



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

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

Re: Farm Mutual Financial Services Inc.

NOTICE OF HEARING

NOTICE is hereby given that a first appearance will take place by teleconference before a Hearing Panel of the Regional Council of the Central Region (the “Hearing Panel”) of the Mutual Fund Dealers Association of Canada (the “MFDA”) in the hearing room located at 121 King Street West, Suite 1000, Toronto, Ontario on Friday, June 27, 2008 at 10:00 a.m. (Toronto), or as soon thereafter as the hearing can be held, concerning a disciplinary proceeding commenced by the MFDA against Farm Mutual Financial Services Inc. (the “Respondent”).

DATED at Toronto this 2nd day of June, 2008.

“Gregory J. Ljubic”
Gregory J. Ljubic
Corporate Secretary

Mutual Fund Dealers Association of Canada
121 King St. West, Suite 1000
Toronto, Ontario, M5H 3T9
Tel: 416-943-5836
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E-mail: CorporateSecretary@mfda.ca

NOTICE is further given that staff of the MFDA alleges the following violations of the By-laws, Rules or Policies of the MFDA:

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

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

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

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

Allegation #4: Between June 2003 and April 2007, the Respondent failed to establish, implement and maintain policies and procedures to adequately and effectively supervise the sale of the Debentures to its clients, contrary to MFDA Rules 2.5.1 and 2.1.1(c) and MFDA Policy No. 2.

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

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

PARTICULARS

NOTICE is further given that the following is a summary of the facts alleged and intended to be relied upon by the MFDA at the hearing:

Registration History

1. The Respondent has been registered in Ontario as a mutual fund dealer since July 2, 1997 and a limited market dealer since July 7, 1999.
2. The Respondent has been a Member of the MFDA since May 10, 2002.

Background

3. FactorCorp held itself out as being in the business of extending credit to companies which purchased accounts receivable from other companies at a discount and then attempted to collect the accounts in full.

4. On June 25, 2003, and again on December 18, 2003, the Respondent entered into a distribution agreement with FactorCorp (the “Distribution Agreement”) pursuant to which the Respondent agreed to promote and distribute the Debentures to its clients through its Approved Persons. Under the terms of the Distribution Agreement, FactorCorp agreed to pay the Respondent a monthly commission based on the total amount invested by the Respondent’s clients (and any other individuals to whom its Approved Persons sold the Debentures).

5. The Debentures offered investors a fixed rate of interest of 6%, 7% or 8% based on one-, two- or three-year terms, respectively.

6. The Debentures were offered to investors in Ontario in reliance on the “accredited investor” exemption set out in section 2.3 of Ontario Securities Commission Rule 45-501 and subsequently National Instrument 45-106.¹

7. At no time prior to entering into the Distribution Agreement, or at any time thereafter, did the Respondent conduct sufficient due diligence on FactorCorp or the Debentures to determine whether the product was suitable for sale to the Respondent’s clients.

8. In June 2003, the Respondent permitted Approved Persons at one of its branch offices to sell the Debentures. In October 2003, the Respondent approved the Debentures for sale by Approved Persons at all of its branch offices.

9. On November 11, 2003, the Respondent’s Manager of Compliance & Auditing sent an email message to all branch managers, the purpose of which was, among other things, to clarify the definition of “accredited investor” in OSC Rule 45-501.

¹ In September 2005, National Instrument 45-106 came into force. Many of the prospectus and registration exemptions previously available under OSC Rule 45-501 were incorporated into NI 45-106. The accredited investor” exemption was amended to a limited extent, however the amendments do not affect the allegations against the Respondents in this proceeding.

10. By the same email message, the Manager of Compliance & Auditing further advised all branch managers that all exempt products, including the Debentures, “fall into a high risk category” and require “extra due diligence in the supervision by the branch manager in reviewing and approving, first of all the account set up for the investor based on the KYC [Know-Your-Client] information and secondly the sale of the product supported by the information obtained by the associate [Approved Person] from the investor.”

11. Between June 25, 2003 and April 1, 2007, 35 Approved Persons of the Respondent sold approximately \$52 million of the Debentures to 680 clients of the Respondent. In that time, the Respondent received, in the ordinary course through its facilities, approximately \$2.1 million in sales commissions from FactorCorp.

12. Between June 2003 and September 2006, none of the Debentures transactions were properly recorded on the Respondent’s books and records.

13. At the time the Debentures were sold, the Respondent’s clients were asked to complete a Farm Mutual new account application form, a FactorCorp Subscription Agreement, and a FactorCorp Accredited Investor Status Certificate (collectively, the “Sales Documentation”). Clients were directed to make all cheques payable to FactorCorp.

14. For each sale, the Approved Person provided the Sales Documentation, along with the client’s cheque in payment for the Debentures, to the Approved Person’s branch manager whose responsibility it was to ensure that the Sales Documentation was complete. The branch manager then forwarded the Sales Documentation, along with the client’s cheque, directly to FactorCorp.

15. The Respondent’s branch managers either did not conduct, or did not adequately conduct, first-tier reviews of these purchases upon receiving the Sales Documentation. In particular, the branch managers did not review the suitability of trades in the Debentures

facilitated by Approved Persons under their supervision at their respective branch office, nor did they review the Sales Documentation to ensure that clients who purchased the Debentures qualified as accredited investors.

16. The branch managers were not required to forward copies of the Sales Documentation to the Respondent's head office, but rather retained copies of the Sales Documentation at the branch offices. At no time did the Respondent conduct second-tier head office suitability reviews of any of the Debentures transactions.

17. Each month, FactorCorp provided the Respondent with a list of all sales commissions payable in respect of sales made by its Approved Persons. The list included the names of clients who purchased the Debentures, the dates of purchase, the amounts purchased, the term of each investment, the Approved Person of record and the commission payable on each transaction. The Respondent did not initiate or conduct a second-tier suitability review at head office of any of the transactions upon receiving the monthly commissions lists from FactorCorp or at any other time.

18. Between June 2003 and April 2007, the Respondent conducted audits of various of its branch offices through which the Debentures had been sold. During the audits, the Respondent reviewed files of clients who had invested in the Debentures. The review of these files consisted solely of ensuring that the Sales Documentation had been collected and retained. The audits did not include a review of the suitability of any of the transactions or an assessment as to whether the clients qualified as accredited investors.

19. On October 31, 2005, the MFDA issued Member Regulation Notice MR-0048 "Know-Your-Product" the purpose of which was to clarify the obligations of Members and Approved Persons with respect to the approval and sale of investment products. The Notice states, among other things, that "Members must perform a reasonable level of due diligence on products prior to their approval for sale by Approved Persons...In the event that products are presently being sold that have not been subjected to a reasonable due

diligence review, such a review must be performed before continuing to sell the products.”

20. FactorCorp suspended redemptions in May 2007. On July 6, 2007, the Ontario Securities Commission issued a temporary cease trade order against FactorCorp Inc. and FactorCorp Financial Inc. (collectively, “FactorCorp”). Conditions of the order included: (i) FactorCorp must engage a monitor to oversee its business, operations and affairs; (ii) no redemptions of the Debentures could be made; and (iii) no further Debentures could be sold. Of the approximately \$52 million invested by the Respondent’s clients in the Debentures, approximately \$49 million remained outstanding and unredeemed at the time of the cease trade order.

21. On August 1, 2007, FactorCorp engaged KPMG Inc. to monitor its business, operations and affairs.

22. On October 17, 2007, KPMG Inc. was appointed as receiver and manager of FactorCorp by the Ontario Superior Court of Justice.

23. On March 25, 2008, by further order of the Court, KPMG Inc. was appointed as trustee in bankruptcy for FactorCorp. A first meeting of creditors was held on April 24, 2008 in London, Ontario.

Due Diligence, Suitability, Business Structures & Supervision

24. The Respondent approved and allowed the sale of Debentures to approximately 680 of its clients without having conducted sufficient due diligence on the product and without having made reasonable inquiries to determine whether the product was suitable for sale to its clients, contrary to MFDA Rule 2.2.1(a), (b), (c) and (d) and MFDA Rule 2.1.1(c). In addition, the Respondent failed to conduct a sufficient and reasonable due diligence review of FactorCorp and the Debentures after Member Regulation Notice MR-0048 “Know-Your-Product” was issued on October 31, 2005.

25. In particular, the Respondent (i) permitted 41 of its clients to invest \$5,116,000 in the Debentures before the Respondent had completed its due diligence assessment of the product; (ii) failed to obtain and review the financial statements of FactorCorp in order to assess the company's financial position; and (iii) failed to develop and communicate guidelines or an investor profile to its Approved Persons to assist them in identifying clients for whom the Debentures might have been a suitable investment and to clearly identify investors for whom the Debentures would not be suitable.

26. The Debentures were a high-risk investment. Of the Respondent's clients who bought the Debentures, only 22 had a risk tolerance of 'high' recorded on their KYC information at the time of their initial purchase, while 52 clients had no risk tolerance information recorded. The remaining 606 clients had a risk tolerance of less than 'high' at the time of their initial purchase.

27. Further, the Respondent and its Approved Persons purported to rely on the "accredited investor" exemption available under OSC Rule 45-501 and subsequently NI 45-106 to sell the Debentures to clients. However, based on the KYC information available for clients at the time the Debentures were initially purchased, only 44 of 680 clients met the income, net financial assets and/or net worth thresholds necessary to qualify for the accredited investor exemption. The remaining 636 clients either did not meet the accredited investor requirements or the Respondent and its Approved Persons failed to collect sufficient information to make that determination.

28. By virtue of the foregoing conduct, the Respondent approved and allowed the sale of the Debentures to its clients without ensuring that the investments were suitable for the clients and in keeping with their investment objectives, contrary to MFDA Rule 2.2.1(a), (b), (c) and (d) and MFDA Rule 2.1.1(c).

29. In addition, the Respondent approved and allowed the sale of the Debentures when it knew or ought to have known that most of clients who purchased the Debentures

did not qualify for the accredited investor exemption set out in OSC Rule 45-501 and subsequently NI 45-106, contrary to MFDA Rule 2.1.1(c), thereby engaging the jurisdiction of the Hearing Panel to impose a penalty on the Respondent pursuant to s. 24.1.2(n) of MFDA By-Law No. 1.

30. The Respondent also failed to ensure that sales of the Debentures to its clients between June 2003 and September 2006 were properly conducted through the Respondent's facilities, contrary to MFDA Rule 1.1.1(a).

31. The Respondent also failed to establish, implement and maintain policies and procedures to adequately and effectively supervise the sale of the Debentures to its clients, contrary to MFDA Rules 2.5.1 and 2.1.1(c) and MFDA Policy No. 2.

Adequacy of Compliance Structure

32. In April 2007, MFDA Compliance Staff conducted a routine compliance examination of the Respondent's sales policies, procedures and practices, the findings of which were reported to the Respondent on August 7, 2007. The examination covered the period December 2003 to April 2007.

33. A number of deficiencies were identified during the compliance examination, including inadequate supervision of trades at the head office level. Specifically, the compliance examination revealed that the Respondent's head office does not review the trading activity of its Approved Persons on a daily basis. The Respondent's head office compliance department only performs daily reviews of mutual fund trades placed by Approved Persons directly with mutual fund companies (i.e. direct-to-fund trades) and trades made by producing branch managers.

34. The Respondent therefore failed to establish, implement and maintain policies and procedures to ensure that trades conducted by its Approved Persons are reviewed on a daily basis at the Respondent's head office, contrary to MFDA Rule 2.5.1 and Policy 2.

Adequacy of Compliance Staffing

35. Commencing in 2001, senior compliance staff of the Respondent advised the Respondent's management and board of directors on numerous occasions that the Respondent's compliance department was under-staffed and requested that additional qualified staff be hired in order to fully and properly fulfill the Respondent's compliance obligations.

36. Between May 2002 and May 2007, the Respondent failed to maintain adequate compliance staff to monitor adherence by the Member and its Approved Persons to MFDA Rules, By-laws and Policies and applicable securities legislation requirements, contrary to MFDA Rule 2.5.1 and MFDA Rule 2.5.2(b)

NOTICE is further given that the Respondent shall be entitled to appear and be heard and be represented by counsel or agent at the hearing and to make submissions, present evidence and call, examine and cross-examine witnesses.

NOTICE is further given that MFDA By-laws provide that if, in the opinion of the Hearing Panel, the Respondent:

- has failed to carry out any agreement with the MFDA;
- has failed to meet any liabilities to another Member or to the public;
- has engaged in any business conduct or practice which the Hearing Panel in its discretion considers unbecoming a Member or not in the public interest;
- has ceased to be qualified as a Member by reason of the ownership, integrity, solvency, training or experience of the Member or any of its Approved Persons or other employees or agents, or any person having an ownership interest in the capital or indebtedness of the Member;

- has failed to comply with or carry out the provisions of any of the By-laws, Rules or Policies of the MFDA; or
- has failed to comply with or carry out the provisions of any applicable federal or provincial statute relating to its business or of any regulation or policy made pursuant thereto;

the Hearing Panel has the power to impose any one or more of the following penalties:

- (a) a reprimand;
- (b) a fine not exceeding the greater of:
 - (i) \$5,000,000.00 per offence; and
 - (ii) an amount equal to three times the profit obtained or loss avoided by the Member as a result of committing the violation;
- (c) suspension of the rights and privileges of the Member (and such suspension may include a direction to the Member to cease conducting securities related business) for such specific period and upon such terms as such Hearing Panel may determine, or, if the rights and privileges have already been suspended under Section 24.3, the continuation of such suspension (including a prohibition on the Member conducting securities related business) for such specified period and upon such terms as such Hearing Panel may determine;
- (d) termination of the rights, privileges and Membership of the Member;
- (e) expulsion of the Member from the MFDA;
- (f) such terms and conditions on Membership of the Member as may be considered appropriate by the Hearing Panel;

- (g) imposition of a monitor to oversee and/or report on the Member's activities; and
- (h) directions for the orderly transfer of client accounts from the Member.

NOTICE is further given that the Hearing Panel may, in its discretion, require that the Respondent pay the whole or any portion of the costs of the proceedings before the Hearing Panel and any investigation relating thereto.

NOTICE is further given that the Respondent must **serve** a **Reply** on Enforcement Counsel and **file** a **Reply** with the Corporate Secretary within twenty (20) days from the date of service of this Notice of Hearing.

A **Reply** shall be **served** upon Enforcement Counsel at:

Mutual Fund Dealers Association of Canada
121 King Street West
Suite 1000
Toronto, Ontario, M5H 3T9
Attention: Jason D. Bennett
Fax: 416-361-9073
Email: jbenett@mfd.ca

A **Reply** shall be **filed** by:

- (a) providing 4 copies of the **Reply** to the Corporate Secretary by personal delivery, mail or courier to:

The Mutual Fund Dealers Association of Canada
121 King Street West
Suite 1000
Toronto, Ontario, M5H 3T9
Attention: Office of the Corporate Secretary; or

- (b) transmitting 1 copy of the **Reply** to the Corporate Secretary by fax to fax number 416-361-9781, provided that the Reply does not exceed 16 pages, inclusive of the covering page, unless the Corporate Secretary permits otherwise; or

- (c) transmitting 1 electronic copy of the **Reply** to the Corporate Secretary by e-mail at CorporateSecretary@mfda.ca.

A **Reply** may either:

- (i) specifically deny (with a summary of the facts alleged and intended to be relied upon by the Respondent, and the conclusions drawn by the Respondent based on the alleged facts) any or all of the facts alleged or the conclusions drawn by the MFDA in the Notice of Hearing; or
- (ii) admit the facts alleged and conclusions drawn by the MFDA in the Notice of Hearing and plead circumstances in mitigation of any penalty to be assessed.

NOTICE is further given that the Hearing Panel may accept as having been proven any facts alleged or conclusions drawn by the MFDA in the Notice of Hearing that are not specifically denied in the **Reply**.

NOTICE is further given that if the Respondent fails:

- (a) to **serve** and **file** a **Reply**; or
- (b) attend at the hearing specified in the Notice of Hearing, notwithstanding that a **Reply** may have been served,

the Hearing Panel may proceed with the hearing of the matter on the date and the time and place set out in the Notice of Hearing (or on any subsequent date, at any time and place), without any further notice to and in the absence of the Respondent, and the Hearing Panel may accept the facts alleged or the conclusions drawn by the MFDA in the Notice of Hearing as having been proven and may impose any of the penalties described in the By-Laws.

End.

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