



THE MANITOBA
SECURITIES
COMMISSION

December 3, 2020

IN THE MATTER OF: THE SECURITIES ACT

- and -

IN THE MATTER OF: KAI ASSET MANAGEMENT INC.

**REASONS FOR DECISION
OF THE DIRECTOR OF
THE MANITOBA SECURITIES COMMISSION**

Panel:

Mr. C.P. Besko, Director

Appearances:

S. Gingera

)

Counsel for The Manitoba Securities
Commission

P. White

B. Woods

A. Duong

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Staff of The Manitoba Securities
Commission

J. Kroft

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KAI Asset Management Inc.

Introduction

KAI Asset Management Inc. (“KAM” or the “Firm”) is registered under securities legislation as a portfolio manager and an exempt market dealer in Manitoba, British Columbia, Alberta, Saskatchewan and Ontario, and as an investment fund manager in Manitoba and Ontario. KAM has been continuously registered since September 4, 2015.

Staff completed a compliance review of KAM in 2018, the findings of which were recorded in a schedule of findings dated January 8, 2019 (the “2019 Report”). The 2019 Report contained numerous significant deficiencies of a fundamental nature. To support KAM in addressing the deficiencies, KAM has been operating subject to a voluntary undertaking given to the Director on April 26, 2019 (the “April 2019 Undertaking”), that was replaced by the current undertaking dated October 11, 2019 (the “October 2019 Undertaking”).

The October 2019 Undertaking required KAM to develop a plan and take certain specified steps intended to rectify all compliance deficiencies identified in the 2019 Report, and any further deficiencies arising from the response to the 2019 Report. Certain of the steps were required to be completed to the satisfaction of the Deputy Director. Until specific conditions were met, KAM is prohibited from accepting any new managed account clients, accepting any new client monies for investment in existing managed accounts, entering into new referral or marketing arrangements, or accepting a referred client. There was also a prohibition on KAM clients increasing their holdings, directly or indirectly, in the KAI Issuers (described below). To date, required steps have not been completed to the satisfaction of the Deputy Director, and these prohibitions continue in effect.

On May 19, 2020, Compliance Staff (“Staff”) of the Manitoba Securities Commission advised KAM in writing it was making a recommendation to the Director to place terms and conditions on the registration of KAM, in part, because of KAM’s failure to meet its obligations under the October 2019 Undertaking and its ongoing failure to cure the deficiencies in the 2019 Report or those that have since arisen.

Staff advised KAM that it was entitled to exercise its right to an opportunity to be heard, which KAM elected to do. A hearing was held on October 20, 2020 by videoconference. A substantial volume of written materials was provided to the Director by Staff and KAM, with oral submissions heard on October 20, 2020.

The written materials are comprised primarily of written communications with various attachments between KAM and its professional advisers and Staff. Counsel for KAM and Staff referred to the written materials in their written and oral submissions. KAM also called two witnesses to provide testimony on the context of certain of the written materials filed by the parties.

For the reasons set out below, I am imposing terms and conditions in the form set out in Appendix A to this decision on the registration of KAM.

Background

Paul Allard is a director of KAM and has been registered with KAM since September 4, 2015 as both an advising representative and a dealing representative. Between September 4, 2015 and June 3, 2019, Mr. Allard was also KAM's Chief Compliance Officer ("CCO") and was KAM's Ultimate Designated Person ("UDP") from September 4, 2015 until July 1, 2019.

Robert MacKay is a director of KAM and has been registered as a dealing representative with KAM since March 31, 2016. He was a registered associate advising representative with KAM between March 21, 2016 and August 21, 2018, and as a registered advising representative since August 21, 2018. Mr. MacKay has also served as KAM's UDP since July 25, 2019.

Under KAM's business model, KAM provides fee-based discretionary managed account services to its clients. Clients are invested in a mix of equity and fixed income investments. The possible equity investments include prospectus exempt equity investments in two issuers that are controlled by Mr. Allard and Mr. MacKay—KAI Properties Inc. ("KPI") and KAI Health Services Inc. ("KHS"). KAM and KAI Financial Services Inc. ("KFS") are wholly owned subsidiaries of KAI Holdings Inc. ("KHI"), which is, in turn, controlled, and primarily owned by, Mr. Allard and Mr. MacKay. A chart showing the corporate inter-relationships is attached as Appendix C.

KPI, KHS and KFS (collectively, the "KAI Issuers") are entities that pool investor funds to be used for the acquisition of interests in operating businesses. The operating businesses are not public companies. The investments are illiquid in nature, as are the KAI Issuers, the securities of which are sold on a prospectus exempt basis. Depending on the client, the exposure to the KAI Issuers can either be direct share holdings, or indirectly through the KAI Core Equity Pool ("KCEP"), one of three pools offered by KAM to its clients. KCEP has a target allocation of 75% to 80% listed equities, and 20 to 25% KAI Issuers. The second pool is the KAI Core Equity Listed Securities which includes only listed equity securities. The third pool is the KAI Fixed Income Pool.

The KAI Issuers have a management agreement with KHI and pay fees to KHI and KAM with respect to management services. The calculation and the basis for the payment of these fees have changed from time to time.

KAM also enters into referral arrangements with other third parties, both registered and unregistered. The arrangements pay compensation to the referring agents. In some cases, KFS has acquired the business of referring agents.

As of January 2019, Mr. Allard and Mr. McKay had ownership and senior management roles with the KAI Issuers, KAM, and KHI. Their roles at the KAI Issuers included directing the operating and financing activities of the KAI Issuers and KCEP. They prepared the valuations of the individual holdings of the KAI Issuers, using inputs determined by them to establish a valuation. Mr. Allard's and Mr. MacKay's valuations established the market value of the investment portfolios reported to KAM clients, the value of KCEP, the calculation of investment performance reported to KAM clients, and the calculation of management fees that flowed to KHI and KAM from the KAI Issuers. These interrelationships create significant conflicts of interest between KAM's clients and

KAM, Mr. Allard, and Mr. MacKay, and are the root cause of many of the deficiencies in the 2019 Report.

The 2019 Report

The 2019 Report detailed Staff's findings after a comprehensive audit of KAM. Seventy-six deficiencies were documented, of which 38 were considered significant. I will not go into detail on all the findings, other than to note that significant deficiencies were noted in virtually all aspects of KAM's operations and these deficiencies impacted on the basic obligations KAM owed its clients. Some examples included the following:

- KAM had issues with the collection and recording of know your client ("KYC") information.
- KAM failed to identify and disclose conflicts to clients.
- KAM failed to document the fee arrangements between KAM, KHI and the KAI Issuers that directly impacted KAM's clients financially.
- KAM used conflicted valuation practices where KAM's principals (Mr. Allard and Mr. MacKay) were valuing the KAI Issuers and their underlying investments relying on unaudited financial information, where those valuations had a direct impact on the value of the KAI Issuers reported to KAM's clients, the investment performance of the client accounts reported by KAM to its clients, and the fees received by KAM and KHI from the KAI Issuers.
- KAM failed in documenting referral arrangements with the referring parties and in the full disclosure of those arrangements to KAM's clients.
- KAM failed in the oversight of referral agents and how they represented their relationships to the Firm.
- KAM failed in the oversight of advising representatives who were restricted in terms of the activities they could carry out.

Also amongst Staff's findings was a general failure of KAM to resource the compliance functions of the Firm, and a significant lack of systems or controls meant to achieve compliance with the regulatory requirements by KAM. At the time of the audit, Mr. Allard was both the UDP and CCO of KAM, in addition to his duties with KHI and the KAI Issuers. In consideration of the significant deficiencies detailed in the 2019 Report, Staff believed Mr. Allard had not adequately performed his UDP responsibilities in supervising the activities of KAM to ensure compliance with securities legislation, and had not promoted compliance by the Firm in key areas of KAM's operations. He also failed to fulfill the CCO responsibilities including maintaining procedures for assessing compliance with securities laws by the Firm and individuals acting on its behalf. It did not appear reasonable controls were implemented to address the material conflicts of interest that exist between Mr. Allard's roles with KAM's portfolio management responsibilities, KAM's related-party KAI Issuers, and his role as KAM's UDP and CCO.

The inability to foster a culture of compliance in KAM could be seen on many fronts:

- KAM had not established, maintained and enforced adequate policies and procedures for assessing compliance by the Firm and its individuals, nor adequately monitored and assessed compliance by the Firm, and the individuals acting on its behalf, with securities legislation.

- The UDP had not demonstrated sufficient supervision of KAM's activities directed towards ensuring compliance with securities legislation by the Firm and each individual acting on the Firm's behalf.
- KAM had not adequately identified and responded to the multiple significant conflicts of interest inherent in the KAI Issuers' business model.
- KAM clients did not receive clear and meaningful disclosure surrounding conflicts of interest and the related party compensation structure.
- KAM did not have an adequate know your product ("KYP") process.
- KAM did not have an adequate KYC and suitability assessment process.
- KAM did not maintain adequate books and records.
- KAM did not have adequate internal controls in place to ensure compliance with securities legislation, and to manage the risks associated with its business.

I agree with Staff that the 2019 Report supports a general finding that there was a general failure on the part of KAM to resource the compliance functions of the Firm and a significant lack of systems or controls meant to achieve compliance with the regulatory requirements by KAM. As noted in Section 11.1 of the Companion Policy 31-103 CP to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("NI 31-103"):

Operating an effective compliance system is essential to a registered firm's continuing fitness for registration. It provides reasonable assurance that the firm is meeting, and will continue to meet, all requirements of applicable securities laws . . . and is managing risk in accordance with prudent business practices. A compliance system should include internal 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.

Taken as a whole, the 2019 Report highlighted numerous fundamental deficiencies that, in large part were accepted by KAM as requiring remediation.

The Undertakings

The 2019 Report demonstrated a genuine concern as to whether KAM was capable of complying with its basic regulatory requirements as a registrant, and how that would impact its existing clients. I believe that KAM recognized the breadth and significance of the deficiencies, and the need to become compliant with its ongoing regulatory obligations and that it needed to take immediate steps to address Staff's concerns. As part of the process to reach this goal, KAM entered into the April 2019 Undertaking, which was replaced by the current October 2019 Undertaking. The current undertaking is attached as Appendix B to this decision. To be clear, the use of an undertaking is voluntary on the part of the registrant and must be acceptable to the Director. In certain instances, an undertaking can achieve results similar to where terms and conditions are imposed on a registrant to remediate significant deficiencies.

In making both the April 2019 Undertaking, and the October 2019 Undertaking, KAM acknowledged and accepted that the undertaking given was in the public interest and for the purpose of maintaining integrity and confidence in the capital markets.

The October 2019 Undertaking imposes several obligations and restrictions on KAM:

- KAM must rectify all compliance deficiencies identified in the 2019 Report and any subsequent deficiencies related to the 2019 Report, including re-performing its account opening process and suitability assessment for all clients utilizing updated documentation and disclosure in a form acceptable to Staff. All deficiencies are to be rectified no later than 180 days after KAM receives notification that Staff has no further comments on KAM's proposed revised client account documents.
- KAM may not accept any new managed account clients, accept any new client monies for investment in existing managed accounts, or enter into new referral or marketing arrangements, or accept a referred client, until the account reopening process is completed to the satisfaction of the Deputy Director, and the Director has released KAM from this prohibition.
- For existing clients, KAM is permitted on a case by case basis to continue to accept pre-authorized contributions that were in place prior to the date of the October 2019 Undertaking, annual registered retirement savings plan contributions and other similar contributions, with the prior consent of the Deputy Director.
- Likewise KAM will not permit the account of any KAM client to increase its holdings in any of the KAI Issuers directly through purchase of securities of the KAI Issuers or indirectly through purchase of units of the KCEP, the KAI Fixed Income Pool or any other new or existing KAI pool, until such time that the client account opening process has been substantially completed and client files have been repapered and updated to the satisfaction of the Deputy Director, and the Director has released KAM from the prohibition.

The October 2019 Undertaking also required KAM to develop a plan for the account reopening process noted above (the "Plan"), which was to include monthly progress reports, as well as a completion report signed by the CCO. The expectation acknowledged in the undertaking was that the monthly progress reports would demonstrate substantial progress to completing the Plan by KAM.

Position of Staff

Staff recommends imposing terms and conditions on KAM's registration. Staff bases its recommendation on KAM's ongoing inability to correct all deficiencies identified in the 2019 Report, the identification of new deficiencies after the 2019 Report, and KAM's inability to comply in full with the undertakings that have been in place since April 2019. The nature of the continuing deficiencies is of a similar nature to deficiencies that have been identified since KAM's new registrant review. Staff's position is that the breadth, depth and enduring nature of the Firm's problems have not been addressed by the October 2019 Undertaking, and require the assistance of a monitor appointed under terms and conditions to rectify.

Staff's proposed terms and conditions would require KAM to retain an independent third-party compliance monitor, who is acceptable to the Deputy Director, to prepare and assist KAM in implementing a plan to review and strengthen KAM's compliance system. The details of the plan and timelines include a comprehensive review of KAM's policies, procedures and systems of controls and report on whether KAM has answered all the

outstanding deficiencies in the 2019 Report, as well as further deficiencies identified after January 8, 2019.

Position of KAM

KAM's position is that while a monitor should be brought in, it should be brought by way of a further revised form of undertaking and not pursuant to terms and conditions. In KAM's view, Staff's position to impose terms and conditions is based upon a factual foundation that is incomplete or presented in a manner that is out of context and does not reflect industry practice. KAM believes Staff has reached subjective conclusions on conduct, competence and diligence which fail to reflect the positive steps taken by KAM to address the outstanding deficiencies.

KAM also argues that the use of terms and conditions on KAM's registration is not needed in the public interest and would be prejudicial to KAM's reputation, since the same objective could be achieved through a revised form of undertaking under which a monitor would be put in place. KAM further took exception to the content of the terms and conditions proposed by Staff as being too broad in scope and failing to consider the successes that KAM achieved in responding to the 2019 Report. KAM also believes that any terms and conditions should include specific and measurable milestones that are assessed against a standard of industry practice.

KAM suggested that the focus of the hearing should be to answer two questions:

1. How should continuing restrictions on KAM be imposed, by way of revised undertaking or by terms and conditions?
2. What are fair and reasonable restrictions on KAM's operations with a monitor in place, and what are objective measures for determining when goals are met and when restrictions can be removed, with such measures being measured against industry practices?

KAM also suggested a two-stage approach—first, appointing a monitor under a revised form of undertaking, and second, reviewing the reporting of the monitor to see if there are concerns raised which would warrant imposing terms and conditions.

KAM submits that the imposition of terms and conditions is not meant to be disciplinary or a punitive exercise to punish past conduct. Rather they should be imposed only if the public is at material risk going forward absent the terms and conditions. KAM has been operating under an undertaking since April of 2019, and KAM argues that the only reason to abandon that approach now is if it has not pursued the plan contemplated by the undertaking with diligence, or if it is not otherwise competent.

Analysis

Since April of 2019, KAM has taken a number of steps, in consultation with Staff, to address the deficiencies in the 2019 Report and meet its obligations under the October 2019 Undertaking. KAM in its submissions highlighted a number of significant steps:

- KAM hired a new and experienced full time CCO who has had compliance experience over a 28-year career with a large, integrated financial services firm, including 12 years as Chief Compliance Officer on IROC and MFDA platforms

within the firm which did not include a portfolio manager or discretionary accounts.

- KAM replaced its UDP.
- KAM retained independent Chartered Business Valuators to perform independent valuations of the KAI Issuers on an ongoing basis.
- To further address Staff concerns and upgrade its policies and procedures, KAM retained an industry compliance consultant.
- KAM then replaced the compliance consultant with specialized independent compliance counsel to advise on addressing the 2019 Report findings.
- KAM established an Independent Acquisitions and Compliance Committee (“IACC”) to further address conflicts of interest and other concerns, especially related to investments in the KAI Issuers. The members of the IACC have significant experience relevant to their roles on the IACC.
- KAM retained independent Chartered Professional Accountants to perform financial audits on the KAI Issuers.
- KAM’s new account documentation was completely revised in collaboration with Staff. The new client documents developed in collaboration with Staff consist of, among other things:
 - A “Client Information Statement” recording basic client data;
 - A “Know-Your-Client Document” (the “KYC Document”) for recording information required to assess suitability;
 - An “Investment Policy Statement” containing a client investment plan;
 - A “Relationship Disclosure Document” containing important information about KAM’s business model, ownership structure, and conflicts of interest and how they are managed; and
 - KAI Issuer Fact Sheets which provide further disclosure to clients.
- KAM met or spoke to each client to reopen their accounts using the new account documentation.

While these changes undertaken by KAM are significant, they were also necessary steps to start addressing the significant deficits in KAM’s compliance with its basic regulatory obligations under NI 31-103. Unfortunately, to date, they have failed to achieve the desired outcome. KAM has failed to address all the deficiencies in the 2019 Report and, subsequent to entering into the October 2019 Undertaking, further deficiencies continue to arise. Some of the deficiencies, viewed on their own would not be considered significant. However, they tended to repeat previously identified deficiencies, and were not identified by KAM before Staff drew them to the attention of KAM, either directly, or in the course of responding to Staff concerning another deficiency. These repeated minor deficiencies, coupled with others that were more substantial, tend to demonstrate that there remains a significant deficiency of systems or controls in place to identify them.

Unfortunately, there are a number of examples, but I will only note some specific examples that illustrate this concern.

KYC Failure

On January 21, 2020, KAM requested an urgent call with Staff to discuss its plans to accommodate a client request to liquidate their holdings in the KAI Issuers. KAM’s plan

in part would result in increasing the levels of certain clients' holdings of the KAI Issuers based on KYC information collected about the relevant clients in December 2019.

As Staff asked questions about the clients' information collected through the KYC process, KAM's UDP and CCO each provided different and incorrect information about the clients' circumstances. All totaled, three different versions of the clients' circumstances were provided to Staff. The UDP had conducted the account reopening and collection of KYC in December 2019 for the clients in question. The actual and necessary client information was not recorded during the reopening of the account leading to KAM providing differing answers over time to Staff. It should be noted this information was required by the Deputy Director as KAM was attempting to preclear the transaction as contemplated in the October 2019 Undertaking. In a response dated January 28, 2020, KAM acknowledged that:

- the account in question, an account in the name of a corporation controlled by individual clients of KAM, did not accurately reflect the ownership structure (which was accurately reflected on an individual account that was reopened around the same time);
- the answers for the timeframe for the account erroneously reflected information instead related to two individuals; and
- that the Client Information Sheet inaccurately listed one client as president and did not reflect the actual ownership interests.

In responses to Staff, KAM noted that Mr. MacKay performed the account reopening and he was aware of a possibility of the liquidation in August of 2019. The information was subsequently corrected.

The accurate collection and recording of KYC information is a fundamental aspect of the client relationship, as discussed in Section 13.2 of Companion Policy 31-103 CP:

Registrants act as gatekeepers of the integrity of the capital markets. They should not, by act or omission, facilitate conduct that brings the market into disrepute. As part of their gatekeeper role, registrants are required to establish the identity of, and conduct due diligence on, their clients under the know your client (KYC) obligation in section 13.2 [of NI-31-103]. Complying with the KYC obligation can help ensure that trades are completed in accordance with securities laws.

KYC information forms the basis for determining whether trades in securities are suitable for investors. This helps protect the client, the registrant and the integrity of the capital markets. . . .

I find this incident to be a significant failure. A failure in meeting the KYC requirements in section 13.2 of NI 31-103 by failing to record accurate information concerning a client's financial circumstances, and section 13.3 in inaccurately recording information to identify a corporate entity. This information is required not just to determine suitability for clients, but also to allow a CCO to perform its duties in reviewing trading activity. It is also a violation of the requirements to maintain records under section 11.5 of NI 31-103. What exacerbates this incident is that the inaccurate information was recorded in the course of the account reopening process as required under the October 2019 Undertaking. KAM is operating under significant restrictions pursuant to the October 2019 Undertaking, and

the UDP, who was responsible for reopening this particular account, made several fundamental mistakes in maintaining accurate KYC.

Books and Records Failures

On January 16, 2020, KAM's CCO provided Staff with a planned client disclosure that indicated no Shareholder Equity Management Fees were funnelled from KHI to KAM in 2019. When Staff questioned this, KAM's CCO confirmed in writing on January 17, 2020, that none of these fees were paid in 2019. Specifically, in her email, the CCO represented that the fee reimbursements were funded through revenues KAM earned from portfolio management fees and revenues KAM earned from KHI. The fee reimbursements were being made to rectify a deficiency noted in the 2019 Report where certain accounts were overcharged by KAM collecting fees that were not fully disclosed, or not disclosed at all.

To ensure clear understanding of the situation, Staff followed up a second time, raising questions about the revenues earned from KHI. On January 20, 2020, KAM's CCO advised in a telephone conversation and subsequent follow-up email that she had further investigated and discovered that the fee reimbursements of approximately \$1 million were funded not from portfolio management fees and revenues, but were instead funded through Shareholder Equity Management fees charged by KHI and then paid to KAM in 2019. During the January 20, 2020 telephone conversation, KAM's CCO also confirmed that there was no agreement governing the 2019 payment of Shareholder Equity Management fees from KHI to KAM. In fact, there has never been an agreement governing the payments of Shareholder Equity Management fees. She further indicated that an agreement should have been in place and would be drafted and submitted to the IACC. KAM corrected the client disclosure.

These two incidents are examples of repeated instances where inaccurate information was provided by KAM to Staff, and it was only through further probing by Staff that the inaccuracies came to light. While I do not believe there was any intention to mislead Staff, these incidents demonstrate failures of internal controls in maintaining accurate books and records (as required by section 11.5 of NI 31-103) and failures in recording transactions that directly impact the fees being charged, the arrangements between KAM and the KAI Issuers, and recording accurate information needed to monitor conflicts of interest that directly impact clients holding KAI Issuers' securities either directly or indirectly (as required by sections 13.4, 13.5, and 13.6 of NI 31-103).

Failure to Oversee Referral Agents

W.M., who has a referral agreement with KAM, as recently as February 12, 2020, misrepresented his relationship and role with KAM in websites, which also included excerpts from KAM's marketing materials depicting the Firm's investment performance. This is contrary to the Firm's policies and procedures and is supposed to be monitored by KAM quarterly. This is a repeat deficiency that was originally identified in the 2019 Report.

Failure to Supervise Registered Individuals

On multiple occasions in 2019, KAM advised Staff that misleading information on websites of T.G., who was registered as an advising representative with KAM

(restricted), had been corrected, when in fact this was not the case. The matter was not adequately concluded until mid-August 2019. This is a repeat significant deficiency that was originally identified in the 2019 Report.

KYC and Books & Records Failures

The most recent incident of concern occurred when KAM filed with Staff a draft completion report KAM prepared under paragraph 2g of the October 2019 Undertaking to demonstrate that the client account opening process has been completed and all client files had been repapered and updated to the satisfaction of the Deputy Director. Acceptance of this completion report would allow for the removal of the restrictions on KAM's activities pursuant to paragraph 4 of the October 2019 Undertaking.

Staff decided to review a small sample of KAM's accounts, and in February, 2020, a sample of 28 clients was selected and all documentation in each of the sampled client files was reviewed to determine the adequacy of KAM's account reopening process and suitability assessment.

- In five cases there were discrepancies between the KYC Document and the Investment Policy Statement on the account; KAM acknowledged the discrepancy, and following a further internal review of other accounts found 10 more instances, for a total of 15 accounts out of 110 reviewed. KAM put this down to clerical errors and asserted that the discrepancies did not impact the accounts at the end of the day.
- One file contained unsigned documentation. That file was selected from a list prepared by KAM of files containing completed, signed documentation. KAM reconciled the files identifying four additional households that should not have been on the list.
- The KYC Document was modified to reflect a change in risk tolerance for a decline in market value was changed from medium to high and initialed by the client. The stated risk tolerance on the client's Investment Policy Statement was not updated and remained at medium.

There were other deficiencies as well. KAM suggests these are all minor, and had not, in the judgment of the particular advising representative, had any impact on the suitability determination.

These deficiencies all occurred during the period KAM was operating under the April 2019 Undertaking and the October 2019 Undertaking. This was a time where KAM needed to build better systems and controls, and further foster a culture of compliance, not attempt to minimize repeated deficiencies.

While it is true KAM has made progress in certain respects, I do not believe the ongoing deficiencies demonstrate that KAM is making substantial Plan progress as required by the October 2019 Undertaking. I find that, to date, KAM has not complied with Section 11.1 of NI 31-103 which requires that registered firms must establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation, and manage the risks associated with its business in accordance with prudent business practice. There continues to be deficiencies in the

collection of KYC, maintaining books and records, and being in a position to properly manage conflicts of interest that arise chiefly from KAM's business model.

Staff has worked closely with the Firm and its representatives for well over a year, continuing to expend a large percentage of Compliance resources to help KAM to address its deficiencies. Despite the Firm's representations regarding new policies and procedures, problems and repeated instances of non-compliance continue to persist.

Terms and Conditions

Not only does a firm need to be fit for registration, a firm also has an ongoing obligation to remain fit for registration. One of the ways to demonstrate this continuing fitness is through compliance reviews. An ability to correct deficiencies identified through such reviews in a timely manner helps demonstrate this continuing fitness for registration.

The Director's ability to impose terms and conditions on a registration are found in s. 7(3) of *The Securities Act*, R.S.M. 1988, c. S50.

Director's authority to impose terms on registration

- 7(3) The Director may, either at the time of registration or afterward,
- (a) restrict or expand a registration with or without terms and conditions, including, but not limited to, the condition that the registration is restricted to trades in certain securities, class of securities, derivatives or class of derivatives; or
 - (b) restrict or expand the duration of a registration.

As noted in *The Matter of: Kenneth Wayne Muzik*, a decision of the Director dated November 4, 2013:

The Director can apply terms and conditions to a registration in order to monitor the activities of a registrant pending a review and investigation of matters involving that registrant's conduct. This type of precautionary term and condition is routinely imposed by the Director to provide additional protection to the public and to permit the Commission and/or a self-regulatory organization to conduct whatever review or investigation is necessary to determine if there is a question with respect to the conduct of a registrant.

It is also important to remember that the imposition of terms and conditions are not intended to be punitive, especially in a situation similar to the one at hand. As noted in *Acker Finley Asset Management, Re*, 2017 CarswellOnt 15313:

Terms and conditions are not intended to punish a registrant, but are a means of establishing a structured program for registrants to remediate the identified deficiencies and breaches of Ontario securities law. It is important that terms and conditions be made public so that any client or prospective client of the registrant has access to the information and is aware of the restrictions under which the firm is operating.

I find that terms and conditions are necessary in this case. In reviewing the evidence as a whole KAM has not been able to remediate the deficiencies of the 2019 Report, and further deficiencies keep arising of a similar nature. While I accept that KAM has been

devoting resources and taken positive steps to position itself to have systems and controls to comply with the requirements of NI 31-103, it has been unable to execute the Plan to remediate the deficiencies in the 2019 Report, or as contemplated by the undertakings given to the Director on April 26, 2019, and on October 11, 2019. A review of some of the work done to meet the requirements imposed by the undertakings revealed further deficiencies. There is no expectation of perfection, but there is an expectation that a registrant not experience the same deficiencies, or the same type of deficiencies, repeatedly. That this continues to happen suggests that the systems and controls that are in place are not sufficient for KAM to be compliant with its obligations as a registrant. In all the circumstances, I find that KAM has not complied with Section 11.1 of NI 31-103, which requires that registered firms establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation, and manage the risks associated with its business in accordance with prudent business practice. There continues to be deficiencies in the collection of KYC, maintaining books and records, and being in position to properly manage conflicts of interest that arise chiefly from KAM's business model. Under these circumstances, the imposition of terms and conditions and the use of a monitor are required.

KAM acknowledged in its submissions that a monitor was appropriate to assist KAM in remedying the outstanding deficiencies. KAM, however proposed this be done by way of revising the undertaking as opposed to terms and conditions. They submitted that imposing terms and conditions at this time was not warranted given the progress KAM had made to date, and it may have a detrimental effect on KAM's reputation as terms and conditions are public. They further suggest that if KAM is unable to fulfill obligations under the revised undertaking, or the monitor finds further deficiencies, at that time I should consider imposing terms and conditions.

I am not prepared to accept a further undertaking from KAM. As I noted above, undertakings can be an appropriate means of addressing issues that would otherwise merit terms and conditions. In this instance, the undertakings have not worked to reach the desired goal over a period approaching 18 months. KAM has been addressing deficiencies identified by Staff for years, both under the new registrant review, and from the 2019 Report. They have been operating under an undertaking to accept no new business since April 26, 2019, and have been developing and implementing plans to address fundamental and significant deficiencies since that time which ultimately failed to address them in full. Since the undertaking has been in place, Staff identified more deficiencies which, while not the same, are similar to those identified previously and which, with proper systems and controls in place, could have been caught prior to Staff identifying them to KAM for resolution. While progress has been made, KAM has not fully, as at the time of the hearing, implemented policies, procedures and systems and controls to achieve a culture of compliance with the requirements of NI 31-103. The appointment of a monitor under terms and conditions is the appropriate means to meet this objective.

I believe the existing officers and employees of KAM have the necessary skills and proficiencies to eventually reach the intended goal with the temporary assistance of a monitor. I also believe a monitor will allow KAM to achieve this goal sooner, to the benefit of KAM's clients.

In appointing the monitor, I acknowledge that KAM has made progress and that Staff have confirmed certain deficiencies have been addressed to their satisfaction. As such, I will be modifying the proposed terms to reflect that the monitor will not be required to review all client files as recommended by Staff. The Monitor will instead be instructed to review a representative sample of files, as described in the terms and conditions set out in Appendix A.

"C.P. Besko"

C.P. Besko

Director

APPENDIX A

Terms and Conditions

The registration of KAI Asset Management Inc. ("KAM" or the "Firm") is subject to the following terms and conditions.

1. Within 30 days of the date from which the Director imposed Terms and Conditions on the registration of KAI Asset Management Inc. ("KAM" or the "Firm"), the Firm shall retain, at its own expense, the services of an independent person as a compliance monitor (the "Monitor") approved by and on terms satisfactory to the Director. The Firm will advise the Deputy Director of the specific retainer date which shall be referred to in these terms and conditions as the "Commencement Date."
2. The Monitor will prepare and assist the Firm in implementing a plan (the "Plan") to review and strengthen the Firm's "compliance system" within the meaning of section 11.1 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103), including the expected dates of completion and person(s) responsible for the Plan's implementation and completion.
3. The Monitor shall provide the Plan to the Deputy Director for approval no later than 30 days from the Commencement Date.
4. The Plan, in addition to providing details on reviewing and recommending steps to strengthen KAM's compliance system, will address steps the Monitor will take to:
 - a. Confirm KAM has in place policies and procedures (including forms and documentation) to obtain know your client ("KYC") information and documentation to carry out an informed, proper suitability assessment and analysis.
 - b. Conduct a comprehensive KYC and suitability assessment for a sample of clients of KAI as of the effective date of these terms and conditions ("Sampled Clients"), taking into account the risks of investment in prospectus exempt securities, including KAI Issuer securities, and ensuring that the allocation of related issuer securities, held directly and indirectly, is suitable. The Sampled Clients shall include:
 - i. all clients who directly own shares of KAI Properties Inc. and KAI Health Services Inc. (the "KAI Issuers");
 - ii. all clients who are 65 years of age or more; and
 - iii. a reasonable sample of other clients selected by the Monitor to allow the Monitor to make its assessment.
 - c. Confirm that the Investment Policy Statement as derived is suitable for each of the Sampled Clients in light of all information obtained during the comprehensive file review conducted by the Monitor.
 - d. Where applicable, validate Sampled Clients for Qualified Client status, and ensure adequate support for same is obtained and documented by KAM.

- e. Where any Sampled Clients are no longer considered Qualified Clients to hold prospectus exempt securities, including KAI Issuer securities, directly or indirectly, the Monitor must oversee rebalancing of the affected Sampled Clients' portfolios to established asset allocation.
 - f. Examine the Firm's current operations, internal policies, practices and procedures and where required, make recommendations for implementing additional procedures to fully satisfy all identified compliance deficiencies in the compliance field review report dated January 8, 2019 (the "Report") and as otherwise identified which have not been rectified as of May 19, 2020.
 - g. Assess the Firm's progress in executing the Plan and determine, whether in the Monitor's opinion:
 - i. The Firm has rectified all material deficiencies outlined in the 2019 Report and otherwise identified; and
 - ii. The Firm is maintaining and applying policies and procedures that establish a system of controls and supervision that have been reasonably designed to ensure compliance with securities laws relating to areas of concern raised by MSC Staff in the 2019 Report and in areas otherwise identified.
5. Each month, by no later than the fifth business day after month end, the Monitor shall submit written progress reports (the "Progress Reports") to the Deputy Director. The Progress Reports shall:
- a. Detail the Firm's progress with respect to the implementation of the Plan and the status of the specific requirements outlined in the Plan; and
 - b. Report the number of Sampled Clients for whom a KYC and suitability assessment has been completed, the Monitor's conclusions as to the adequacy of the Firm's KYC information and suitability assessment for the noted clients, and provide an explanation of any actions required by KAM as a result of the Monitor's findings.

Upon completion of the Monitor's review of KAM's compliance system and the Sampled Clients' documentation (Phase 1), monthly reports as outlined in Term and Condition number 8 will be required.

6. Until such time that the Monitor has completed the review and analysis of the Sampled Clients KYC and suitability assessments, and reported satisfactorily to the Deputy Director, KAM is prohibited from:
- a. Accepting any new managed account clients (New Clients).
 - b. Entering into new referral or marketing arrangements, or accepting a referred client.
 - c. Permitting existing Clients to increase their exposure to the KAI Issuers, whether directly through ownership of securities of the KAI Issuers or indirectly through ownership of units of the KAI Core Equity Pool, the KAI Fixed Income Pool or any other new or existing KAI pool.
7. Upon completion of the review and analysis of Sampled Clients' KYC and suitability assessments to the satisfaction of the Monitor, and upon the Monitor's report (Phase 1 Report) being approved by the Deputy Director:

- a. KAM will be allowed to accept New Clients (clients who become clients of the Firm after the prohibition on new accounts is lifted) and new client monies. New Clients will not be permitted to have exposure to KAI Issuers, whether directly through ownership of securities of the KAI Issuers or indirectly through ownership of units of the KAI Core Equity Pool, the KAI Fixed Income Pool or any other new or existing KAI Pool until such time as the Monitor assertion required by Term and Condition number 9 is satisfied.
 - b. The prohibition on investing existing Client funds into the KAI Issuers will be lifted.
 - c. KAM will be allowed to enter into new referral arrangements (as defined by NI 31-103 and in accordance with same) and accept referred clients.
8. Commencing at the time New Clients are permitted, the Monitor will file monthly reports with the Deputy Director:
- a. Confirming that the Firm has conducted a KYC and suitability analysis (in accordance with the requirements in NI 31-103) for each New Client account opened during the monthly reporting period; and
 - b. Confirming compliance processes related to KYC and suitability assessment are and continue to be followed by the Firm.

These monthly reports shall be submitted to the Deputy Director by no later than the fifth business day after month end.

9. Until such time that the Monitor determines and asserts to the Deputy Director that the compliance processes related to KYC and suitability assessment are well established and consistently being followed by KAM, KAM will not permit the account of any New Clients to acquire any interest in the KAI Issuers directly through purchase of securities of the KAI Issuers or indirectly through purchase of units of the KAI Core Equity Pool, the KAI Fixed Income Pool or any other new or existing KAI pool.

APPENDIX B

October 2019 Undertaking

MANITOBA SECURITIES COMMISSION UNDERTAKING TO THE DIRECTOR

Introduction

KAI Asset Management Inc. (“KAM” or the “Firm”) is registered as a portfolio manager and exempt market dealer in Manitoba, British Columbia, Alberta, Saskatchewan and Ontario and as an investment fund manager in Manitoba and Ontario.

On January 8, 2019 Compliance Staff (“Staff”) of the Manitoba Securities Commission (the “Commission”) issued a Schedule of Findings (the “Report”) detailing deficiencies identified as a result of a compliance examination of KAM conducted under the authority of Section 35 of The Securities Act (Manitoba) (the “Act”).

The undertakings provided herein to the Director of the Commission by KAM replace KAM’s Undertaking to the Director dated April 26, 2019 and are accepted in the public interest and for the purpose of maintaining the integrity and confidence in the capital markets.

Undertakings of the Registrant

KAM, through its directors, Paul Allard and Robert MacKay, undertakes to the Director of the Commission effective October 15, 2019 that:

1. KAM will rectify all compliance deficiencies identified in the 2019 compliance report dated January 8, 2019 (the Report) and any subsequent correspondence related to the Report. This includes re-performing its account opening process and suitability assessment for all clients (as outlined in the Report) utilizing updated documentation and disclosure in a form acceptable to MSC Staff (Staff). All deficiencies will be rectified no later than 180 days after KAM receives notification that Staff has no further comments on KAM’s proposed revised client account documents.
2. KAM will:
 - a. Prepare and implement a plan acceptable to the Deputy Director, to re-perform its account opening process and suitability assessment for all clients (the Plan).
 - b. Document the account opening and suitability process for each client.
 - c. Ensure the Firm continues to direct sufficient human and financial resources in order to fully complete the Plan in accordance with the timelines set out above.

- d. Ensure that the re-performance of the account opening process and suitability assessment for all clients is conducted by Paul Allard or Robert MacKay in their capacities as the Firm's Advising Representatives.
 - e. Ensure its Chief Compliance Officer ("CCO") supervises and regularly reviews KAM's progress with respect to implementation and completion of items identified in the Plan. As part of this activity, the CCO will participate in a representative sample of client meetings acceptable to the Deputy Director, in order to assess the adequacy of KAM's communications with clients.
 - f. Ensure its CCO submits written monthly progress reports to the Deputy Director reporting on the progress being made in executing the Plan. These reports will be submitted by the fifth business day following the month being reported on; and
 - g. Ensure that upon completion of the Plan, the CCO submits a final report to the Deputy Director, that assesses the effectiveness of the Plan's execution and states that, in the CCO's opinion:
 - i. KAM has adequately re-performed the necessary account opening process for all clients in accordance with the Firm's obligations as set out in the Act and in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*.
3. KAM understands and acknowledges that Staff expects that substantial Plan progress will be demonstrated in each of the CCO's progress reports.
4. KAM will not:
- a. accept any new managed account clients,
 - b. accept any new client monies for investment in existing managed accounts,
 - c. enter into new referral or marketing arrangements, or accept a referred client,

until such time that the client account opening process has been completed and all client files have been repapered and updated to the satisfaction of the Deputy Director and the Director has released KAM from the provisions herein.

Notwithstanding the above, for existing clients, KAM will be permitted on a case by case basis to continue to accept pre-authorized contributions that were in place prior to the date of this Undertaking, annual registered retirement savings plan contributions and other similar contributions, with the prior consent of the Deputy Director.

5. KAM will not permit the account of any KAM client to increase its holdings in any of the KAI Issuers directly through purchase of securities of the KAI Issuers or indirectly through purchase of units of the KAI Core Equity Pool, the KAI Fixed Income Pool or any other new or existing KAI pool, until such time that:

- a. the client account opening process has been substantially completed and client files have been repapered and updated to the satisfaction of the Deputy Director, and
- b. the Director has released KAM from the provisions herein.

APPENDIX C

KAI GROUP OF COMPANIES | ORGANIZATION STRUCTURE

