

ALBERTA SECURITIES COMMISSION

DECISION

Citation: Sentinel Financial Management Corp., Re, 2008 ABASC 477 Date: 20080731

Sentinel Financial Management Corp.

Panel:	Glenda A. Campbell, QC Kenneth B. Potter
Appearing:	Lorenz Berner for Commission Staff Patrick Donnelly for Sentinel Financial Management Corp.
Dates of Submissions and Hearing:	23 May 2008; 6 and 23 June 2008; 10 July 2008
Date of Decision:	31 July 2008

I. INTRODUCTION

A. The Application

1. Background

[1] Sentinel Financial Management Corp. ("Sentinel") applied to the Alberta Securities Commission (the "Commission") for an exemption order under section 213 of the *Securities Act*, R.S.A. 2000, c. S-4 (the "Act") to permit Sentinel's Saskatchewan-resident salespersons registered under the Act ("Authorized Salespersons") to trade in securities described in an offering memorandum and offered to Alberta-resident clients in accordance with the offering memorandum exemption contained in section 2.9 of National Instrument 45-106 *Prospectus and Registration Exemptions* (the "Offering Memorandum Securities"), under the supervision of Sentinel's Saskatchewan-resident compliance officer ("Sentinel's Compliance Officer") registered under the Act. This would involve granting Sentinel an exemption under section 16(c) of the *Alberta Securities Commission Rules (General)* (the "Rules"). Sentinel's written application was dated 23 May 2008.

[2] In September 2007, Sentinel had applied to Commission Staff ("Staff") for relief in this regard. On 20 December 2007, Staff advised in writing – with accompanying reasons – that they were not prepared to recommend the exemptive relief sought by Sentinel. On 6 June 2008, Staff submitted their written position on Sentinel's 23 May application to this panel. In support of their position, Staff tendered the affidavit sworn 6 June 2008 of David McKellar ("McKellar"), the Commission's Director, Market Regulation ("McKellar's Affidavit"). McKellar's Affidavit included a copy of the Mutual Fund Dealers Association of Canada's (the "MFDA") "Branch Report" for Sentinel's Calgary branch office dated 10 July 2007 (the "Branch Office Report"). The Branch Office Report noted deficiencies observed by MFDA's compliance department following its 2007 compliance examination of Sentinel's operations (the "2007 Compliance Review").

[3] On 23 June 2008 Sentinel filed its written reply to Staff's written submissions. Sentinel's reply included the 19 June 2008 affidavit (the "Sentinel Affidavit") of Sentinel's Executive Administrative Manager ("Sentinel's EAM").

[4] After reviewing the parties' written material, we requested that the parties appear before us to answer our questions arising from that review. Staff requested that they be permitted to call at least one witness during their appearance before us. We agreed to hear further evidence, including viva voce evidence and directed that any party wishing to call a witness was to provide the name and "will say" statement of any proposed witness to the other party seven days prior to the scheduled appearance before us.

2. Application Denied

[5] The parties appeared before us on 10 July 2008. We heard the testimony of three witnesses (for reasons discussed below) and the parties' responses to questions from the

panel. We then adjourned to consider the matter. During the course of our deliberations we also had the benefit of the parties' thorough written submissions.

[6] For the reasons set out below, we declined to grant Sentinel the exemption it sought from section 16(c) of the Rules.

B. Witnesses

1. Parties' Positions

[7] During the proceeding Staff cross-examined Sentinel's EAM on the contents of her Sentinel Affidavit and called two witnesses – McKellar and Jennifer Dodds ("Dodds"), Manager, Compliance, Prairie Region of the MFDA. Counsel for Sentinel objected to both McKellar and Dodds giving evidence in the proceeding on essentially two grounds. First, counsel argued that the will say statements inadequately summarized the nature of each witness's proposed testimony, such that Sentinel would not be accorded procedural fairness in this matter (while we need not elaborate on our reasons given during the hearing, we rejected that argument as any deficiency in the information set out in the will say statements could be adequately addressed by more complete disclosure and a short adjournment to consider that additional information, which Sentinel declined). Second, counsel for Sentinel objected to the substance of the evidence that each of these witnesses was to give.

[8] Counsel for Sentinel was concerned that McKellar's evidence would be more in the nature of argument or expert evidence. However, Staff neither intended to nor did call McKellar as an expert witness; McKellar's evidence was to provide factual background surrounding the reasons behind the conditions imposed on mutual fund dealers permitted to sell Offering Memorandum Securities in Alberta and why Staff was of the view that a compliance officer registered under the Act ought to reside in Alberta. Counsel for Sentinel also noted that McKellar had already given evidence through McKellar's Affidavit and Staff should not be able to reintroduce him "to plug the holes in [Staff's] case".

[9] Sentinel's counsel argued that Dodds' proposed evidence about the deficiencies identified during the MFDA's 2007 Compliance Review ought not to be heard on the basis it was irrelevant to the matter before us, as there had been no finding of wrongdoing by Sentinel. In other words, counsel for Sentinel contended that an audit report should be used only for audit purposes, and it would be abusive to allow an incomplete audit process to be considered in determining whether to grant or deny an exemption application. Staff argued that Dodds' evidence would be relevant on the question of Sentinel's intent or ability to comply with the conditions normally imposed on mutual fund dealers who are permitted to sell Offering Memorandum Securities in Alberta.

2. Ruling

[10] Sections 29(e) and 29(f), respectively, of the Act provide that in a hearing the Commission "shall receive that evidence that is relevant to the matter being heard" and that "the laws of evidence applicable to judicial proceedings do not apply". This provision gives the Commission considerable latitude in determining what evidence to admit and, if admitted, the weight to assign to that evidence. As part of that assessment, we consider the policy and legal requirements of evidentiary rules.

[11] This was an application for discretionary relief. Staff did not seek to adduce this evidence in the context of an enforcement proceeding from which serious consequences could flow if a respondent were found to have contravened a provision of Alberta securities laws or acted contrary to the public interest. Given that we were asked to exercise our discretion in determining whether to grant a departure from the usual requirements of Alberta securities laws and that it is in the public interest that we receive the best evidence available, we ruled that we would hear the testimony of both McKellar and Dodds. Counsel for Sentinel was, of course, entitled to cross-examine each witness and did so.

II. FACTUAL BACKGROUND

A. Registration Requirements

[12] Section 75 of the Act prohibits any person or company from trading in securities or exchange contracts unless the person or company is registered with the Executive Director as a dealer, salesperson or partner, director or officer "of a registered dealer that acts on behalf of the dealer."

[13] Section 16(c) of the Rules requires that a registered mutual fund dealer be a member of the MFDA and "trade exclusively in the shares or units of mutual funds".

[14] Alberta Securities Commission Policy 3.10 *Sale of Securities under Registration and Prospectus Exemptions by Salespersons of Restricted Dealers* establishes guidelines under which the Commission may exempt a mutual fund dealer from section 16(c) of the Rules and permit its salespersons to trade Offering Memorandum Securities to their clients under the supervision of the dealer.

[15] On 22 June 2007 the Commission issued an order (the "Blanket Order"; see *Certain MFDA Members: Trades in Non-Mutual Fund Securities*, 2007 ABASC 412) providing blanket relief from section 16(c) of the Rules to permit MFDA members to trade Offering Memorandum Securities in Alberta if certain conditions were met, including:

- the salesperson must ensure that the investment in the Offering Memorandum Securities is a suitable investment for the client;
- the salesperson must ensure the client understands other information about the unique nature of securities sold under this exemption from the registration and

prospectus requirements of the Act, including that certain protections, rights and remedies are not available to investors; and

- following receipt of a subscription for the sale to a client of Offering Memorandum Securities, the mutual fund dealer's compliance officer, who must be an Alberta resident, is to review the subscription agreement and follow up with both the salesperson (to ensure compliance with the Blanket Order) and the client (to answer questions and to ensure that the client had an opportunity to seek independent advice and that the investment is suitable for the client).

B. Sentinel

[16] Sentinel is incorporated under the laws of Saskatchewan, is a member of the MFDA, and is registered in good standing in Alberta and Saskatchewan as a mutual fund dealer to trade exclusively in the shares and units of mutual funds.

[17] However, Sentinel no longer has physical offices in Alberta, Alberta-resident salespeople or an Alberta-resident compliance officer. On approximately 15 October 2007 Sentinel advised its Alberta clients of the closure of Sentinel's operations in Alberta. As of 22 May 2008, Sentinel had 19 salespersons who were not resident in Alberta but who were registered under the Act to sell mutual fund securities to Alberta-resident clients.

[18] Sentinel's Compliance Officer – a resident of Saskatchewan – is registered with the Executive Director as an officer of Sentinel and as a trader, and is subject to the Act.

[19] In 2007 the MFDA completed its 2007 Compliance Review of Sentinel. From their examination of Sentinel's Calgary branch office, MFDA staff identified deficiencies in Sentinel's operations as a mutual fund dealer, which were communicated to Sentinel in the Branch Office Report. The deficiencies included:

- seven out of 30 trades reviewed did not have evidence of trade supervision and suitability review;
- seven out of 26 client files reviewed displayed instances where the client's current Know Your Client ("KYC") information in the client file was inconsistent with the KYC information on the customer care and billing system ("CCB System") (the client file and the CCB System are apparently both intended to include up-to-date, matching information relevant to assessing what investments are suitable for a client);
- Sentinel was unable to provide a copy of the new account application form or any KYC documentation for two client accounts;
- two out of 13 new client accounts reviewed were opened without evidence of written approval by a qualified supervisor; and

- the investments in nine client accounts appeared inconsistent with the clients' documented investment objectives and KYC information (indicating that the suitability of the investments for these clients might be in question).

[20] MFDA compliance staff also identified serious compliance deficiencies – including deficiencies related to sales of exempt securities – in a compliance examination of Sentinel's head office in Saskatchewan that was communicated to Sentinel in a second report (the "Head Office Report"; we refer to the Branch Office Report and the Head Office Report collectively as the "2007 Compliance Reports").

[21] Dodds characterized the compliance findings in the Head Office Report as "significant" and testified that she had referred identified instances of Sentinel's non-compliance with suitability, KYC and supervision requirements and with unauthorized sales of exempt securities to the enforcement division of the MFDA for further investigation. She did not know the current status of that investigation or whether enforcement proceedings would be initiated against Sentinel. Although the investigation continues and (in the words of counsel for Sentinel) a "hearing has not been conducted which would elevate these allegations into findings of fact", Dodds was clear that Sentinel was fully informed as to what the 2007 Compliance Reports would say and had sufficient opportunities to correct any information or conclusions that might have been incorrect.

[22] Dodds expressed continuing concern about Sentinel's conduct in selling exempt market securities. The following exchanges occurred between Dodds and the panel:

Q THE CHAIR: . . . With respect to the findings on suitability, was – were your findings that suitability had not been performed; or was it that suitability may have been performed, but it wasn't properly documented; or was it that . . . the client was sold a product that was, in fact, unsuitable for that client?

A Actually, all three.

. . .

Q And I take it, based on the findings of your audit, you have concerns about Sentinel selling exempt products?

A Yes.

Q What about mutual funds?

A Yes.

[23] Dodds also was concerned with the large volume of exempt market securities being sold by Sentinel salespersons compared to their sales of mutual fund securities.

Finally, Dodds testified that Sentinel's Compliance Officer (who would be ensuring compliance were we to grant Sentinel's application) and the MFDA have "quite a disagreement on – especially around suitability and how suitability is applied, how the MFDA views suitability, and how he views suitability".

[24] Sentinel continues to work with MFDA staff to resolve the outstanding deficiencies. As part of this resolution, Sentinel is in the process of preparing a policies and procedures manual for use by its salespersons. This is intended to address areas of non-compliance identified by the MFDA. Although drafts of the policies and procedures manual have been provided to the MFDA, the document has yet to be finalized and implemented, partially because of problems the MFDA had with the proposed drafts (Dodds testified to a lack of specifics and a minimizing of risks associated with exempt products).

[25] There was no evidence of any complaints by clients about Sentinel.

[26] Sentinel has previously been granted exemptive relief that permitted its Alberta-resident salespersons to sell certain non-mutual fund securities, such as Offering Memorandum Securities, to their clients. This exemptive relief applied to Sentinel's Alberta branch offices then in operation.

III. PARTIES' POSITIONS

A. Sentinel

[27] Sentinel proposes to offer Offering Memorandum Securities for sale to Alberta-resident clients by Authorized Salespersons under the supervision of its Saskatchewan-resident Compliance Officer. Sentinel argued that it would have been able to rely on the Blanket Order and avail itself of the exemptive relief granted to other MFDA members that permits them to sell Offering Memorandum Securities, except that Sentinel is unable to fulfill the requirement that the supervising compliance officer be a "resident of Alberta".

[28] Sentinel submitted that its Saskatchewan-resident Compliance Officer would perform the same functions as would be performed by an Alberta-resident compliance officer. Therefore, it contended that Alberta-resident clients who purchase Offering Memorandum Securities from Approved Salespersons would receive the same protections that are provided to residents of Alberta who purchase Offering Memorandum Securities offered by other mutual fund salespersons in reliance on the Blanket Order. Sentinel further submitted that its Alberta-resident clients would be prejudiced if Sentinel could not offer them the opportunity to invest in Offering Memorandum Securities as are offered to clients of other mutual fund dealers.

[29] Sentinel also argued that Staff's apparent reliance on the deficiencies identified by the MFDA in the 2007 Compliance Reports as a basis for opposing Sentinel's application

is not a legitimate reason for denying the relief sought by Sentinel because no finding of wrongdoing has been made against Sentinel. Moreover, since there has been no finding of any wrongdoing by Sentinel, such deficiencies and any related enquiries are irrelevant and should not be considered by the Commission in its determination of Sentinel's application. Sentinel also pointed out that the deficiencies identified by the MFDA during its 2007 Compliance Review are in the process of being resolved by Sentinel.

B. Staff

[30] Staff opposed Sentinel's application for exemptive relief, stating that the public interest would be prejudiced were the application to be granted. Staff pointed out that Offering Memorandum Securities "are more complex and require greater levels of suitability review and client communication than mutual funds."

[31] Staff's concerns appeared to be in three general areas: first, Sentinel no longer has an Alberta-resident compliance officer; second, Sentinel communicated poorly with its Alberta clients regarding the closure of its Alberta operations; and, third, Sentinel has "a poor track record on suitability review" and on compliance standards in general.

[32] Staff noted that Sentinel closed its Alberta branches and terminated its Alberta-resident employees between approximately September and December 2007, although Sentinel apparently made the decision to do so in early August 2007. One communication issue that concerned Staff was that Sentinel notified Staff of the closures on approximately 19 September 2007 and notified its Alberta clients on approximately 15 October 2007 – well after the decision was made and partway through the closure process.

[33] Given our findings and conclusions below, we need not address Staff's concerns regarding Sentinel's lack of office or salespeople located in Alberta and its communication of the Alberta office closure.

[34] On the third ground – history of poor compliance, including related communication concerns – Staff noted Sentinel's compliance problems as outlined in the Branch Office Report. After hearing Dodds' testimony, it was clear that there were also serious compliance problems, as described by her and documented in the Head Office Report. Staff pointed out that Sentinel's compliance deficiencies identified by the MFDA's 2007 Compliance Review involved failures to properly supervise and failures by Sentinel salespersons to comply with suitability and KYC requirements in connection with the sale of both mutual fund securities and exempt market securities.

[35] Staff submitted that, in view of the pattern of problems outlined in the 2007 Compliance Reports, the panel should not exercise its discretion to grant Sentinel the exemption it was seeking.

IV. ANALYSIS

A. Exemptive Relief Applications

[36] The grant of an exemption from any requirement of Alberta securities laws involves an exercise of discretion by the hearing panel. In exercising that discretion our primary consideration is the public interest as defined by our mandate to protect investors and to foster a fair and efficient capital market and confidence in that market.

[37] The onus rests with the applicant, in this case Sentinel, to satisfy us that an exemption from the usual requirements of Alberta securities laws is appropriate in its specific circumstances, not contrary to the public interest and consistent with the Commission's overriding regulatory objective set out above. We disagree with counsel for Sentinel's characterization of the Blanket Order as now setting the parameters for the sale of exempt products by mutual fund dealers. Rather, this application is properly assessed on whether, in the specific circumstances of Sentinel, it should be granted an exemption from the requirements of Alberta securities laws. The grant of an exemption is a privilege not a right.

B. Factors Considered

[38] In furthering the objectives of the Act, including the protection of the investing public, the Commission requires registrants – those granted the privilege of registration under the Act – to maintain high standards of proficiency and business conduct to ensure that registrants act honestly and fairly in their dealings with clients. In conjunction with their valuable role in our capital market, registrants also have the potential to cause harm to investors and the capital market. Thus, regulating a registrant's conduct of its business affairs falls clearly within our public interest jurisdiction.

[39] In determining whether to exercise our discretion and grant the exemption sought, Sentinel's history of dealings with clients, Alberta securities laws and other applicable regulatory requirements – evidenced, in part, by its compliance record – provides us with an indication as to what Sentinel's future conduct might reasonably be expected to be, were it not to change its compliance practices.

[40] The Commission has recognized the MFDA as a self-regulatory organization responsible for the oversight of mutual fund dealers in our securities regulatory regime. The Commission relies on the MFDA to use its expertise and enforcement capabilities to provide an effective oversight regime that protects clients and enhances the integrity of our capital market.

[41] As part of its regulation of the conduct of its members, the MFDA prescribes standards of business conduct including minimum standards of business practices and supervision specifically designed for the mutual fund industry. In connection with its oversight function, the MFDA conducts routine compliance examinations of its members to ensure compliance with the regulatory requirements. Deficiencies noted by the MFDA

during a compliance examination are communicated to the mutual fund dealer and the dealer is then given an opportunity to remedy the deficiency. In more serious cases, as here, a disciplinary process may be considered, although it is uncertain whether any disciplinary proceeding will be undertaken in the present case.

[42] We consider serious the deficiencies raised by the MFDA arising from the 2007 Compliance Review. In particular, some of the deficiencies identified by the MFDA concerned the very areas that Sentinel will be required to comply with if permitted to sell Offering Memorandum Securities – failures to properly supervise and to properly apply suitability and KYC requirements when recommending mutual funds and exempt market securities to clients. This raises a fundamental and legitimate cause for concern about Sentinel's future ability to comply with regulatory requirements – that is, whether Sentinel has the necessary policies and procedures in place to ensure that its Approved Salespersons are compliant with the conditions that would be imposed if permitted to sell Offering Memorandum Securities to Sentinel's Alberta-resident clients.

[43] It is true that there has been no finding of contraventions of Alberta securities laws or other applicable regulatory requirements such as those of the MFDA. However, it is relevant that the MFDA, as the regulatory body charged with responsibility for overseeing the business conduct of Sentinel, identified areas of non-compliance. Our responsibility is to ensure that Alberta investors receive the significant protections and safeguards that flow from full compliance with Alberta securities laws.

C. Conclusion

[44] Were we to grant Sentinel's application, we would impose terms and conditions on Sentinel akin to those in the Blanket Order. These would provide safeguards to address regulatory concerns that arise in the usual circumstances in which mutual fund salespersons are permitted to sell Offering Memorandum Securities.

[45] However, we conclude on the evidence that Sentinel does not currently have in place appropriate policies and procedures to ensure compliance with such terms and conditions. We remain concerned that Sentinel's management and salespersons may not be applying the suitability and KYC requirements in an appropriate way to clients and products. Finally, the concerns raised by the 2007 Compliance Review suggest to us that Sentinel's Compliance Officer's appreciation or execution of his compliance supervisory role may be lacking.

[46] In our view, investor protection considerations eclipse any unfairness that might result to Sentinel. It has been granted the privilege of registration as a mutual fund dealer entitled to sell mutual fund securities to the public. With that privilege come special obligations on Sentinel to ensure strict compliance with regulatory requirements.

[47] Therefore, although the evidence suggests that Sentinel is acting to address and hopefully eliminate the risk that a recurrence of past practices would be repeated, those steps are not completed and the MFDA's outstanding concerns are not completely addressed. Accordingly, we are not satisfied, at this time, that it is in the public interest to exercise our discretion to permit Sentinel's Approved Salespersons to sell Offering Memorandum Securities to Alberta-resident clients.

V. DECISION

[48] For investor protection reasons we conclude that it is not in the public interest that Sentinel be granted an order that permits its Approved Salespersons to sell Offering Memorandum Securities to its Alberta-resident clients. Accordingly, Sentinel's application for an exemption from section 16(c) of the Rules is denied.

[49] Our decision to deny Sentinel an exemption from section 16(c) of the Rules at this time does not preclude Sentinel from reapplying for an exemption once it has resolved its outstanding compliance issues with the MFDA.

31 July 2008

For the Commission:

"original signed by"

Glenda A. Campbell, QC

"original signed by"

Kenneth B. Potter