In *Norshield*, two service providers, who provided portfolio management and marketing services for the investment products offered by the investment vehicle, were alleged to have breached their registrant obligations under section 2.1 of Rule 31-505. The Commission applied a broad interpretation to the registrant's obligation under section 2.1 of Rule 31-505 and held that the investors in the investment vehicle were "clients" of the service providers.

[69] Staff submits that, when interpreting a registrant's duty to act fairly, honestly and in good faith, the Commission should have regard to the purposes of the Act and refers in this regard to the Commission's decision in *Black* (2015), 38 OSCB 2043 ("***Black***"). Staff submits that, in *Black*, the Commission found that "[a]s the Act's mandate is protective in

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[26] See for example section 7 of each of Exhibits 448, 449 and 450 which states that PFAM may act as an intermediary in facilitating a secondary market for the PPNs.

nature, it is appropriate to interpret the Act in a purposive manner to achieve the Act's mandate to protect Ontario's capital markets."[27] Accordingly, Staff submits that it would be inconsistent with the purpose of section 2.1 of Rule 31-505 to define "clients" narrowly so as to carve out certain activities of registrants from the requirement to act fairly, honestly and in good faith.

[70] Based on a purposive interpretation of the term "clients", Staff submits that all of the Noteholders who purchased PPNs during the initial distribution of the PPNs and all of those who sought to sell PPNs in the secondary market should be considered PFAM's clients within the meaning of section 2.1 of Rule 31-505.

[71] Staff submits that the following evidence supports Staff's position that, as a registrant, PFAM owed an obligation to all of the Noteholders to act fairly, honestly and in good faith:

- According to PFAM's compliance manual, the general duty on each registrant to deal fairly, honestly and in good faith extended to all "customers and clients;"[28]
- According to the market intermediary section of PFAM's compliance manual, PFAM accepted cheques from "clients" payable to "Pro-Financial Asset Management Inc. In Trust" and to PPN investors as the "proposed client base".[29]
- All the subscription and redemption proceeds were handled by PFAM and investor monies flowed through the PFAM Trust Account.
- PFAM was paid sales and trailing commissions for marketing and selling PPNs to investors and these fees were paid out of investor monies.
- PFAM played a key role in collecting secondary market sale requests, submitting them to the Banks, updating the price on the IAS system and ensuring that the redemption proceeds were paid to clients.

(Staff's Written Submissions, para 388)

[72] McKinnon submits that the historical context of Rule 31-505 supports the interpretation of the term "client" in the context of the "client model" of a retail brokerage firm, in which the dealer and its advisers owe specifically defined duties to their clients. Nothing in the current or former rule suggests that it was intended to, or should, apply to conduct by any registered dealer or adviser that did not relate to its activities as a dealer or adviser.

[73] McKinnon submits that both the title of Rule 31-505, "Conditions of Registration", and the heading of section 2.1, "General Duties", suggest that the section applies to the

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[27] *Black*, para 78.
[28] Exhibit 450, p. 5.
[29] Exhibit 450, p. 26.

governance of activities requiring or engaging a firm's registration. He further submits that the usage of the word "deal" in section 2.1 suggests that there must be some sort of transactional or business nexus between the registered dealer/adviser and its clients that would exclude merely incidental contact or impact.

[74] McKinnon points to a number of Commission decisions in which Rule 31-505 has been applied. In McKinnon's submission, liability has been found in cases involving direct harm to persons who are clearly "clients" caused by disreputable conduct involving or relating to the provision of investment advice. These cases include:

(a) 'Boiler room' operations;[30]

(b) The forging of retail clients' signatures;[31]

(c) Requiring retail clients to sign a disclaimer releasing the dealer from investment losses;[32]

(d) Causing retail investors to purchase unsuitable investments without properly knowing the clients or explaining risks, including the use of high pressure sales tactics or excessive leverage;[33]

(e) Failing to substantially comply with rules of self-regulatory organizations and requiring retail clients to absorb losses from unsuitable trades;[34]

(f) Making misrepresentations about investment products as well as other "reprehensible" conduct;[35]

(g) Selling stock as principal at excessive markups;[36]

(h) Engaging in transactions with clients that created conflicts of interest;[37] and

(i) Failing to disclose material facts about the financial viability of an underlying investment.[38]

(McKinnon's Written Submissions, para 114)

[75] McKinnon submits that, in *Norshield*, the Commission used the terms "investor" and "clients" interchangeably to conclude that the respondents had breached section 2.1 of Rule 31-505 and that the decision was not consistent with *Sextant*. McKinnon further submits that the Commission should treat the decision in *Norshield* with considerable caution and, in any event, PFAM's function as an administrative agent did not directly affect the performance of the PPNs from the perspective of the Noteholders.

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30 *EA Manning Ltd.* (1995), 18 OSCB 5317, p. 21.
31 *Obasi* (2011), 34 OSCB 3012 at para 15; *Reaney* (2015), 38 OSCB 6413, paras 141, 153 and 155.
32 *Kingsmont Investment Management Inc.* (2013), 36 OSCB 9577, paras 23 and 24.
33 *Hopper* (2009), 32 OSCB 1645, para 78.
34 *Argosy Securities Inc.* (2016), 39 OSCB 4040, para 83.
35 *DeLellis* (1998), 21 OSCB 305, paras 17 and 32-36.
36 *Curia* (2000), 23 OSCB 7505, p.4.
37 *Mark Edward Valentine* (2005), 28 OSCB 59, para 48.
38 *North American Financial Group Inc.* (2015), 38 OSCB 617, paras 28 and 266-268.

Accordingly, the degree of proximity between the Noteholders and PFAM is distinguishable from that of the portfolio manager and unitholders in *Sextant* and *Norshield*.

[76] Finally, McKinnon takes the position that, for Rule 31-505 to apply in this proceeding, the term "clients" would also have to be interpreted so broadly as to apply to any investor who may be indirectly affected by a firm's performance of its contractual duties to a third party. McKinnon submits that such an unnatural interpretation would be inconsistent with the regulatory regime and the well-established meaning of the term "client" in the securities industry.

(b) Analysis and Findings

[77] In *Norshield*, the Commission held that two registrants who communicated information to investors which was based on artificially inflated net asset values and engaged in transactions that gave preference to particular redemption requests over others, breached their duties to act fairly, honestly and in good faith under section 2.1 of Rule 31-505. In the appeal of the Commission's decision in *Norshield*, the Divisional Court held that:

> The problem, as seen by the appellants, is that Rule 31-505 is general in the responsibility it imposes. In the absence of any specific set of facts against which to measure its requirements, it would be difficult to define with any precision the boundaries of dealing "fairly, honestly and in good faith" with his or her clients. This being so, the appellants say that the Rule should be narrowly interpreted, at least as to whom it is to be applied. They say "investors" are not "clients", as referred to in the Rule, and should not be treated as such. This approach presumes that the words "clients" and "investors" are necessarily independent of each other. The word "client" may be a general term of broad application. It is not unreasonable to suggest that the word "investor" is narrower in its meaning and, in certain circumstances, can be subsumed within the term "client". This is the case here.[39]

[78] PFAM's duties in respect and on behalf of the Noteholders were extensive and, in our view, entirely consistent with the duties of a market intermediary and registrant to its clients. As we have already found that these activities constituted registrable activities and related to the business of securities trading, it is entirely consistent that those on whose behalf these activities were undertaken should be considered clients and be afforded all of the protections available under the Act. PFAM was not merely a back office provider which recorded or settled trades. They accepted orders on behalf of clients, dealt with the issuer banks on behalf of clients and accepted funds from and on behalf of clients. For the foregoing reasons, we find that the Noteholders were clients of PFAM for the purposes of Rule 31-505.

[79] We also note that PFAM's activities in relation to the Banks likely constituted registrable activities relating to securities notwithstanding McKinnon's submissions that the Banks were not clients of PFAM and that Staff's suggestion that PFAM mislead the Banks and

[39] *Norshield Asset Management (Canada) Ltd.*, 2011 ONSC 4685, para 88.

thus violated section 2.1 of Rule 31-505 only serves to “muddy the waters”. As Staff has not made submissions that the Banks should also be considered clients of PFAM, we have not considered the issue further.

D. Did PFAM Fail to Deal Fairly, Honestly and in Good Faith with its Clients?

1. The PPN Deficiency

[80] Having concluded that (i) the PPNs were securities within the meaning of the Act; (ii) PFAM was a market intermediary with regard to the PPNs and its activities were therefore registrable; and (iii) the Noteholders were clients of PFAM, we address below PFAM’s conduct in relation to the PPNs and the PPN Deficiency.

[81] Staff alleges that, as adviser, selling agent and/or notes administrator of the nine series of PPNs, PFAM engaged in the following conduct which resulted in or contributed to the PPN Deficiency and that such conduct constituted a failure to act fairly, honestly and in good faith with is clients:

(a) Unsupported redemption requests;

(b) The mishandling of redemption payments;

(c) The failure to account for monies in PFAM’s trust account;

(d) Deficiencies in the PPN records: and

(e) The failure to communicate and investigate the PPN Deficiency.

[82] As noted in paragraph [28] above, McKinnon acknowledges PFAM’s shortcomings in relation to the PPNs, however, he asserts that the allegations concern, more properly, the adequacy of PFAM’s policies and controls and are appropriately considered in the context of those allegations and not under section 2.1 of Rule 31-505.

[83] It is McKinnon’s submission that the case law is clear that innuendo, or suggestions that conduct is merely concerning or inappropriate, will not be sufficient to find liability under section 2.1 of Rule 31-505 and that there must be proof of real misconduct. McKinnon argues that *Sextant* and *Norshield*, which expand the scope of section 2.1 beyond its traditional application, are distinguishable because they contain critical elements which are lacking in this proceeding, namely, (i) self-interest or self-dealing on behalf of the registrant; (ii) a conflict of interest by the registrant; and (iii) substantial harm to “clients’.

2. Unsupported Redemption Requests and the Mishandling of Redemption Payments

(a) <u>Background and Submissions</u>

[84] Staff alleges that PFAM made unsupported redemption requests and mishandled redemption payments by applying different trade prices without the knowledge or agreement of the Banks, Concentra or the Noteholders. Staff submits that the unsupported redemption requests were misrepresentations of the actual client redemption requests and the application of different trade prices were a misrepresentation of the Banks’ prices and, accordingly, PFAM’s conduct was dishonest and contrary to Rule 31-505.

[85] By letter to the Enforcement Branch dated April 23, 2013, PFAM provided the Commission with its report relating to the cause of the PPN Deficiency (the "**First Reconciliation Report**"). The Report identified several factors which contributed to the PPN Deficiency, the most important of which were the price differences and the estimation process used in connection with the early redemptions of PPNs.[40]

[86] The First Reconciliation Report stated that the prices paid to PFAM by the Banks for early redemptions often differed from the prices PFAM paid to the Noteholders. Exhibit 9 of the First Reconciliation Report shows that there was a net overpayment of $566,839 from PFAM to Noteholders for early redemptions across all series of the PPNs. However, the Report also shows that some of the Noteholders were underpaid and the holders of two series of PPNs received less in total than the amounts the Banks had paid to PFAM on their behalf.

[87] The First Reconciliation Report also identified PFAM's practice of "estimated" early redemption requests as an important contributor to the PPN Deficiency. According to the Report, PFAM would routinely submit early redemption requests to the Banks for more units than were actually requested by Noteholders. This resulted in the records of the Banks indicating fewer PPNs outstanding than the Noteholders actually held and, therefore, the amount paid by the Banks at maturity would be less than was required to pay the actual PPNs outstanding. PFAM did not attribute a specific dollar amount of the PPN Deficiency to this cause.

[88] According to the analysis prepared by Ho, approximately 11,814 units (approximately $1.2 million par value of PPNs) more than the number requested by Noteholders were redeemed by PFAM, making unsupported redemption requests the largest contributing factor to the PPN Deficiency. Ho agreed that the price differences would also have contributed to the PPN Deficiency; however, he did not have sufficient information to identify that amount accurately. When cross-examined, Ho indicated that the methodology used in the First Reconciliation Report, while "reasonable", reflected the poor state of PFAM's records and was not exact as it may have combined the effects of the price and quantity differences. When re-examined by Staff, Ho testified that the lack of a complete set of trade records prevented PFAM from matching the specific Bank trade with the specific client order. Accordingly, there is some uncertainty around the Banks' price for each specific client order making it impossible, according to Ho, to place an accurate value on the contribution that price differences made to the PPN Deficiency.

[89] Prando and Drumm testified that they had no knowledge of the above-described conduct on the part of PFAM. In their view, any price which was different from that which was actually paid by the Banks was outside the expected conduct under their respective agreements with PFAM. Drumm testified that there was only one price at which the PPNs were purchased and sold and that the PFAM price variance made no sense. Prando testified that SGC did not quote two prices, that PFAM did not have the discretion to establish a price for early redemption and that its role was intended solely as a conduit. She also testified that SGC viewed the different prices paid to the Noteholders as a breach of section 4.2 of SGC's Escrow and Administration Agreement with PFAM.

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[40] The term estimation process used by PFAM is described by Staff as unsupported redemption requests.

Chan's testimony was entirely consistent with and supported the testimony of Prando and Drumm.

[90] Similarly, each of SGC, BNP, IAS and Concentra was confounded by PFAM making early redemption requests that were unsupported by Noteholder orders, also known as the "estimation process". Drumm testified that there was no need or provision for an estimation process and that he found it baffling. Prando testified that SGC issued approximately 100 PPNs between 2004 and 2006, including those with PFAM, and that it was the first time that SGC had ever seen a notion such as an estimation process in connection with the early redemption of notes. She also testified that extra orders were contrary to SGC's agreements with PFAM. Bell testified that Concentra eventually required PFAM to provide evidence of Noteholder requests for redemptions because no trade should happen without a client request. Chan was emphatic in stating during his testimony that there was no place for estimations and that estimations were not necessary.

[91] PFAM's explanations for its conduct varied. The First Reconciliation Report and the second such report dated September 30, 2013 explained that the price differences resulted from timing issues in the early redemption process. As stated in the First Reconciliation Report, "The purchase price contracted by the [Banks] several months before the settlement date often differed from the price received by clients at actual [settlement] date."[41] The First Reconciliation Report goes on to state that differences in cut-off dates between the Banks and the IAS system "required" PFAM to estimate the number of PPNs to redeem in excess of actual Noteholder requests in order to avoid penalties imposed by FundSERV.

[92] Bozzo testified that the foregoing practices were long-standing and, at least since 2009, had been discussed and approved by senior management of PFAM, including McKinnon. Bozzo also testified that he was instructed by Farrell and McKinnon to "request a little bit more" when making redemption requests[42]to avoid the work of informing dealers and Noteholders of a change in the cut-off dates for early redemptions which occurred sometime between 2008 and 2009. Bozzo further testified that, while he did submit unsupported redemption requests, he did not control the prices and amounts which Noteholders were paid.

[93] Jog, who assumed responsibility for the redemption process in early 2013, learned of the price differences and estimation process from Bozzo, and researched their contributions to the PPN Deficiency for the purposes of the First Reconciliation Report. Jog testified that timing differences and system constraints gave rise to the price differences. He also testified that the price differences were the "bulk" of the problem and speculated that PFAM started to redeem excess PPNs to cover the shortfall created in the trust account by the price differences.

[94] During his testimony, McKinnon denied having any personal knowledge of the early redemption process, the use of estimates leading to the unsupported redemption requests and/or price variations. In his submissions, McKinnon points to "inconsistencies" between the Bank Agreements and what occurred in practice and stated that "Ho agreed that PFAM's explanation of the structural issues which led to a price variance were

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[41] First Reconciliation Report, p. 6.
[42] Hearing Transcript, April 20, 2016, p. 33.

reasonable, and that this price variance led to an overpayment to Noteholders, which in turn needed to be funded somehow."[43] He asserts that only Bozzo's testimony supports Staff's theory that McKinnon encouraged or otherwise authorized PFAM to engage in price differences or the unsupported redemption requests and that a more plausible explanation is that Bozzo unilaterally implemented the estimation process on an *ad hoc* basis without seeking authorization. McKinnon further asserts that the contractual responsibility to reconcile and recognize any discrepancy was ultimately Concentra's, an appointee of PFAM and the Banks. McKinnon points to discrepancies existing at the initiation of the PPNs and inconsistencies in the Banks' practices throughout the period as evidence of the shared responsibility for the PPN Deficiency. Finally, McKinnon submits that, regardless of the causes of the PPN Deficiency, the Noteholders were not at risk because of the Banks' obligations to pay the Noteholders on the maturity of the PPNs, which, in fact, is what ultimately occurred.

(b) Analysis and Findings

[95] In the First Reconciliation Report and in subsequent correspondence with Staff, a number of PFAM employees described the use of an estimation process leading to unsupported client requests and price variances without any indication that this was not PFAM's normal practice, or that it was the work of a rogue employee.

[96] The analysis undertaken by Ho shows that, from the outset of PFAM's involvement, client redemptions were made at prices that were different from the Banks' trade prices. This was confirmed by Jog in his testimony. The practice predated Bozzo's involvement and continued throughout the relevant period, despite the high staff turnover at PFAM.

[97] In seven out of eight PFAM compliance manuals provided to Staff, a section entitled "Market Intermediary Activities" describes the practice of PFAM buying and selling PPNs in the secondary market to facilitate Noteholder requests at prices established by PFAM "…which may be different than those established by the [Banks]". The manuals go on to describe controls such as authorization by senior management, limits on the price variation allowed, the maximum total risk acceptable to PFAM and the circumstances in which profits could be generated; all indicating that applying a different price from the price used by the Banks was standard practice. PFAM's internal compliance checklists for the period from 2010 to 2013 also confirm Bozzo's testimony that the prices for the PPNs were the responsibility of the portfolio management group and accounting and not Bozzo's. In addition, the First Reconciliation Report states that smaller note redemptions (fewer than 2,000 units), were paid without requesting funds from the Banks, further indicating PFAM's practice of purchasing the PPNs as principal which would confirm the details in the manuals described above.

[98] Similarly, the large redemption in the amount of $203,500 in September 2004, which was not related to a Noteholder request as confirmed by Ho and Jog, supports Staff's allegations and casts doubt on McKinnon's explanation that Bozzo was acting alone as that redemption occurred several years prior to Bozzo's employment. McKinnon's alternate explanation that this unsupported redemption request was the result of an error

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[43] McKinnon's Written Submissions, para 139.

also seems unlikely. There was no evidence of a reversal of the redemption in support of McKinnon's alternate explanation.

[99] Finally, on January 30 2013, after the magnitude of the PPN Deficiency had been identified and Staff had been alerted to the fact by Butler and Cox, Pinto, the CFO of PFAM at the time, submitted a redemption request for $385,000 par value to BNP without an underlying Noteholder request. Bozzo could not have been responsible as he had been dismissed by PFAM on January 28, 2013. Pinto testified that there was no Noteholder request supporting this trade request and that she continued to press Concentra to process the trade, despite its concerns and the clear instructions from Staff that no payments should be made to any of the Noteholders without a full reconciliation.

[100] The evidence shows that McKinnon was actively involved in the discussion about whether to make the redemption request described in paragraph [99] above, as summarized in Bozzo's e-mail message to McKinnon of January 25, 2013. While McKinnon instructed Bozzo not to proceed with the request on January 28, 2013 and then terminated Bozzo's employment on the same day for transferring confidential documents to his personal e-mail account, the same unsupported redemption request was made only two days later by Pinto. Under the circumstances, it would be inconceivable that Pinto acted without McKinnon's full knowledge and agreement. The reason for this redemption request was unrelated to any timing or operational issues, but was solely and improperly motivated by PFAM's desire to cover the shortfall in the amounts owed to Noteholders for the recently matured PPNs. We have considered Bozzo's testimony with care given the obvious animosity between him and McKinnon and have concluded that we can accept his testimony where it is consistent with other proven or undisputed facts or with the preponderance of probabilities disclosed by the facts.

[101] We agree with Staff that the expected conduct of a registrant when acting as an agent is to comply exactly with the instructions provided by its client. Making any adjustments to a client order without the express authorization of the client and/or interposing the registrant as a principal to an agency transaction without the knowledge of the other participants introduces risk and is unacceptable conduct. We are also persuaded that the evidence supports Staff's position that the practice of unsupported redemption requests and price variance at PFAM was more than the behaviour of a single employee acting alone.

[102] Substituting a different price in a securities transaction than the actual trade price is dishonest and this conduct was not mitigated by the fact that the price paid to Noteholders was often higher. While some Noteholders may have received a benefit from PFAM's conduct in the form of higher prices which they were not entitled to receive, others received lower prices than they were entitled to receive and those whose PPNs matured after December 2012 were harmed by the extended delay of up to two years and the opportunity costs they incurred as a result of the PPN Deficiency. In addition, the Banks were harmed and were obligated to pay approximately $1.2 million more than they would otherwise have been required to pay.

[103] For the foregoing reasons, we find that PFAM knowingly made redemption requests that were unsupported by Noteholder requests and mishandled redemption payments by applying different trade prices and that this conduct was improper. PFAM's

misrepresentation of the Noteholders' orders to the Banks and the Banks' prices to the Noteholders was dishonest and a breach of PFAM's obligation to deal fairly, honestly and in good faith with its clients.

3. Failure to Account for Monies in the PFAM Trust Account and Deficiencies in the Records for the PPNs

(a) <u>Background and Submissions</u>

[104] Staff alleges that the money held in PFAM's trust account belonged to clients and not to PFAM and that PFAM had a fiduciary responsibility to handle trust assets in a manner which put the clients' interests ahead of PFAM's interests. Staff also alleges that PFAM's failure to account for monies in its trust account is a serious breach of its general obligation to act fairly, honestly and in good faith in dealings with its clients.

[105] Staff points to the inability of either PFAM or Staff investigators to completely reconcile the trust account as evidence of PFAM's mismanagement, notwithstanding the considerable time and resources spent on the task. Staff highlights Ho's analysis of the trust account transactions for 2009 (based on Pinto's worksheets) which provided no explanation for differences totalling $979,206 between the amount paid for redemptions on the basis of the trust account and the amount paid for redemptions on the basis of the IAS records. Staff also highlights the improper use of funds from one series of PPNs to pay Noteholders in another series of PPNs.

[106] McKinnon does not provide a specific response to Staff's allegations regarding PFAM's management of the PPN trust account other than stating that there was a lack of malicious intent and that any shortcomings were the result of inadequate resources. During his testimony, McKinnon denied any knowledge of monies from the PPN trust account being used for inappropriate purposes.

(b) <u>Analysis and Findings</u>

[107] The lack of appropriate reconciliation practices, which are designed to identify and allow for the correction of any discrepancies as they arise, appeared to be a permanent feature of PFAM's operations. Further complicating any analysis is the fact that, until 2010, funds from the PPNs as well as other products were comingled in a single PFAM trust account. Notwithstanding the eventual establishment of a separate trust account for the PPNs, Cox and Atlija testified that the same account was used for all PPNs and opening balances were never reconciled.

[108] Ho and Chan testified that the records of the inflows to the trust account from the Banks through Concentra were clear and matched expectations, i.e., the Banks paid the full amount of all redemption requests and those funds were deposited to the PFAM trust account. Chan also determined that the IAS records were in complete accord with the records of the Noteholders, i.e., the total amount owing to the Noteholders was accurate as stated on the IAS system. We note in this regard that the Banks ultimately paid the Noteholders on the basis of the IAS records. Accordingly, in the opinion of Chan, the real source of the PPN Deficiency was the movement of funds from the PFAM trust account for which there was incomplete documentation and for which PFAM had sole responsibility. We agree with Chan's assessment.

[109] Of serious concern is the fact that PFAM could not provide any documentation or otherwise account for many of the movements of funds to and from the trust account. For example, Ho's analysis demonstrated that there were 140 undocumented movements of funds with the largest undocumented withdrawal being $872,760 and the largest undocumented deposit being $384,750. We can only draw a negative inference from this lack of documentation given the size of the PPN Deficiency.

[110] If all of the funds received by PFAM from the Banks in excess of what was required to pay the actual Noteholder redemptions had remained in the trust account for the benefit of the Noteholders, the PPN Deficiency would have been much smaller, notwithstanding the over-payments through higher prices.

[111] There is troubling evidence of PFAM's apparent habitual improper use of the funds received in trust for the Noteholders. The analysis by Ho of the PPN trust account for the period December 31, 2010 to July 9, 2012 is illuminating in this regard. Ho's analysis showed that the funds received from the Banks for redemption or maturity payments for seven of the PPN series were less than the payments made by PFAM, and that the funds received from two of the PPN series were greater than the payments made by PFAM. Ho concluded that the foregoing showed that the funds received from the maturity of certain series were used to fund the deficits in other series. We agree with Ho's conclusion.

[112] There was also other evidence of a casual acceptance by PFAM, including McKinnon, of the proposition that a "surplus" in one series of the PPNs could be used to cover a "deficit" in another series of the PPNs. The evidence showed that McKinnon had knowledge of projected surpluses and deficits across the PPNs, starting at least with the first maturity in December 2010 and the Bozzo analysis in May 2012. When asked why he did not take more vigorous action to determine the source of these discrepancies, McKinnon testified that he focused on the net difference of $13,000, implying that it was acceptable to use the surplus from one series to make up the deficit of another. McKinnon testified that he was more interested in essentially the bottom line and that "Thirteen thousand over $100 million was just a very small amount".[44] McKinnon's attitude with respect to funds held in trust was completely improper and a direct contravention of PFAM's fundamental obligation as a registrant to deal fairly, honestly and in good faith with its clients.

[113] For the foregoing reasons, we find that PFAM failed to account for monies in the trust account and failed to maintain appropriate records which contributed to the shortfall of approximately $1.2 million and harm to the Noteholders who were not paid on the maturity of their respective PPNs.

4. Failure to Communicate and Investigate the PPN Deficiency

(a) <u>Background and Submissions</u>

[114] The final element of Staff's allegations in relation to Rule 31-505 is PFAM's failure to investigate and communicate the PPN Deficiency to the appropriate parties when it first arose in December 2010. Prando testified that SGC was not advised of this surplus or the subsequent deficiency for the series which matured on December 15, 2011. SGC was also not informed of PFAM's failure to pay the proceeds of the series which matured on

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[44] Hearing Transcript, June 13, 2016, p. 146.

December 19, 2012, until February 12, 2013 all of which aggravated the PPN Deficiency by allowing it to continue and increase.

[115] McKinnon denies knowledge of a "broader structural problem or discrepancy in records" prior to the December 2012 maturity. He maintains that he was not involved in the day-to-day operations relating to the PPNs and assumed that, if there had been an issue, he should have been informed by his staff. McKinnon points to instances of deliberate deception by Bozzo in response to Bozzo's assertion that McKinnon was completely apprised of the problems relating to the PPNs.

(b) Analysis and Findings

[116] The evidence is clear that the surplus received by PFAM on the initial maturity in December 2010 triggered some action by PFAM; however, it was all internally focused with no communication to external parties. Bozzo informed McKinnon of the 2010 surplus by e-mail and McKinnon responded by inquiring whether the other series of PPNs were in surplus or not. Bozzo, Butler and Cox testified that a discussion, which included McKinnon, was held at PFAM to determine the correct course of action with regard to the surplus. Instructions were provided to PFAM's staff to reconcile the trust account; however, there is no evidence that a reconciliation was completed and no evidence that any external party was informed of the surplus. In fact, McKinnon's reaction in an e-mail message to Bozzo on December 31, 2010 was "Finally some good news….!!!!!!! Please do not let anyone know yet……."[45]

[117] In August 2011, McKinnon requested that Bozzo prepare a reconciliation of the PPN balances of IAS, Concentra and the trust account.[46] The evidence also establishes that, in December 2011, when the second PPN series matured and resulted in a shortfall of $114,803, McKinnon asked Bozzo and Colin Hodgins, the CFO at the time, to confirm that there were no issues with the maturing series of PPNs.[47] In May 2012, McKinnon asked Bozzo to prepare a PPN summary which showed a net surplus across all series of PPNs of approximately $13,000, however, there were large variations in shortfalls and surpluses across the different series. McKinnon immediately requested information on the maturity dates of the individual PPNs, and asked Colin Hodgins to see him about the matter. Yet again in July 2012, McKinnon asked the CFO to review the trust account reconciliation to determine if there was a credit balance. The foregoing suggests that McKinnon was well-informed and understood the scope of the problem, notwithstanding his testimony that he "assumed everything was humming along fine."[48] There is no evidence that any of the reconciliations requested by McKinnon or recommended by IAS, Atlija or Cox were ever completed.

[118] The evidence is also clear that, while McKinnon did not personally perform the tasks related to the operations of the PPNs, he was an engaged and involved senior officer to whom the accounting and operations staff reported except for the brief period of Cox's employment. We note that PFAM only had 14 or 15 employees and that the three person accounting staff worked in close proximity to McKinnon.

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45 Exhibit 167.
46 Exhibit 171.
47 Exhibit 508.
48 Hearing Transcript, June 15, 2016, p. 94.

[119] On the basis of the evidence, we find that it is more likely than not that the PPN Deficiency was a known issue at PFAM and known to McKinnon, and that, while there were some attempts to define and understand the scope of the problem internally, PFAM did nothing to communicate the issue externally. If the source of the problem had been a shared responsibility, it is more likely than not that PFAM would have engaged with the Banks, Concentra and/or IAS to identify the source of the problem and determine liability and remedial action. Instead, the evidence supports the conclusion that the PPN Deficiency was a problem of PFAM's own-making and that its failure to inform the Banks, Concentra, IAS and the Noteholders resulted from its self-interested desire to conceal the problem.

[120] We also find that, whether or not the factors contributing to the PPN Deficiency were a product of deliberate malfeasance or a product of multiple operational failures, McKinnon's complete denial of any knowledge of the problems relating to the PPNs before December 2012 is not credible.

[121] For the foregoing reasons, we find that PFAM failed to investigate and communicate the known operational and accounting issues which allowed the problems to continue and increase, thereby eventually resulting in the PPN Deficiency and, in so doing, failed to deal fairly, honestly and in good faith with its clients in breach of its obligations under subsection 2.1(1) of Rule 31-505.

IV. OTHER DUTIES REQUIRED OF PFAM AS A REGISTRANT

A. Did PFAM Breach the Standard of Care Required of an Investment Manager?

1. Background and Submissions

[122] PFAM acted as the investment fund manager ("**IFM**") of nine prospectus-qualified mutual funds (the "**Pro-Index Funds**") under the transition provisions of section 16.4 of NI 31-103.

[123] On March 28, 2013, PFAM filed its annual audited and interim financial statements and management reports of fund performance ("**MRFPs**") for the year ended December 31, 2012 (the "**December 2012 MRFPs**") for each of the Pro-Index Funds and, on August 29, 2013, PFAM filed its semi-annual MRFPs for the period ended June 30, 2013 (the "**June 2013 MRFPs**") for each of the Pro-Index Funds.

[124] MRFPs are required to disclose the management expense ratio (the "**MER**") of each fund which must be calculated in accordance with section 15.1 of National Instrument 81-106 – *Investment Fund Continuous Disclosure* ("**NI 81-106**"). PFAM published incorrect calculations of the MERs for the Pro-Index Funds in both the December 2012 MRFPs and the June 2013 MRFPs. On March 6, 2014, PFAM filed a press release, as ordered by the Commission, which provided, among other things, disclosure relating to the incorrect MERs and the corrected ratios.

[125] On January 15, 2014, PFAM's counsel advised the IF Branch that the existing prospectus receipted for the Pro-Index Funds on January 14, 2013 had not been renewed as the result of inadvertence. As a result of PFAM's failure to renew the prospectus, the distribution of the Pro-Index Funds under that prospectus could no longer continue which necessitated a formal lapse date extension application to the Commission which was granted. Two further extension applications were made by PFAM, the second of which

was denied by the Commission, largely as a result of PFAM's failure to file annual financial statements for the Pro-Index Funds. As a result, the prospectus for the Pro-Index Funds lapsed and the distribution of the Pro-Index Funds ceased on April 21, 2014.

[126] PFAM failed to file annual audited financial statements and MRFPs for the Pro-Index Funds for the year ended December 31, 2013 within the time period prescribed by NI 81-106. PFAM similarly failed to deliver the T3 Statements of Trust Income Allocations and Designations (the "**T3 Slips**") to the unitholders of the Pro-Index Funds on time.

[127] Subsection 1(1) of the Act defines an investment fund as "a mutual fund or a non-redeemable investment fund" and an IFM as "a person or company that directs the business, operations or affairs of an investment fund".

[128] The statutory duties of IFMs are set out in section 116 of the Act, which provides as follows:

> **Standard of care, investment fund managers** – Every investment fund manager,
>
> (a) shall exercise the powers and discharge the duties of their office, honestly, in good faith and in the best interests of the investment fund; and
>
> (b) shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.

[129] On the foregoing basis, Staff submits that the statutory duty of care under subsection 116(b) of the Act extends to the unitholders of the funds which IFMs manage and not just to the funds themselves.

[130] McKinnon did not object to Staff's foregoing submission that an IFM's statutory duty of care under subsection 116(b) of the Act extends to the unitholders of the funds managed by the IFM, a submission with which we agree.

[131] Staff alleges that by (i) disclosing inaccurate MERs in the December 2012 MRFPs and the June 2013 MRFPs; (ii) failing to take the steps necessary to ensure that the Pro-Index Funds' renewal prospectus, annual and interim financial statements and annual and interim MRFPs were filed on a timely basis; and (iii) failing to deliver 2013 T3 Slips to unitholders on time, PFAM failed to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances and, in doing so, breached the standard of care for IFMs under subsection 116(b) of the Act.

[132] McKinnon submits that the degree of care, diligence and skill required depends on the "circumstances" which requires the Commission to adopt a context-specific approach in determining whether or not the section has been breached. McKinnon also submits that subsection 116(b) should be read in harmony with subsection 116(a) which requires that each IFM act honestly, in good faith and in the best interests of the investment fund.

[133] McKinnon does not contest Staff's allegations that PFAM's conduct with respect to the failure to renew the prospectus on time, and making calculation errors in respect of the MERs is a violation of subsection 116(b) of the Act. McKinnon does, however, point to external circumstances which adversely affected PFAM's ability to perform its duties despite its best intentions and disputes Staff's allegations that the late filings of the

audited financial statements, MRFPs and tax slips fell below the standard set out in subsection 116(b) of the Act in the circumstances and also disputes that he authorized, permitted or acquiesced in any violations of subsection 116(b) of the Act.

[134] With respect to the late filing of financial statements, MRFPs and the late delivery of T3 Slips, McKinnon submits that the delays were the result of PFAM "…seeking to ensure that the unitholders in the Pro-Index Funds did not have to bear the burden of the excessive and unreasonable fees demanded by IAS"[49] and, in so doing, PFAM was, in fact, fulfilling its fiduciary obligations and acting in the best interests of the unitholders.

[135] With respect to the lapsed prospectus, McKinnon's submissions highlight the resource challenges that PFAM was experiencing at that time. He points to the loss of staff and legal support at the same time as the increase in demands from the on-going sale process and the PPN Deficiency as key factors that prevented PFAM from filing on time. McKinnon asserts that the lapse was unintentional and resulted in significant and foreseeable adverse consequences for PFAM which would have been avoided if it had been possible to do so.

[136] With respect to the incorrect MERs, McKinnon submits that he was not aware of any issues in the MRFPs at the time that he approved them and that, while Pinto advised him that she had calculated them at the fund level, he was not at that time aware of what that meant. McKinnon further submits that his approval of calculations was based on the advice he received from PFAM's CFO and does not equate to an intent on his part to violate securities laws.

2. Analysis and Findings

[137] There is no dispute that the Pro-Index Funds' prospectus was not renewed on time and eventually lapsed, that the December 31, 2013 financial statements and MRFPs were filed 67 days late, that the interim financial reports and MRFPs were filed 133 days late and that the T3 Slips were delivered to unitholders over 60 days late.

[138] There is also no dispute that the MERs published by PFAM in the December 2012 MRFPs and the June 2013 MRFPs were incorrect. Staff of the IF Branch was alerted to the possibility of incorrect MER calculations in June 2013 and requested documentation from PFAM. PFAM was unable to provide the original calculations for December 2012 and supplied only fund level calculations for June 2013, despite the requirement for the calculation to be completed at the class level.

[139] PFAM's press release dated March 6, 2014 which disclosed the corrected MERs reflected the fact that, of the 26 MERs originally reported as at December 31, 2012, the ratio was increased in 24 cases and decreased in two and the ratios for all of the 26 MERs originally reported as at June 30, 2013 were increased by material amounts. As a result, the investors had been misled for the better part of a year with respect to the costs of their investments.

[140] McKinnon had no explanation for the incorrect MERs and testified that, although he approved the MRFPs as a director of PFAM, he did so in reliance on the expertise of Pinto. Pinto had no explanation for the errors in the December 31, 2012 calculations and

[49] McKinnon's Written Submissions, para 160.

cited her use of estimates for the class-level calculations as an explanation for the June 30, 2013 errors.

[141] It is clear that the evidence supports McKinnon's submission that PFAM was under great operational and financial stress. There is no doubt that, by June 2013, the continuing effects of staff turnover, client redemptions, the PPN Deficiency and regulatory scrutiny had combined to create a nearly impossible operating environment at PFAM. It is also no surprise that errors occurred and filing and other deadlines were missed.

[142] We do not agree, however, that a difficult operating environment is a sufficient defense to Staff's allegations of breaches of the IFM's duty of care. The duty to provide accurate and timely disclosure to investors regarding the management of the assets they have entrusted to the IFM as a fiduciary does not vary depending on the circumstances of the IFM's business. These are fundamental duties that are the minimum requirements of an IFM and, if an IFM is not able to meet these standards, it should seek to transfer the role to another IFM which is capable of doing so without delay.

[143] We also do not agree that a nefarious intent is necessary for there to be a breach. The standard is an objective standard and IFMs are required by the Act to "exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances".

[144] There is no evidence that the errors in the calculation of the MERs were intentional, despite the fact that virtually all of the errors created results that were significantly more favourable to PFAM. The evidence does, however, support a finding of a lack of care, diligence and/or skill.

[145] Pinto testified that she (i) failed to ensure accurate MERs when acting as a supervisor; (ii) promoted the use of estimates based on personal judgement instead of complying with the statutory requirements when performing the work herself; and (iii) continued to fail to produce accurate calculations even following Staff's intervention. All of these failures are evidence of a lack of care, diligence and/or skill on the part of PFAM as an IFM.

[146] The prospectus lapse, late filings of financial statements and the late delivery of T3 Slips were no doubt partly a result of PFAM's operating stresses at the time. However, in these matters, the evidence is more supportive of a wilful disregard for the best interests of the investment fund than McKinnon's assertion that these failures resulted from PFAM trying to advance the investment funds' best interests.

[147] The dispute with IAS was long-standing and multi-faceted. IAS had terminated its agreement with PFAM and had commenced the arbitration of its unpaid fees in April 2013. In September 2013, a full six months prior to the regulatory deadline for filing the financial statements for the Pro-Index Funds, IAS wrote to PFAM to clearly outline the terms and conditions on which IAS would prepare the annual financial statements. PFAM did not, however, request exemptive relief until March 28, 2014, the last business day prior to the deadline.

[148] Similarly, PFAM had already missed the deadline for the prospectus renewal filing when it requested a lapse date extension in early 2014. There is no evidence that PFAM had been working toward the filing or that the missed deadline was "inadvertent" as claimed by McKinnon.

[149] The result of these failures was that unitholders were left with no current disclosure regarding their investments at a time of general concern about PFAM's ability to continue in business. The prospectus lapse also resulted in a lack of liquidity for existing unitholders and reduced options for managing their investments. Clearly, this result was not in the best interests of the investment fund or its unitholders.

[150] The foregoing specific breaches follow years of regulatory concerns about PFAM's management practices. Starting with the first review by the Commission in 2009, errors in fundamental calculations and inappropriate management practices surfaced every time a light was shone on PFAM's operations. These regulatory concerns are described in greater detail in paragraphs [184] and [207] below.

[151] The turnover of staff, the financial stress and the regulatory scrutiny experienced by PFAM were issues that would cause a reasonably prudent person to conclude that greater scrutiny by PFAM's UDP and board of directors was warranted. It is not unreasonable to expect that the appropriate degree of care, diligence and skill exercised by a board of directors during periods of operating stress should be greater than during periods of optimal operating conditions. Notwithstanding the foregoing, there was no evidence of enhanced engagement or oversight by McKinnon or by PFAM's board of directors. Instead, in his testimony and submissions, McKinnon endeavoured to maintain his distance by attributing the errors solely to the individual staff members who had direct responsibility.

[152] At every point, the focus of PFAM and of McKinnon, who controlled and had oversight of all aspects of PFAM's business as the Chief Executive Officer and as a member of PFAM's board of directors together with his wife and Farrell[50], appears to have been on furthering the business operations of PFAM rather than on the best interests of the investment fund as required under subsection 116(b) of the Act.

[153] For the foregoing reasons, we find that PFAM failed to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances and, in doing so, breached the standard of care for IFMs under subsection 116(b) of the Act.

B. Did PFAM Fail to Maintain the Required Minimum Working Capital and Report its Capital Deficiency?

1. Background and Submissions

[154] Section 12.1 of NI 31-103 sets out the working capital requirements for registered firms and further provides that a registered firm must notify the regulator as soon as possible if, at any time, its working capital was less than the amount required.

[155] The minimum capital required by PFAM was $50,000.[51] The parties did not dispute that this minimum working capital requirement amount applied to PFAM.

[156] PFAM was indebted to Laurence Financial Services Corp. ("**Laurence Financial**") in connection with a loan by Laurence Financial in the amount of $500,000 which was

[50] Pinto replaced Farrell following Farrell's departure from PFAM.
[51] Subsection 12.1(3)(b) of NI 31-103.

evidenced by a Fixed Rate Promissory Note dated April 24, 2008 (the "**Laurence Loan**"). The terms of the Laurence Loan required PFAM to pay 59 monthly instalments with a final balloon payment of $304,142.23 which was due on May 1, 2013. As of May 1, 2012, the balloon payment became a short-term liability which was required to be included in the calculation of PFAM's working capital.

[157] In November 2012, approximately 19 months after they ceased to be employees of PFAM, Butler and Cox expressed concerns to the CRR Branch about PFAM's solvency and other issues based on information which they had obtained while undertaking their due diligence prior to joining PFAM in 2010 as investors and officers and the documents they received from Bozzo.

[158] As a result, the CRR Branch informed PFAM that they wished to conduct a site visit to review the monthly working capital calculations for the period May to October 2012. At the site visit, which took place on November 21, 2012, Pinto provided PFAM's working capital calculations for the period May to October 2012 which showed that PFAM had maintained the required working capital during the period and that, on October 31, 2012, PFAM's working capital exceeded the required amount by $19,498.

[159] Staff requested the financial statements to support the working capital calculations and Pinto responded that she needed to review them first.[52] After repeated requests, Pinto provided the unaudited financial statements on November 30, 2012. Pinto also provided a revised working capital calculation which showed that PFAM's working capital was at least $183,367 less than the required amount. Notably, this calculation did not include the Laurence Loan balloon payment as a short-term liability.

[160] Pinto advised Staff that McKinnon had arranged a loan in the amount of $200,000 from his mother to cover the working capital deficiency. Pinto did not advise Staff that the loan from McKinnon's mother was not subordinated, as required, if the amount of the loan was to be eligible for inclusion in the working capital calculation.

[161] In early December 2012, Staff prepared its own calculation of PFAM's working capital position which showed a working capital deficiency of $634,423 as at October 31, 2012. Staff's calculations of working capital for the period May to November 2012 showed that PFAM's working capital was from $141,000 to $224,000 less than the minimum amount required for each month during the period.

[162] The day after the CRR Branch visit, McKinnon sent an e-mail message to Laurence Financial requesting a call and, on the following day, sent another e-mail message requesting an extension of the term of the Laurence Loan, stating that the balloon payment on May 1, 2013 affected PFAM's working capital. Following discussions with Laurence Financial, on March 12, 2013, the term of the Laurence Loan was extended by five years to May 2018.

[52] It should be noted that Pinto had only joined PFAM as CFO on October 12, 2012, less than six weeks prior to Staff's site visit on November 21, 2012.

[163] Staff submits that the working capital requirement is "a fundamental feature of the registrant regulation regime"[53] and that, as UDP, McKinnon was responsible for ensuring that his firm met this requirement.

[164] Staff submits that the evidence shows that PFAM failed to include the Laurence Loan balloon payment of $304,142.23 as a current liability in its calculations of working capital for the period May 31, 2012 to October 31, 2012. Had it done so, Staff further submits that PFAM would have been capital deficient for the entire period by at least $125,000.

[165] Staff submits that despite McKinnon's duty to report a working capital deficiency to the Commission as soon as possible and to rectify the deficiency within 48 hours, PFAM did not report any working capital deficiency from May 2012 until October 31, 2012. Staff also points out that it was only after Staff's review that PFAM revised its calculations and finally reported a capital deficiency nine days later, noting that the revised calculation still did not include the Laurence Loan balloon payment even though McKinnon had contacted Laurence Financial at least a week earlier.

[166] Staff submits that a breach of section 12.1 of NI 31-103 does not require knowledge and, accordingly, McKinnon's claim that he was unaware of the working capital deficiency until November 2012 or that he relied on his accounting staff to prepare the calculation and did not take into account the current liabilities does not alter PFAM's breach of section 12.1 of NI 31-103. Staff points to the decision of the Director of the CRR Branch in *Takota* which states that:

> It is the responsibility of the registrant to ensure compliance with Ontario securities law. The failure to meet the minimum capital requirements occurred as a result of errors created by a professional accounting firm when it established the accounting system for Takota and completed its financial statements… Even though the registrant retained a professional accounting firm to establish their accounting system, the obligation to establish appropriate internal controls and systems remains with the registrant.
>
> (*Takota*, para 10)

[167] McKinnon submits that he cannot be held responsible for the working capital deficiency because he did not possess knowledge of all of the relevant facts and was, therefore, unaware that PFAM was in a capital deficient position. He also points out that, on many occasions, he injected his personal capital into PFAM to keep it solvent and in compliance with regulatory requirements. He further submits that he was not aware that the loan from his mother needed to be subordinated.

[168] McKinnon submits that the evidence shows that his assumption that PFAM did not have a problem with working capital was not unreasonable and that he relied on his accounting staff and Farrell, who was the Chief Compliance Officer ("**CCO**") at the time, to review

[53] *Takota Asset Management Inc.* (2013), 36 OSCB 7808 ("***Takota***"*),* para 6.

the working capital calculations. McKinnon testified that he "would look at the bottom line to ensure that we were capital - our capital was onside. I don't know how to calculate the working capital and I didn't do it. I relied on the staff that did it for me obviously."[54]

[169] McKinnon also submits that there was no intent on the part of PFAM to hide information from Staff or to purposely delay reporting a working capital deficiency. He maintains that he was not aware that the Laurence Loan needed to be included in the short-term liability calculation and that the reason it took nine days after the Staff visit to prepare revised calculations was that Pinto was new to PFAM and they needed time to review the financial statements and confirm the validity of the working capital calculations.

2. Analysis and Findings

[170] Previous decisions of Directors of the Commission have held that the working capital requirement is a fundamental feature of the registrant regulation regime as solvency is one of the three pillars of suitability for registration[55] and that all registrants are required to meet the capital requirements of the Act.[56] As stated by the Director in his decision in *Pente Investment Management Ltd.* (2006), 29 OSCB 6795 ("***Pente***"):

> Maintaining minimum free capital is a serious regulatory obligation placed on registrants. This requirement helps to protect investors from insolvency and fosters confidence in Ontario's capital markets.
>
> (*Pente*, para 10)

[171] There is no doubt that PFAM had a responsibility as a registrant to maintain adequate working capital and also had a duty to report to CRR Staff as soon as possible if the working capital was less than the minimum amount required for two consecutive days. As UDP, McKinnon was responsible for ensuring that PFAM maintained the minimum capital required and he cannot absolve himself from this responsibility by indicating that he relied on his staff to make sure that the calculation was correct.

[172] As PFAM was a small firm which had experienced significant staff turnover including two CFOs in 2012 (one of whom had health problems), it is possible that McKinnon may not have been aware that the Laurence Loan needed to be moved to the short-term liability category immediately on May 1, 2012. However, it is clear from Chan's testimony that McKinnon had concerns about working capital in the summer of 2012 and, in fact, had discussed his concerns relating to working capital with Chan on a number of occasions over a period of three years. As a result, it is not credible that, by the end of October 2012, McKinnon was not aware that the Laurence Loan balloon payment was coming due in approximately six months and that he did not appreciate that the payment of a $304,000 debt would have a significant effect on PFAM's working capital.

[173] Even if McKinnon was unaware of the fact that the Laurence Loan balloon payment had to be included in the working capital calculation beforehand, he would have known following the meeting with CRR Staff on November 21, 2012 and yet the balloon

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54 Hearing Transcript, June 15, 2016, pp. 126-127.
55 *Takota*, para 6.
56 *Pente*, para 10.

payment was still not included in the revised calculations provided to CRR Staff on November 30, 2012.

[174] None of the mitigating factors cited by McKinnon – namely, that he relied on his accounting staff to calculate working capital, that Pinto had been at the firm less than six weeks, whether the Laurence Loan should be considered short-term debt and the treatment of IAS credit memos which were discussed extensively with Chan – alter the fact that, as of the end of October 2012, PFAM did not have the required working capital and did not inform the Commission, as it was required to do.

[175] We note that McKinnon caused PFAM to repay the loan from his mother on May 17, 2013, the same day that PFAM's registration was suspended by the temporary order of the Commission.

[176] For the foregoing reasons, we find that PFAM breached its obligation to maintain the minimum working capital required of a registered firm and failed to report its working capital deficiency, contrary to section 12.1 of NI 31-103.

C. Did PFAM Fail to Keep Satisfactory Books and Records?

[177] Subsection 19(1) of the Act provides that:

> **Record-keeping** - Every market participant shall keep the following records:
>
> 1. Such books, records and other documents as are necessary for the proper recording of its business transactions and financial affairs and the transactions that it executes on behalf of others.
>
> 2. Such books, records and other documents as may otherwise be required under Ontario securities law.
>
> 3. Such books, records and other documents as may reasonably be required to demonstrate compliance with Ontario securities law.

[178] Staff submits that, in addition to complying with subsection 19(1) of the Act, registrants[57] must also comply with sections 11.5 and 11.6 of NI 31-103 which require registrants to accurately record their business activities, financial affairs and client transactions and maintain those records in a safe location and in a durable form so that the firm is able to demonstrate compliance with applicable securities legislation. Subsection 11.5(2) specifies the types of records which are required under subsection 11.5(1).

[179] Staff submits that, contrary to subsection 19(1) of the Act and sections 11.5 and 11.6 of NI 31-103, PFAM failed to maintain and retain appropriate books and records for several key areas. The paragraphs which follow summarize Staff's submissions, McKinnon's response, where applicable, and our views:

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[57] In its submissions relating to subsection 19(1) of the Act, Staff refers to "registrants" rather than "market participants". The term "market participant" is defined by Subsection 1(1) of the Act to include the term "registrant".

(a) Trust Account Disbursements

Staff requested supporting documents for 125 transactions in the trust account in its Summons dated February 14, 2014. In response, Pinto stated that Staff's request was "extensive" and asked Staff to narrow the scope of the request. However, even after Staff narrowed the request to 13 transactions, PFAM did not provide the requested supporting documentation. In McKinnon's Written Submissions, he argues that the documents were difficult to access or find because PFAM had moved multiple times which necessitated placing the documentation in storage.

Regardless of the fact that PFAM had moved, the maintenance of documentation in a safe, secure and accessible place is required of all market participants. Many market participants store documents in electronic form or in offsite locations due to space limitations at their office locations but are still able to readily access those documents. The fact that PFAM had moved its office location does not reduce its responsibility to store the documents in a secure fashion and be able to produce them at the request of the Commission.

(b) Calculation of Original 2012 MERs

PFAM was also unable to provide its original calculations for the December 2012 MERs calculations when requested to do so by Staff. McKinnon submitted that the calculations were performed by an employee who had left PFAM and that it was not possible to locate the required information in her e-mail or records, some of which had been shredded prior to her leaving PFAM. However, at the time that the calculations were completed for the December 2012 MERs, copies of the calculations should have been placed in a file that was kept in a safe and secure location, as required. No required documentation should be kept solely in one employee's files and records but must be retained in a secure location with the documentation that market participants are required to maintain.

(c) Monthly Approval Form 31-103F for May to October 2012

During his interview by Staff on July 30, 2014, McKinnon provided an undertaking to confirm that the Form 31-103F1s, which had been provided to Staff in November 2012 (covering the period from May to October 2012), regarding working capital calculations had been approved by him and, if not, that he would provide the Forms that had been approved by him. In a subsequent letter to Staff, McKinnon's counsel advised that he was unable to confirm that the Forms had been approved by him and did not have access to the original Forms which had been approved. During the Hearing, both McKinnon and Pinto testified that the Form 31-103F1s were reviewed, approved and signed (electronically) by McKinnon but were unable to provide the actual signed Forms. In McKinnon's Written Submissions, McKinnon simply states that PFAM did not have access to the specific Forms which had been approved, and did not provide an explanation. Once again, PFAM was unable to provide the records which it was required to maintain as part of its record-keeping obligations.

(d) Management Fees-Contra Line Item

Ho testified that Staff had requested information regarding the line item "Management Fees – Contra" in the general ledger for the Pro-Index Funds in December 2013. By letter to Staff dated January 17, 2014, PFAM's counsel advised Staff that they were having difficulty obtaining the required information from IAS. PFAM did not at any time provide the requested information to Staff. In McKinnon's Written Submissions, McKinnon argues that they had followed-up with IAS on three occasions in January 2014 and states only that IAS was unwilling to provide the information in question. Regardless of whether IAS did or did not co-operate in providing the information in 2014, PFAM's obligation was to maintain adequate records and supporting documentation for items in the general ledger of the Pro-Index Funds as specified in subsection 11.5(1) of NI 31-103, namely, records that would "permit timely creation and audit of financial statements and other financial information required to be filed or delivered".

(e) Expenses Waived/Absorbed by Manager

Staff submits that PFAM was unable to provide an explanation for the line item "Expenses Waived/Absorbed by Manager" in PFAM's financial statements for 2012 and 2013, and refers to the compelled interview of Pinto on July 17, 2014 in which she stated that only IAS could explain the expenses waived or absorbed by the manager. McKinnon submits that Staff provided no evidence during the Hearing that a request for the information was made. As Staff did not raise the issue with Pinto during her testimony at the Hearing and Chan's testimony with respect to the issue was only based on his understanding of the practices of fund managers, we are unable to make a determination with respect to this specific alleged failure.

[180] We might find it understandable if PFAM's failure to produce documents was isolated or related to a specific transaction, time or area of its business. However, the evidence presented during the Hearing demonstrated that PFAM was unable to produce documents related to numerous critical areas of its business, including documents required for trust account reconciliation, working capital calculations, the PPN Deficiency, the MER calculations for the Pro Index Funds and financial reporting for the funds. It is clear from the evidence that PFAM did not properly record or maintain the documents related to its business activities as required and, in at least eight separate instances, PFAM's response to requests by Staff for documentation was that the records were unavailable and some records were never provided.

[181] For the foregoing reasons, we find that PFAM failed to maintain appropriate books, records and other documents as required by subsection 19(1) of the Act and sections 11.5 and 11.6 of NI 31-103.

D. Did PFAM Fail to Maintain Appropriate Controls and Compliance Systems?

[182] Subsection 32(2) of the Act provides as follows:

> **Duty to establish controls, etc**. – Every registrant that is a registered dealer, registered adviser or registered investment fund manager shall establish and maintain systems of control and supervision in accordance with the regulations for controlling his, her or its activities and supervising his, her or its representatives.

[183] Section 11.1 of NI 31-103 and NI 31-103CP provide further guidance on the importance of effective compliance and how an effective compliance system would provide the appropriate controls and supervision. Specifically, NI 31-103CP states that "operating an effective compliance system is essential to a registered firm's continuing fitness for registration" and that such a compliance system "should include controls and monitoring systems that are reasonably likely to identify non-compliance at an early stage and supervisory systems that allow the firm to correct non-compliant conduct in a timely manner".[58]

[184] In May 2009, the CRR Branch conducted a compliance review of PFAM. Following the review, a report was sent to McKinnon that identified significant deficiencies that would "significantly impact your firm's fitness for registration"[59] citing a lack of a compliance system, among other things. Terms and conditions were imposed which required PFAM to employ a consultant to work with PFAM to resolve the issues. A follow-up review by the CRR Branch was carried out in May 2011 and the subsequent report to PFAM was more explicit about PFAM's lack of a suitable compliance system, identifying, among other deficiencies under securities law, "an inadequate compliance system, UDP not adequately performing responsibilities, and CCO not adequately performing responsibilities."[60]

[185] Staff submits that the following conduct demonstrates PFAM's failure to establish and maintain systems of control and supervision contrary to subsection 32(2) of the Act and section 11.1 of NI 31-103:

(a) Submitting unsupported redemption requests to the Banks;

(b) Making redemption payments to the Noteholders at different prices than those that were used by the Banks for redemption proceeds paid to Concentra;

(c) Failing to properly account for monies received in the PFAM trust account;

(d) Using the surplus from the initial series of PPNs to make redemption or maturity payments for other PPN series;

(e) Failing to discover that there was a shortfall on the maturity of the Pro 706 Series of PPNs;

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[58] NI 31-103CP, section 11.1.
[59] Exhibit 148.
[60] Exhibit 237.

(f) Failing to properly investigate and communicate the PPN Deficiency to the Banks, Concentra, IAS and the Noteholders;

(g) Failing to ensure that adequate controls were in place for the calculation of the MERs for the Pro-Index Funds;

(h) Failing to renew the prospectus for the Pro-Index Funds; and

(i) Failing to ensure adequate controls for the calculation and maintenance of PFAM's working capital calculations.

[186] In McKinnon's Written Submissions, McKinnon admits that the evidence does reveal areas in which PFAM's controls and compliance systems did not detect or prevent some issues. However, he submits that he made *bona fide* efforts to ensure that PFAM's compliance systems were in accordance with industry standards.

[187] We acknowledge that McKinnon made some efforts, but the fact remains that the actions that he did take were inadequate to address the compliance system deficiencies. Two separate CRR Branch Compliance Field Review Reports identified numerous compliance deficiencies and cited the lack of an adequate compliance system.

[188] For the foregoing reasons, we find that PFAM failed to establish and maintain systems of controls and supervision contrary to subsection 32(2) of the Act and section 11.1 of NI 31-103.

V. MCKINNON'S RESPONSIBILITIES

A. Did McKinnon authorize, permit or acquiesce in PFAM's breaches?

1. Background and Submissions

[189] Section 129.2 of the Act attaches liability to officers and directors of a corporation for its non-compliance with Ontario securities law as follows:

> **Directors and officers** – For the purposes of this Act, if a company or a person other than an individual has not complied with Ontario securities law, a director or officer of the company or person who authorized, permitted or acquiesced in the non-compliance shall be deemed to also have not complied with Ontario securities law, whether or not any proceeding has been commenced against the company or person under Ontario securities law or any order has been made against the company or person under section 127.

[190] Staff submits that, as a director and officer of PFAM, McKinnon authorized, permitted or acquiesced in PFAM's non-compliance with Ontario securities law and, accordingly, he should be deemed to have failed to comply with Ontario securities law pursuant to section 129.2 of the Act.

[191] Staff submits that McKinnon was actively involved in PFAM's operations and was aware of and participated in the following conduct:

(a) PFAM's failure to deal fairly, honestly and in good faith with its clients;

(b) PFAM's breach of its standard of care as an IFM;

(c) PFAM's failure to maintain required working capital;

(d) PFAM's failure to keep satisfactory books and records; and

(e) PFAM's failure to maintain adequate internal controls and systems.

[192] Staff relies on the decision in *Momentas* in which the Commission determined that:

> … the threshold for liability under section 122 and 129.2 is a low one, as merely acquiescing in the conduct or activity in question will satisfy the requirement of liability. The degree of knowledge of intention found in each of the terms "authorize", "permit" and "acquiesce" varies significantly. "Acquiesce" means to agree or consent quietly without protest. "Permit" means to allow, consent, tolerate, give permission, particularly in writing. "Authorize" means to give official approval or permission, to give power or authority or to give justification.
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> (*Momentas*, para 118)

[193] McKinnon and Staff agree on the applicable legal test for section 129.2 as articulated in *Momentas.* However, McKinnon submits that section 129.2 of the Act specifically requires that the director or officer have knowingly participated in the non-compliance. McKinnon further submits that Staff is required to prove that he possessed the requisite knowledge and intent necessary to demonstrate he either authorized, permitted or acquiesced in any alleged violation by PFAM.

[194] McKinnon relies on a decision of the Alberta Court of Appeal which held that, to sustain a conviction under subsection 194(1)(a) or (b) of the Alberta *Securities Act*[61], it was necessary to prove pursuant to section 194(4) that the officer or director "authorized, permitted or acquiesced" in a misrepresentation. The Court held that the "provision has not been construed as one of strict liability, but rather one that incorporates a subjective *mens rea*."[62]

[195] Staff disputes McKinnon's submissions relating to knowing participation and intent and submits that is not the standard that has been articulated by the Commission and that merely acquiescing in the conduct will satisfy the requirement for liability under section 129.2 of the Act. In this regard, Staff points to the Commission's decision in *Bluestream Capital Corp.* (2015), 38 OSCB 2333 ("***Bluestream***") in which the Commission reaffirmed the low threshold for liability pursuant to section 129.2 of the Act and held

[61] RSA 2000 c S-4.

[62] *Alberta (Securities Commission) v Workum*, 2010 ABCA 405, para 134.

that "merely acquiescing to the conduct or activity in question will satisfy the requirements for liability; in other words, passive consent is all that is required".[63]

2. Analysis and Findings

[196] McKinnon was the indirect owner, President, Chief Executive Officer and a director of PFAM since its incorporation and was actively involved in PFAM's business. While certain employees of PFAM were responsible for performing working capital calculations, MER calculations and various other reporting requirements under Ontario securities law, they all reported to McKinnon. Reliance on other employees to perform certain duties does not absolve McKinnon from liability for PFAM's non-compliance as an officer and director.

[197] McKinnon signed PFAM's cheques, approved the MER calculations and was responsible for ensuring that PFAM maintained the required minimum capital. Although McKinnon did not personally perform all of the tasks relating to the PPNs which we address above in these Reasons, he was the directing mind of PFAM and exercised full control of PFAM's accounting and operations staff and sat in close proximity to them. McKinnon's failure to address the circumstances which gave rise to the PPN Deficiency and his authorization, permission or acquiescence in the use of a "surplus" in one PPN series to cover a "deficit" in another PPN series was completely improper given that the funds were held in trust. In summary, McKinnon permitted or acquiesced in PFAM's breach of its fundamental obligation to deal fairly, honestly and in good faith with its clients.

[198] For the foregoing reasons, we find that, as a director and officer of PFAM, McKinnon authorized, permitted or acquiesced in PFAM's non-compliance with Ontario securities law and is therefore deemed to also have not complied with Ontario securities law pursuant to section 129.2 of the Act.

B. Did McKinnon Fulfill His URP and UDP Responsibilities?

1. Background and Submissions

[199] As PFAM's URP from October 19, 2005 to September 28, 2009, McKinnon had the ultimate responsibility for ensuring PFAM's compliance with Ontario securities law pursuant to Rule 31-505. As PFAM's UDP since October 26, 2009, McKinnon was obligated to comply with section 5.1 of NI 31-103 which provides that:

> **Responsibilities of the ultimate designated person** – The ultimate designated person of a registered firm must do all of the following:
>
> (b) supervise the activities of the firm that are directed towards ensuring compliance with securities legislation by the firm and each individual acting on the firm's behalf;
>
> (c) promote compliance by the firm, and individuals acting on its behalf, with securities legislation.

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[63] *Bluestream*, para 50.

[200] NI 31-103CP provides that the intention of the UDP designation is to ensure that responsibility for a registered firm's compliance systems rests at the very top of the firm. The UDP has an obligation to establish, maintain and apply policies and procedures that support effective compliance with the applicable securities regulation which includes having sufficient trained resources as well as an effective system of controls and oversight.

[201] In promoting a culture of compliance, the UDP must ensure that a firm's compliance program manages any potential risks related to compliance failure and any potential risks which would result in harm being caused to investors or the markets or in financial losses or reputational damage to the firm.

[202] Staff submits that McKinnon failed to meet his responsibilities as PFAM's UDP by failing to supervise the activities of PFAM and by failing to promote compliance with securities legislation. Staff points to the following evidence which, in Staff's submission, demonstrates McKinnon's failure to supervise the activities of PFAM directed towards compliance with securities legislation:

(a) Unsupported redemption requests and the use of estimates;

(b) Using prices for the payment of redemption proceeds that were different from the prices used by the Banks to pay to Concentra;

(c) The surplus in the Pro 101 Series of PPNs and the subsequent failure by PFAM to investigate the cause and notify the other parties;

(d) The use by PFAM of the Pro 101 surplus to make redemption or maturity payments for other PPN Series;

(e) PFAM's failure to account for monies in PFAM's trust account;

(f) The CRR Branch Compliance Field Review report dated March 5, 2010, which is addressed in paragraph [207] below;

(g) PFAM's failure to notify the Commission of its working capital deficiency during the period of May 31 to October 31, 2012 until November 30, 2012;

(h) The inaccurate calculation of the June 2013 MERs by Pinto; and

(i) The approval of the MRFPs which included inaccurate MERs for December 2012 and June 2013.

[203] McKinnon submits that liability under section 5.1 of NI 31-103 is not strict and a URP or UDP is not necessarily prosecuted for the acts or omissions of his or her firm. He also submits that a finding that PFAM breached securities laws does not necessarily lead to a finding that McKinnon breached his obligations as URP or UDP.

[204] In his testimony and in his oral and written submissions, McKinnon repeatedly submits that he was not involved in the day-to-day operations of PFAM and relied on his staff to advise him of any problems which arose. McKinnon relies in this regard on *Rowan* (2008) 31 OSCB 6515 ("***Rowan***") in which the Commission stated that the UDP is "not operationally responsible for day-to-day compliance activities"[64] which, in McKinnon's

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[64] *Rowan*, para 316.

submission, fall to the CCO. He also asserts that a finding that PFAM breached securities law does not necessarily lead to a finding that he breached his obligations as UDP.

[205] McKinnon submits that his obligations as URP or UDP must be read in conjunction with those of the CCO whose obligations under the former Rule 31-505 and the current NI 31-103 include establishing policies and procedures, monitoring and assessing compliance and reporting violations or potential violations to the UDP.

[206] Finally, McKinnon submits that he performed his supervisory functions in a commercially reasonable manner in the circumstances and sought to establish and foster a climate of compliance. In McKinnon's submission, the documentary evidence and his own testimony suggest that McKinnon took his compliance responsibilities seriously.

2. Analysis and Findings

[207] In May 2009, staff of the CRR Branch conducted a compliance review of PFAM which resulted in the CRR Branch's Compliance Field Review Report dated March 5, 2010 which identified a number of serious issues. The Report, which was sent to McKinnon, should have been the first "red flag" to McKinnon in his role as UDP as the language used in the Report is direct and stark, stating that there were significant deficiencies that would "significantly impact your firm's fitness for registration"[65] and citing the lack of a compliance system, the CCO not adequately performing his responsibilities, the overstatement of net asset values and a prohibited loan from one of the Funds. The CRR Branch stipulated that PFAM had 21 days to address these deficiencies before Terms and Conditions were imposed on the firm. Subsequently, Terms and Conditions dated June 29, 2010 were imposed which required PFAM to hire a consultant to work with PFAM to develop a proper compliance system.

[208] A second CRR Branch compliance review was undertaken in May 2011 and the resulting CRR Compliance Field Review Report dated October 7, 2011 was even harsher in its assessment of PFAM's lack of a suitable compliance system. The Report stated that "your ultimate designated person, (UDP), Stuart McKinnon, has not adequately performed his responsibilities under securities law" and "your CCO, John Farrell, has not adequately performed his responsibilities under securities law."[66]

[209] While we would agree that McKinnon was not involved in performing the daily operations of PFAM and may not have had working knowledge of the detailed processes followed by his staff, he cannot absolve himself of responsibility for oversight of these activities and for his responsibility to ensure that the firm was being appropriately managed to ensure compliance. In this regard, we note that the Commission in *Rowan*, on which McKinnon relies, states clearly that:

> Each firm must have a UDP who is responsible for the firm's overall compliance with regulatory requirements as well as overseeing the development and implementation of its compliance practices and procedures.
>
> (*Rowan*, para 316)

[65] Exhibit 148, p. 1.
[66] Exhibit 237, pp. 1-2.

[210] As UDP, McKinnon reviewed and approved the firm's compliance manuals. He stated in his testimony that all employees were required to sign an acknowledgment form stating that they had reviewed and would comply with the compliance manual. Yet, on cross-examination, he said several times that he had not seen the section of the compliance manuals relating to the pricing of PPNs and was not aware that PFAM was establishing secondary market prices that were different from the Banks' prices. As UDP, and as the person who had established the PPN relationships with the Banks, it was McKinnon's responsibility to ensure that the PPNs were processed according to the terms of the Bank Agreements.

[211] Similarly, McKinnon was made aware that there was a discrepancy in PPN records in December 2010 when Bozzo informed him that there was a surplus of $197,031. He treated this as a windfall rather than as a red flag that there might be a deficit in another Series. Subsequently, in May 2012, when Bozzo sent him a report which showed imbalances in several PPN series, he said that he was not concerned because there was a net surplus of approximately $13,000. As we have previously found, this response meant that McKinnon permitted the use of surplus funds from one series of PPNs to settle a shortfall of funds on another series and, depending on the timing of maturities, it was likely that PFAM would have had a shortfall that PFAM would have been unable to pay. McKinnon's willful blindness to the seriousness of this issue demonstrates that he was not discharging his duties as UDP.

[212] On numerous occasions, PFAM was asked to produce various documents for review by the CRR Branch including working capital calculations, policies and procedures manuals, trust account and PPN reconciliations, that they were either unable to produce at all or took days, weeks or months to produce. There were many examples of accounting documents that were lost, destroyed or misplaced. The responsibility to maintain adequate books and records is a cornerstone of the appropriate oversight of any registrant firm and, while McKinnon may not have written or prepared any of these documents himself, as UDP, it was his responsibility to ensure that the firm prepared all of the required records and that they were maintained in a safe and secure fashion.

[213] A number of issues regarding the calculation of working capital have been raised in this proceeding. It is clear that the UDP must ensure that his firm has appropriate working capital to ensure the viability and solvency of the firm. In addition, McKinnon had taken the Partners, Directors and Senior Officers Course of the Canadian Securities Institute which requires, among other things, knowing how to calculate working capital. Yet McKinnon testified that he "didn't know how to calculate the working capital and didn't do it" and that he just looked at the "bottom line" to ensure that the working capital exceeded the minimum amount required. McKinnon was not entitled to delegate his responsibility relating to the adequacy of working capital to the CFO or the head of accounting. As UDP, he must ensure that he has competent staff with the appropriate qualifications to manage the ongoing calculation of working capital and he must review and assure himself that those calculations are being done correctly. Indeed, he was required to provide his certification as UDP that he had reviewed the working capital calculation and that he believed it to be correct.

[214] McKinnon failed to carry out his obligations as UDP by failing to appropriately supervise the activities of PFAM and by failing to establish and maintain the firm's required

compliance with securities legislation. He also failed to promote a culture of compliance and oversee the effectiveness of PFAM's compliance system. The lack of a robust compliance system resulted in financial and regulatory risks which caused harm to investors and the markets as well as financial losses and reputational damage to the firm and the industry. This is the very reason that NI 31-103 assigns responsibility for a registrant's compliance system to the most senior level of the organizational structure.

[215] McKinnon argued during the Hearing that the repeated investigations, visits and demands for information from the CRR Branch adversely affected PFAM's ability to maintain and attract business and resulted in increased costs and loss of staff productivity. In closing oral submissions, his counsel stated:

> the progression or regression of the business of Pro-Financial and the different stresses it was under at different points of time financially as a result of its business disputes, <u>as a result of repeated and ongoing compliance field audits from CRR Staff, ultimately leading to a diminution of assets under management</u> and financial difficulties that led to the working capital deficiency. [Emphasis added.]
>
> (Hearing Transcript, September 15, 2016, p. 102)

[216] However, the compliance deficiencies found by the CRR Branch in its 2009 review were very clearly outlined to PFAM in the Report delivered in March 2010. The Report identified a lack of an effective compliance system and a CCO inadequately performing his responsibilities. It further enumerated numerous significant deficiencies related to the use of the trust account, net asset value calculations, fund accounting and regulatory reporting. Many of these deficiencies were inadequacies dating back several years (2005-2008). The Report also stated that PFAM had 21 days to address the deficiencies so that they could be "able to avoid the costs and administrative burdens of having terms and conditions imposed on its registration".[67] PFAM did not address the deficiencies and, as a consequence, Terms and Conditions were imposed by the CRR Branch on June 29, 2010. PFAM did engage a consultant (as specified in the Terms and Conditions), and did implement some of the recommended changes. However, the subsequent CRR Branch review in May 2011 resulted in a second report which again identified many significant deficiencies, some of which are summarized above in these Reasons.

[217] Had McKinnon and PFAM adequately addressed the concerns raised by the CRR Branch after its first review, they might have avoided many of the difficulties and regulatory costs which they later incurred. As UDP, McKinnon should have understood the seriousness of non-compliance with regulatory obligations and been far more proactive in ensuring that the compliance and regulatory requirements of the firm, as identified by the CRR Branch, were met.

[218] McKinnon's failures as UDP were extensive and significant and are simply indisputable. Accordingly, we find that, since October 19, 2005 and prior to September 28, 2009, McKinnon breached his obligations as PFAM's URP pursuant to subsection 1.3(2) of

[67] Exhibit 148, p. 2.

Rule 31-505 and, on or after September 28, 2009, he breached his obligations as PFAM's UDP pursuant to section 5.1 of NI 31-103.

VI. BREACHES OF ONTARIO SECURITIES LAW

[219] For the foregoing reasons, we find that:

(a) PFAM failed to deal fairly, honestly and in good faith with its clients, contrary to subsection 2.1(1) of Rule 31-505;

(b) PFAM failed to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances and, in doing so, breached the standard of care for IFMs, contrary to subsection 116(b) of the Act;

(c) PFAM failed to maintain the minimum working capital required of a registered firm and failed to report its capital deficiency, contrary to section 12.1 of NI 31-103;

(d) PFAM failed to keep satisfactory books, records or other documents, contrary to subsection 19(1) of the Act and sections 11.5 and 11.6 of NI 31-103;

(e) PFAM failed to establish, maintain and apply policies and procedures that establish an adequate system of controls and supervision, contrary to subsection 32(2) of the Act and section 11.1 of NI 31-103;

(f) McKinnon, as a director and officer of PFAM, authorized, permitted or acquiesced in PFAM's breaches as set out above (a) through (e) and is therefore liable pursuant to section 129.2 of the Act; and

(g) McKinnon breached his obligations as URP and UDP of PFAM, contrary to section 5.2 of NI 31-103.

VII. CONDUCT CONTRARY TO THE PUBLIC INTEREST

[220] Staff alleges that the conduct of PFAM and McKinnon described in the Statement of Allegations was contrary to the public interest. The Commission's public interest jurisdiction is preventative in nature and prospective in orientation. It is intended to be exercised to prevent future harm to investors and Ontario capital markets.

[221] PFAM and McKinnon breached numerous provisions of Ontario securities law. PFAM failed to discharge the duties and responsibilities of a registered firm and McKinnon, as an officer and director of PFAM, authorized, permitted or acquiesced in those breaches and ultimately failed his responsibilities as URP and as UDP.

[222] For the foregoing reasons, we find that PFAM and McKinnon's conduct was contrary to the public interest.

VIII. SANCTIONS HEARING

[223] The parties are requested to contact the Office of the Secretary of the Commission by 5:00 p.m. on April 27, 2017 to schedule a sanctions hearing.

Dated at Toronto this 20th day of April, 2017.

"Christopher Portner"

Christopher Portner

"Judith N. Robertson"

Judith N. Robertson

"AnneMarie Ryan"

AnneMarie Ryan