

IN THE MATTER OF A HEARING
BEFORE THE
EXECUTIVE DIRECTOR
ALBERTA SECURITIES COMMISSION
ss. 76(3) of the Securities Act (R.S.A. 2000, c. S-4, as amended)
(the "Act")

RE: LYSALTA CAPITAL DEVELOPMENT CORPORATION
APPLICATION FOR RENEWAL OF REGISTRATION
AS A MUTUAL FUND DEALER
s. 76 of the Act and s. 16(c) ASC Rules

**REASONS FOR DECISION OF THE
EXECUTIVE DIRECTOR**

BEFORE: David C. Linder, Executive Director

APPEARANCES: Terry D. Hutcheon
For the Staff of the Alberta Securities Commission

Catherine A. Crang
Carscallen Lockwood LLP
Barristers and Solicitors
For Lysalta Capital Development Corporation

HEARD: Calgary, Alberta
January 21, 2004

I. Background

On January 21, 2004, a hearing was conducted before the Executive Director of the Alberta Securities Commission (“ASC”) to determine pursuant to ss. 76(3) of the Act whether the renewal of the registration of Lysalta Capital Development Corporation (“Lysalta”) as a mutual fund dealer would be refused.

Since 1996, Lysalta has been registered as a mutual fund dealer with the Alberta Securities Commission. During the late 1990’s, the Mutual Fund Dealers Association (the “MFDA”) was established as a self-regulating organization (“SRO”) for the purpose of regulating mutual fund dealers across Canada. The MFDA sought formal recognition from the ASC as an SRO for the purpose of s.16 of the ASC Rules (General) (“Rule 16”). This application for recognition was granted in March 2001 (the “Recognition”) with an effective date of May 1, 2001. Under the ASC Rules (General) (as amended May 1, 2001), mutual fund dealers in Alberta are required to be members of an SRO recognized by the ASC (see R. 16(c)(ii)). This requires that Lysalta join the MFDA.

Prior to the Recognition, Lysalta had written to the MFDA on September 3, 1999 and to the OSC on September 9, 2000, outlining its concerns with the proposed establishment and policies of the MFDA. Lysalta did not join the MFDA. In January and February, 2003, ASC staff undertook an examination of Lysalta’s operations. A report was provided by faxed letter dated February 18, 2003 outlining the ASC staff’s findings, outlining deficiencies and requesting Lysalta respond to the deficiencies. Over the balance of the year, discussions both verbal and in writing took place culminating with a staff letter dated December 12, 2003. This letter reiterated that Lysalta was not yet a member of the MFDA and therefore the dealer was in violation of s.16(c)(ii) of the Rules. In addition, the letter outlined four outstanding issues emanating from the compliance examination relating to financial statements, know your client information, client statements and out of province clients. The letter concluded that Lysalta had not addressed staff’s concerns and accordingly staff believed the dealer was not suitable for renewal of registration. Lysalta was also advised it had the opportunity to request a hearing before the Executive Director.

By letter dated December 22, 2003, Lysalta requested a hearing. ASC staff acknowledged the letter and agreed that Lysalta’s registration would continue for a period of 30 days in order to permit the hearing to proceed and allow Lysalta to continue in business.

Counsel for Lysalta and ASC staff submitted a binder of Agreed Documents and Agreed Facts which was marked as an exhibit in the proceedings. In addition, each party provided written submissions which helped identify and define the issues of the hearing. Lysalta called Terry Lys as a witness, and ASC staff called Nicole Chute, Registration Examiner. The Executive Director requested that Kenneth Parker, Director of Capital Markets be called to address two questions which the Executive Director felt were necessary for a determination of the hearing.

The parties agreed from the commencement of the hearing that the relevant issues were:

- (1) the requirement of Lysalta to be an MFDA member;
- (2) the accuracy of Lysalta's financial statements;
- (3) the compliance of Lysalta with the Know Your Client ("KYC") Rules;
- (4) the compliance of Lysalta's client statements with ASC Rule 39(5); and
- (5) Lysalta's legal ability to service out of province clients.

II. Lysalta Evidence

Mr. Lys testified that he was 50 years old, the president of Lysalta and owned all of the voting shares of the company. Essentially, Terry Lys is Lysalta. Mr. Lys has two bachelor degrees, one in arts, and one in administration in accounting and finance. He took Investment Funds Institute of Canada ("IFIC") industry courses in the early to mid-90s. Initially, he worked briefly for a public accounting firm. He then was with a number of oil companies for nine years, before going to work in the mutual fund dealers' industry. He worked for approximately five years in mutual fund sales with two dealers based in Ontario. In 1996, he incorporated Lysalta and started the business which is the subject of the proceedings. He operates the company out of his home.

Mr. Lys described his business, which is a small enterprise, as consisting of approximately 30 households (as distinct from actual accountholders). On an asset basis, 60% of Lysalta's clients are relatives of Mr. Lys. The total value of the entire holdings are relatively modest ranging from one account of \$300 to an account in the seven-figure range. Lysalta, as provided by its registration, trades only in mutual funds. As part of its business, Lysalta never holds cash or securities of its clients. A client provides a cheque payable to the mutual fund company, Lysalta records the transaction on its trading blotter and the trade is then confirmed either by phone or through the fund company confirmation document.

(a) MFDA Membership

Mr. Lys stated that the reason that Lysalta did not apply for membership in the MFDA is that when the concept had first been broached, representations had been made to industry participants that its creation would not produce any barriers to entry for existing dealers. He said that once the MFDA got up and running, this proved not to be the case. The minimum fee required was \$3,000, which was on top of the ASC fee of \$1,000. For a small dealer like Lysalta, this represented a significant amount. Mr. Lys was also concerned about the investor protection fund and its associated costs, which have not yet been determined. Mr. Lys stated that Lysalta, because it did not hold any client funds nor securities, had no need for the protection fund, nor its associated costs. According to Mr. Lys, even in the event of a bankruptcy of Lysalta, its clients would have no risk of losing their investments. Mr. Lys also objected to the MFDA requiring that Lysalta's net free capital move from a threshold of working capital of \$25,000 to \$50,000. He felt with his bond coverage, the \$25,000 was more than enough protection for his clients.

(b) Client Statements

Mr. Lys testified that Lysalta does not send client statements to its clients once a year. Rather, Lysalta provides statements to clients upon request, which indicate the holdings of securities of clients (or families), its present worth and historical cost, but does not show the individual transactions which have been made during the year. Lysalta relied upon the statements produced by the mutual fund companies which were sent to its clients to reflect the individual transactions which occurred during any particular year. In the ASC's compliance audit, the examiner advised Mr. Lys that Lysalta was required by law (Rule 39(5)) to send out a statement to its clients at least once a year, with the yearly individual transactions itemized. Mr. Lys stated that for the company to comply with the Rule, it would have to purchase software at an annual cost of \$12,000. This would be cost prohibitive for Lysalta. Mr. Lys commented that this additional cost would provide only one third to one half of his clients with additional information, and depending on what was sent, might well include less information than they presently received. Prior to the MFDA rules, Lysalta used to update the client information on pricing of their securities internally weekly, but with the implementation of the MFDA, Mr. Lys had ceased to do this. He felt he could reinstitute this practice if his present statements were permitted. In cross-examination, Mr. Lys stated that although the requirements of Rule 39(5) had not changed, their application by the ASC had. He pointed out that the office procedures he had filed October 28, 1996 indicated that the clients of Lysalta received statements directly from the mutual fund companies twice a year. His policy then goes on to describe Lysalta's internal system which acts as a check and balance for the client. The purpose is to be able to provide the client with a statement at any time which indicates their current position in relation to the historical cost. The policy does not indicate that the internal statements would be sent on request of the client, although Mr. Lys' submission was that this was implied.

(c) Know-Your-Client Rules

Mr. Lys stated that the KYC requirements were met through frequent contact of clients. He advised that he felt he could comply with the requirements of the MFDA in this regard. Given the nature of the personal relationship Mr. Lys has with most, if not all of his clients, he felt that complying with a KYC policy would not in and of itself prove to be an obstacle.

(d) Financial Statements

The monthly financial statements of Lysalta were prepared by Mr. Lys and submitted to the ASC. The company is audited once a year by a chartered accountant. Mr. Lys said that the professional advice he received was that at the end of a fiscal year, any net income in Lysalta should be paid out to him in the form of bonus. In considering the issue of net free capital, Mr. Lys recalled at one time he had been required to put in a shareholder's loan of \$3,000 to ensure that the working capital minimum of \$25,000 was covered. Those monies were eventually paid back by the company to him. He acknowledged that he had been unaware that repayments of shareholder loans must be approved by the Executive Director. Mr. Lys disagreed with the observation of the ASC examiner that the net free capital was kept too low by Lysalta. He also responded to the allegation that the company's revenue was low by observing that the financial markets have been in a severe downturn since April of 2000. Mr. Lys did acknowledge that he had refused to provide financial projections requested by ASC staff, but was prepared to do so, going forward. Mr. Lys also acknowledged that the ASC audit had caused him to make more accruals than had been done in the past.

Mr. Lys' testimony was that Lysalta's client base consists of approximately one third of individuals who reside outside the province of Alberta. In terms of value, those out of province clients make up approximately 50% of Lysalta's assets under administration. The majority of this group are relatives of Mr. Lys. The balance consists of a long time friend and former residents of Calgary. Mr. Lys does not actively solicit clients outside Alberta. Mr. Lys' opinion is that the requirement of the ASC that he not manage his relative's accounts outside the province strikes at family values. This completed Mr. Lys' testimony.

III. ASC Staff Evidence

Staff's case was put in through Nicole Chute, C.A., who is a Registration Examiner. She has held that position since October 2001 and prior to that was a senior staff accountant in private practice with a national firm. Ms. Chute conducted the examination of Lysalta in January and February 2003. Ms. Chute confirmed that the ASC letter of December 12, 2003 outlined the unresolved deficiencies of Lysalta as identified in the review. Ms. Chute confirmed that Lysalta was not a member of the MFDA. She advised that she had requested additional information concerning the financial statements of the company,

since she had identified concerns with those statements. She also identified the KYC issues relating to obtaining such information, its updating and its maintenance. She also testified on the remaining two issues regarding Lysalta's client statements and its out of province clients.

(a) Financial Statements

Ms. Chute testified that she had requested further information from Lysalta since its financial filings throughout the year reflected negative income. This further information is typically required when there are concerns about the ability of an entity to continue to be a going concern and an active company. Ms. Chute also advised that her investigation revealed that Lysalta was not properly accruing expenses. She noted that because the net free capital was so low, virtually any unrecognized accrual would have the potential of reducing the net free capital below the \$25,000 threshold. Ms. Chute also stated that a further concern was the size of the shareholder loan in relation to the company's revenues. This, combined with the low salary, suggested that Mr. Lys was not able to make a living out of the company. A requirement of the Act is that Mr. Lys, as a salesperson, be employed full-time with Lysalta (Rule 41(1)). She advised that where a company's financial health is in question, this creates a circumstance in which misappropriation of client's funds may occur. This type of request for further financial information by the company enables the ASC to continually monitor the business to ensure that the business is active and continuing. Mr. Lys refused to provide the further information because it was not something he would otherwise have prepared.

(b) KYC Requirements

Ms. Chute's evidence was that of the 24 client files of Lysalta reviewed, over 80% of those files revealed concerns with the KYC information. This ranged from no information at all, to missing information, to failure to update information for over one year. As far as the ASC was aware, this aspect has never been addressed by Lysalta.

(c) Client Statements

Ms. Chute testified that one of the important reasons that a dealer is required to provide statements is to permit the client to compare that information with the statement he is receiving from the mutual fund company. This enables the client to identify errors through discrepancies between the two statements.

(d) Out-of-Province Clients

On the final identified issue, Ms. Chute stated that by conducting this business, Mr. Lys and Lysalta were in contravention of the requirement to be registered in the other provinces in which Lysalta's clients resided. This reflected unethical behaviour in failing to recognize the law, and created doubts about Mr. Lys' regard for Alberta law.

(e) Additional Evidence

Kenneth Parker, Director of Capital Markets was called at the request of the Executive Director to respond to two questions. Mr. Parker acknowledged that the document representing Lysalta's office procedures filed October 28, 1996 was something the ASC required from its mutual fund dealers. Mr. Parker advised that the ASC was not doing compliance audits in 1996, and therefore he could not advise whether mutual fund dealers were relying upon the mutual fund company statements as compliance with Rule 39(5). He did advise that if asked, the ASC would have advised that the dealer provide, at least annually, a statement reflecting all transactions that the client had entered into with the dealer. Mr. Parker stated that to his knowledge there had been no complaints by clients in relation to the failure to receive statements from dealers. Mr. Parker, also in response to a query of the Executive Director, stated that the only two companies which had not become members of the MFDA as at December 31, 2003 were Lysalta and Pewter Financial Ltd. Pewter Financial Ltd. is presently appealing the decision of the Alberta Securities Commission to refuse renewal of its registration as a mutual fund dealer to the Alberta Court of Appeal.

IV. Findings

I will deal with each issue in turn.

(a) Membership in the Mutual Fund Dealers Association

It was the submission of Lysalta's counsel that its application was two-pronged: an application under s. 76(3) of the *Act* relating to the compliance issues and an application under s. 213 of the *Act* seeking relief from the requirement of Lysalta to comply with Rule 16(c)(ii) of the ASC Rules. As I indicated from the commencement of the hearing, s. 213 requires an application to the Commission. The Executive Director has no jurisdiction to grant an exemption order pursuant to that section. As I indicated in my decision relating to Pewter Financial Ltd. dated February 25, 2003, it would not be appropriate for the Executive Director to grant registration on terms and conditions which in effect grant an exemption order from the requirements of the *Act*. This is the domain of the Commission. As I stated during the hearing, on this ground alone, the registration of Lysalta would not be renewed as the failure to be a member of the MFDA, absent an exemption order from the requirements of s. 16(c)(ii) of the Rules by the Commission, demonstrates unsuitability, and I find such registration to be objectionable.

(b) Financial Statements

This issue relates to ASC staff's request for further information in addition to the actual statements which Lysalta files on a monthly basis. Mr. Lys has filed his unaudited statements monthly as required, but has resisted providing the updated projections requested to supplement that information. Although it would appear that Lysalta meets the minimum required positive net free capital, ASC staff is concerned that this may be done without properly recording accrued expenses. It is proper for ASC staff to require further information where, based on the risk of the entity involved, they feel it prudent to do so. Indeed, s. 82 of the *Act* provides that the Executive Director may require such information. Mr. Lys has indicated that Lysalta will comply with this requirement in the future.

(c) Compliance with KYC Requirements

The failure of Lysalta to keep up to date with the KYC requirements appears to reflect a certain lack of formality and paper trail in its dealings with clients. Mr. Lys indicates that he speaks often with his clients and through such contact is likely able to fulfill the KYC requirements. As is often the case in smaller operations, his detail as to the formal paper requirements is absent. Again, during his evidence, Mr. Lys stated that he would comply with the formal KYC requirements in the future.

(d) Client Statements and ASC Rule 39(5)

The position of Lysalta is that since their original registration, they have carried on business by providing statements to their clients only upon request. Mr. Lys points out that the statements of the mutual fund companies provide the transaction detail required by Rule 39(5). He also advises that Lysalta statements provide more information to the client, other than individual transaction history, than is required by the Rule. Despite this, it is clear that the Rule is mandatory and, absent an exemption, must be complied with. Lysalta seemed to be making the argument that since Lysalta has carried on business in this fashion since 1996 and the ASC permitted it, presumably, by some form of estoppel, the ASC cannot now insist on a strict application of the Rule. As Mr. Parker testified, the reason Lysalta was able to continue in this practice (and also service out of province clients) is that the ASC did not have the resources, until recently, to conduct examinations. This was one of the reasons the MFDA was formed, so that mutual fund dealers' operations would be subject to a regular review.

The principal objection that Lysalta has concerning preparation of client statements is one of cost in that the software needed and the related licence fees would virtually bankrupt the company. The other alternative would be for Mr. Lys to manually prepare this information which would involve considerable time and resources. Regardless, unless Lysalta obtains an exemption from the Rule, Lysalta cannot carry on in breach of the Rule.

(e) Out of Province Clients

This issue is problematic in that there is not a remedy that the Executive Director, or the Commission for that matter, can provide to allow Lysalta to continue service to the subject clients. In each of the jurisdictions outside of Alberta where Lysalta has clients, it is a requirement for Lysalta to either be registered or obtain an exemption from registration. Mr. Lys has indicated he made inquiries with Saskatchewan and was advised that an exemption has never been granted for this type of relief before. From the ASC's point of view, we cannot allow an Alberta registrant to wilfully disregard the laws of a sister province. We would expect Saskatchewan, for example, to revoke the registration of a Saskatchewan mutual fund dealer who refused to register in Alberta and yet continued to service Alberta clients. Lysalta must either discontinue this practice immediately, seek an exemption from registration or apply for registration in the affected provinces.

(f) Conclusion

Lysalta is a very small player who will have trouble adapting to the requirements of the MFDA. Regardless, Lysalta, even prior to the MFDA, was not complying with the requirements of the *Act*, so its regulatory problems are not new. Notwithstanding its ability to satisfy its clients, Lysalta is in a regulated industry and must comply with the requirements of law. To date, it has not done so. It would not be appropriate for the Executive Director to grant relief from certain portions of the requirements of the MFDA. The Commission has decided that mutual fund dealers should be governed by the requirements of the MFDA. If Lysalta wishes relief from such requirements then the proper procedure would be either an application for relief to the MFDA or alternatively an application to the Commission.

It would appear that the cost of regulation is the main challenge for Lysalta. It may be that an application to the Commission to be exempt from the requirements of Rule 16(c)(ii) might succeed in that Lysalta's situation is extremely unique, somewhat akin to the prospectus exemption for close friends and relatives (s.131(1)(z)). Regardless of the success of such application, the continued service of out of province clients, without appropriate relief from the relevant jurisdictions, must cease. This, in itself, may prove to be the demise of Lysalta as it involves approximately 50% of its business.

Based on the foregoing, I confirm the finding of ASC staff that the proposed renewal of the registration of Lysalta as a mutual fund dealer is objectionable. In order for Lysalta to pursue its statutory appeal, I will agree to extend its registration on an interim basis from time to time, until such rights of redress no longer exist. I will also grant such relief to permit Lysalta to pursue membership of the MFDA. This is conditional upon Lysalta pursuing such rights in a timely fashion and there being no conditions or circumstances which in my opinion would constitute a risk to the clients of Lysalta. In addition, Lysalta

must discontinue its service of its out of province clients. It has 30 days in which to move the accounts to a properly registered entity in the home jurisdiction in which its clients reside. Alternatively, Lysalta may pursue registration or an exemption in those jurisdictions, subject to Lysalta pursuing such remedy in a timely fashion and providing evidence of same to the Director of Capital Markets of the ASC.

Dated at the City of Calgary, in the Province of Alberta, this 30th day of January, 2004.

“Original Signed By”_____

David C. Linder
Executive Director