BRITISH COLUMBIA SECURITIES COMMISSION
Securities Act, RSBC 1996, c. 418

Citation: Re Capstone Asset Management, 2023 BCSECCOM 537 Date: 20231117

Notice of Administrative Penalty

Capstone Asset Management Inc.

Section 162.01 of the *Securities Act*, RSBC 1996, c. 418

Summary of Alleged Contraventions and Conditional Findings

[1] Staff submitted a report (the Report) alleging that Capstone Asset Management Inc. (the Respondent) contravened sections 12.5(2) and 11.1(1) of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103), by failing to:

(a) maintain the bonding or insurance coverage required by NI 31-103; and
(b) establish policies and procedures to provide reasonable assurance that it would comply with its ongoing insurance requirements.

[2] Staff recommended that I impose an administrative penalty under section 162.01 of the *Securities Act*, RSBC 1996, c. 418 (the Act).

[3] Based on the information in the Report, and subject to the Respondent's right to dispute the allegations or amount of the penalty under section 162.04 of the Act, I find that:

(a) the Respondent has contravened sections 12.5(2) and 11.1(1) of NI 31-103 in the manner described above; and
(b) it is in the public interest to require Respondent to pay an administrative penalty of $12,000.

[4] My reasons follow.

Contraventions

[5] The Respondent is a Langley, BC-based company that was registered under the Act as an investment fund manager, exempt market dealer and portfolio manager at all material times. It provides discretionary managed account services to clients and manages a number of prospectus-exempt investment funds.

Contravention of Section 12.5(2) of NI 31-103

[6] Section 12.5(2) of NI 31-103 provides that a registered investment fund manager must maintain bonding or insurance of the type set out in the rule in the highest of the following amounts for each required clause:

(a) one per cent of assets under management, as calculated using the investment fund manager's most recent financial records, or $25,000,000, whichever is less;
(b) one per cent of the investment fund manager's total assets, as calculated using the investment fund manager's most recent financial records, or $25,000,000, whichever is less;
(c) $200,000;
(d) the amount determined to be appropriate by a resolution of the investment fund manager's board of directors or individuals acting in a similar capacity for the firm.

[7] Given the amount of the Respondent's total assets, the Respondent was required to maintain coverage based on its assets under management (AUM).

[8] In response to a production order, the Respondent prepared a summary of its AUM for the quarters ended December 2018 through March 2023 (Exhibit K in staff's submissions). It shows that the Respondent's AUM exceeded $480,000,000 for the quarters ended December 2020 through December 2022. Therefore, under s. 12.5(2) of NI 31-103, the Respondent was required to maintain coverage *in excess of* $4,800,000 during that period.

[9] However, based on the copies of the Respondent's Financial Institution Bonds that staff provided, for the period December 31, 2020 to October 27, 2022, the Respondent only had coverage of $4,800,000. I find that the Respondent contravened section 12.5(2) of NI 31-103 during that period.

Contravention of Section 11.1(1) of NI 31-103

[10] Under section 11.1(1) of NI 31-103:

> A registered firm must establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to (a) provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation ... .

[11] The Companion Policy to NI 31-103 contains guidance on the specific elements that an effective compliance system should include. Under "Detailed policies and procedures" it says:

> The firm should have detailed written policies and procedures that:
> ...
> - clearly outline who is expected to do what, when and how

[12] During the period the Respondent was underinsured, its policies and procedures manual had a section called "Insurance and Capital Requirements". It said "To maintain its registration in good standing, CAM [the Respondent] is required to maintain at all times the following minimum insurance and capital:". Below that there was a chart listing the Respondent's registration categories, and in the row for Investment Fund Manager, under the heading "Minimum Insurance" it said "See subsection 12.5(2) of NI 31-103". There was no explanation of who would do what, when and how to ensure the Respondent complied with the insurance requirements in NI 31-103.

[13] In contrast, after staff brought the insurance deficiency to the Respondent's attention, its revised policies and procedures manual explained that the firm's Finance department is responsible for calculating AUM at least once per quarter and monitoring the insurance adequacy based on the AUM calculation. In the new manual, the Finance team must confer with the Compliance team before submitting an application for renewal or additional insurance. This illustrates the type of detail that was missing from the Respondent's manual at the time of the insurance contraventions to establish a system of controls and supervision sufficient to provide reasonable assurance of compliance.

[14] After BCSC compliance staff identified the insurance deficiency, the Respondent explained in its November 2022 letter to staff that there had been turnover in its compliance department and that it had made significant efforts to transition insurance duties and provide training. It went on to say that:

> in the context of remote work and pandemic conditions, we acknowledge there was a failure to provide sufficient training and oversight in respect of monitoring the adequacy of the firm's insurance coverage and the annual insurance renewal process

[15] I accept that staff turnover likely contributed to the insurance deficiency. However, as Staff point out, one of the key purposes of having detailed policies and procedures is to increase the likelihood that compliance processes continue to happen when there is turnover. I also accept that the pandemic likely made training and oversight more difficult for the Respondent and many other firms, but in this case, the more fundamental problem was with the manual. Merely referring readers to the relevant rule did not establish a system of controls and supervision that provided reasonable assurance of compliance.

[16] Given the deficient manual in place at the time of the insurance coverage contravention, I find that the Respondent contravened section 11.1(1) of NI 31-103 by failing to establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to provide reasonable assurance that the Respondent complies with securities legislation.

Administrative Penalty

[17] Under section 162.01 of the Act, if I consider that the Respondent has contravened NI 31-103 and consider it to be in the public interest, I may give written notice requiring the Respondent to pay an administrative penalty. Under section 162.01(1) of the Act, in determining the amount of the penalty, I must consider the factors set out in the headings below.

The Respondent's past conduct

[18] The Respondent has no prior disciplinary record.

[19] During the Respondent's 2018 compliance examination, staff identified a previous instance in which the Respondent had failed to comply with the insurance requirement in NI 31-103. In response to that finding, the Respondent wrote:

> we will monitor our AUM and insurance coverage on a regular periodic basis to ensure compliance with these requirements going forward

[20] The fact that this case involves a repeat deficiency tends to support that something beyond another direction and agreement to comply is needed.

The seriousness of the conduct

[21] This was not a complete failure to maintain insurance; rather, the amount of coverage did not keep up with the Respondent's AUM growth. The failure to maintain adequate insurance did not cause any client or market harm. By staff's estimation (which staff acknowledge is not exact), the Respondent may have saved approximately $4700 by not increasing its coverage, but there is no suggestion this was an intentional money-saving decision. The seriousness of the violation is low.

Factors that mitigate the person's conduct

[22] I agree with staff that there are no mitigating factors in this case. I do note that the Respondent fully cooperated with staff's compliance review and quickly remedied the deficiency, however this is expected of registrants. Staff turnover and pandemic operating challenges are not mitigating factors; a proper policy and procedures manual is intended to mitigate against those types of developments.

The need to demonstrate the consequences of inappropriate conduct to those who access the capital markets
The need to deter those who participate in the capital markets from engaging in inappropriate conduct

[23] I agree with staff that the above two factors can be addressed together.

[24] It is important for both the Respondent and the industry to see that failing to remedy a compliance deficiency the first time staff detect it can lead to more serious consequences. If the only consequence of failing to maintain proper insurance is that staff will direct the Respondent and other firms to increase their coverage, then there will be limited incentive to prevent future coverage violations.

Orders made by the commission in similar circumstances in the past

[25] Staff did not identify any previous Commission orders or settlements in which monetary penalties under section 162 of the Act have been issued specifically for insurance-related contraventions. However, they referred me to the following four settlements:

(a) In *Kilburn Ogilvie Waymann Investment Management Ltd. and Trevor G. Kilburn*, 2012 BCSECCOM 289 (*Kilburn #1*), the respondents admitted that they failed to a) maintain minimum regulatory capital under s. 12.1(3) of NI 31-103 for about 9.5 months, and b) establish and maintain an adequate compliance system, contrary to sections 5.2 and 11.1 of NI 31-103. The respondents were reprimanded and agreed to pay $12,000. I agree with staff that a failure to maintain regulatory capital is generally more serious than a failure to maintain insurance in the appropriate amount because of the major consequences to clients from an insolvency. On the other hand, there is no mention of a repeat violation in *Kilburn #1* and the period of non-compliance was only 9.5 months versus approximately 22 months in this case. It is not clear whether the respondents in Kilburn #1 avoided any costs as a result of the violation.

(b) In *Kilburn Ogilvie Waymann Investment Management Ltd.*, 2021 BCSECCOM 380 (*Kilburn #2*), the firm paid $30,000 (on top of $25,700 in examination costs) for a repeat violation of section 11.1 of NI 31-103 – another failure of compliance systems, record keeping, marketing violations, administrative requirements and financial reporting. The conduct in *Kilburn #2* was more widespread and serious than in the present case. It was also a second formal settlement for compliance system violations, whereas the Respondent has no disciplinary history.

(c) In *Lee, Turner & Associates Inc.*, 2023 BCSECCOM 253, Commission staff did three examinations, the third of which found a significant number of deficiencies and led to terms and conditions of registration for six months. A fourth examination again found significant and repeat deficiencies in know-your-client (KYC) information, suitability failures, reporting failures, policy and procedure manual deficiencies, process failures and an incomplete audit report on the firm's financials. The firm admitted to a breach of section 11.1 of NI 31-103 as well suitability violations. It hired a compliance monitor, paid $23,000 in examination costs and paid $30,000 under the settlement.

(d) In *Quantum Financial Services (Canada) Ltd.*, 2013 BCSECCOM 37, the firm undertook to hire a compliance consultant for a year and paid $50,000 after three examinations that found KYC, policy and procedures manual and compliance officer performance and oversight deficiencies. The deficiencies were corrected and there was no client harm. The misconduct was more serious than in this case.

[26] I agree with staff that *Kilburn #1* is most helpful in assessing the appropriate penalty in this case. I find the Respondent's misconduct similar in nature and overall seriousness to the misconduct in *Kilburn #1*. The other settlements involved a wider range of violations and either a previous formal settlement or multiple repeat deficiencies involving compliance system failures, whereas this case involves an inadequate amount of insurance and a policy and procedures violation related to it.

Any other matter relevant to the public interest

[27] I have not identified any other factors relevant to determining the appropriate penalty in the public interest.

[28] In addition to reviewing the above factors, staff submitted that the general principles that guide the Commission's orders under sections 161 and 162 of the Act apply equally to the exercise of my authority under section 162.01. Staff referred me to a recent summary of these principles from paras. 11 to 14 of *Re Stock Social*, 2023 BCSECCOM 372, which I would further summarize as follows:

- Orders should be protective and preventative and intended to prevent future harm
- I must aim to protect investors, promote the fairness and efficiency of the capital markets, and preserve public confidence in those markets
- Sanctions should be sufficient to deter misconduct while remaining proportionate to the misconduct
- I may consider both specific and general deterrence, keeping in mind that general deterrence should not lead to a crushing or unfit penalty.

[29] I agree with staff that the general principles that guide the Commission's orders under sections 161 and 162 of the Act apply to the exercise of my authority under section 162.01. One difference with penalties under section 162.01 is that they can currently only be issued for contraventions of the regulations and decisions, as no provisions of the Act have been prescribed for the purposes of this section. The Act addresses the most serious types of misconduct, such as fraud, market manipulation and insider trading. Penalties under section 162.01 can also only be issued by the executive director, not the Commission. This may suggest that the Legislature intended for section 162.01 to be used for less serious violations of securities requirements. Nevertheless, I see nothing in the Act to suggest the above general principles should not apply. In particular, it is clear that punishment can never be an objective of penalties under section 162.01.

[30] After reviewing the above factors and general principles, staff submitted that it is in the public interest for me to issue a notice requiring the Respondent to pay an administrative penalty in the range of $20,000 – $25,000.

[31] As discussed above, the fact that the Respondent previously failed to maintain adequate insurance coverage and promised to monitor its AUM and coverage to ensure compliance going forward suggests that there should be a more significant consequence for the latest breach. That said, the insurance violation (s. 12.5(2)) in this case is low on the seriousness spectrum, and this is a first-time violation of section 11.1(1).

[32] While staff's estimate of $4,700 in cost savings is not exact, I do accept that the Respondent likely saved some premium costs up to that amount, and that in theory, the sanction must exceed the amount saved in order to incentivize future compliance by both the Respondent and other industry participants.

[33] The financial statements provided by staff show that the Respondent is a relatively small firm and a penalty in the thousands of dollars would be significant in the context of the Respondent's revenue and other expenses. I do not think a large penalty is required to ensure the Respondent complies with its insurance requirements going forward.

[34] On the other hand, general deterrence requires that the sanction be significant enough to deter other industry participants from non-compliance.

[35] Staff submitted that any penalty should consider the effect of inflation, but cited no authority for that proposition. I have not determined an appropriate amount based on the settlements cited, and then increased it for inflation. I have simply determined the amount I consider to be appropriate today.

[36] Taking into account all of the above, I find that a total penalty of $12,000 is appropriate for both contraventions.

Requirement to Pay or Dispute the Administrative Penalty

[37] Under section 162.01 of the Act, and subject to the Respondent's right to dispute the alleged contraventions or penalty amount under section 162.04 of the Act, I consider the Respondent to have contravened sections 12.5(2) and 11.1(1) of NI 31-103 and that it is in the public interest to require the Respondent to pay a total administrative penalty of $12,000.

[38] Under section 162.04(1) of the Act, within 30 days of receiving this notice, the Respondent must:

- pay the administrative penalty; or
- give me written notice requesting an opportunity to be heard to dispute the alleged contraventions or the amount of the administrative penalty.

[39] The Respondent will be deemed to have contravened sections 12.5(2) and 11.1(1) of NI 31-103, under section 162.04(2.1) of the Act, and the administrative penalty set out in this notice will be payable to the commission, if the Respondent:

- pays the administrative penalty; or
- fails to pay the full amount of the administrative penalty, or fails to request an opportunity to be heard to dispute the alleged contraventions or the amount of the administrative penalty, within 30 days of receiving this notice.

Peter J. Brady
Executive Director