



Ontario
Securities
Commission

Commission des
valeurs mobilières
de l'Ontario

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**IN THE MATTER OF THE *SECURITIES ACT*
R.S.O. 1990, c. S.5, AS AMENDED**

-AND-

**IN THE MATTER OF
BMO NESBITT BURNS INC.**

SETTLEMENT AGREEMENT

PART I – INTRODUCTION

1. The Ontario Securities Commission (the “Commission”) will issue a Notice of Hearing to announce that it will hold a hearing to consider whether, pursuant to section 127 of the *Securities Act*, R.S.O. 1990, c. S.5, as amended (the “Act”), it is in the public interest for the Commission to make certain orders in respect of BMO Nesbitt Burns Inc. (“BMONB”).

PART II – JOINT SETTLEMENT RECOMMENDATION

2. Staff of the Commission (“Staff”) agree to recommend settlement of the proceeding commenced by Notice of Hearing dated November 8, 2010 (the “Proceeding”) against BMONB according to the terms and conditions set out in Part VI of this Settlement

Agreement. BMONB agrees to the making of an order in the form attached as Schedule “A”, based on the facts set out below.

PART III – AGREED FACTS

3. BMONB agrees with the facts and conclusions set out in this agreement solely for the purpose of this proceeding. BMONB expressly denies that the terms of this agreement are intended to be an admission of liability, misconduct or wrongdoing by it in any other context to any person, company or other entity.

I. Background

4. FMF Capital Group Ltd. (“FMF”) was a company incorporated under the laws of the Province of Ontario on October 20, 2004 with its head office in Toronto, Ontario. On or about March 24, 2005, FMF became a reporting issuer in Ontario and in other Canadian provinces and territories by way of an initial public offering (the “IPO”) and a prospectus dated March 16, 2005 (the “FMF Prospectus”).
5. FMF Capital LLC (“FMF Capital”) is a limited liability company incorporated under the laws of the State of Delaware in the United States on November 4, 2004. FMF Capital was FMF’s operating subsidiary and was the successor business to Michigan Fidelity Acceptance Corporation (“MFC”). At the time of the IPO, MFAC, and subsequently FMF Capital, carried on business as a wholesale subprime residential mortgage lender entirely in the United States. Their head office was situated in Southfield, Michigan.
6. BMONB is registered with the Commission as an Investment Dealer and is a member of the Investment Industry Regulatory Organization of Canada. BMONB carries on the business of investment and corporate banking, operating under the name BMO Capital Markets. BMONB was the lead underwriter for the IPO.
7. FMF Capital was a wholesale subprime lender which originated subprime mortgage loans using a network of independent mortgage brokers. Loans were funded by FMF

Capital using two secured warehouse lines. FMF Capital then sold all of its mortgage loans to institutional loan purchasers within an average of 35 days of funding.

8. Subprime mortgage lending involves providing higher risk loans to borrowers with one or more of: (i) impaired or limited credit histories with Fair Isaac Corporation “FICO” scores below 660; (ii) higher levels of consumer debt; (iii) limited employment histories; and/or (iv) higher debt-to-income ratios. In addition, subprime mortgage loans usually have a higher loan-to-value ratio than prime mortgage loans.
9. In 2005, the US subprime residential mortgage lending market was an established market in which more than 150 lenders participated, including some of the largest financial institutions in the United States. The subprime mortgage market had been the fastest growing segment of the US residential mortgage lending industry, increasing to USD\$530 billion in subprime mortgage loan originations in 2004.

II. FMF’s Offering

10. BMONB marketed the FMF IPO in March 2005 at a yield range of 10% to 11%.
11. Pursuant to the FMF Prospectus, FMF issued 19,750,000 income participating securities (IPS) units at a price of \$10.00 per IPS for gross proceeds of \$197.5 million. Each IPS unit represented one common share and \$6.524 principal amount of 14.5% subordinated notes (the “Subordinated Notes”) of FMF for a blended yield of 11%.
12. On or about March 16, 2005, BMONB signed a certificate stating that to the best of its knowledge the FMF Prospectus constituted full, true and plain disclosure of all material facts relating to FMF’s IPS units.
13. Fees paid to the underwriters totalled approximately \$11.3 million. Approximately \$4.41 million was paid to BMONB and the remaining fees were split among the participating underwriters. A further \$659,895.03 was paid to BMONB on the sale of the subordinated notes.

14. FMF's IPS units never traded at or above their IPO price of \$10.00 per IPS and started a downward decline in unit price almost immediately after being listed on the Toronto Stock Exchange ("TSX").

III. Conduct Inconsistent With Reasonable Underwriting Practices

15. Staff and BMONB agree that underwriters should perform reasonable due diligence, the nature of which will differ depending on the circumstances. In particular, especially thorough due diligence is expected in circumstances in which: (i) the issuer is undertaking an initial public offering; (ii) the issuer has undergone recent significant growth or a significant change in business in the recent past (eg. 24 months); (iii) the issuer is a new client for the underwriter and no previous due diligence has been performed on the issuer; or (iv) the issuer has-not previously raised capital in Canada.
16. In the course of its underwriting of FMF, BMONB at times conducted due diligence in a manner that did not comply with reasonable underwriting practices. Such lapses were inconsistent with the Act's goal of fostering confidence in the capital markets.
17. If BMONB had followed reasonable practices for underwriting due diligence in all respects, BMONB and its agents would have completed additional due diligence prior to BMONB signing a certificate stating that to the best of its knowledge the FMF Prospectus constituted full, true and plain disclosure of all material facts related to the IPS units. The details are described below. In summary, BMONB and its agents should have:
 - (a) followed up on the declining premiums and declining gain on sale margins experienced by FMF Capital and its competitors;
 - (b) conducted further testing of the distributable cash flow model prepared by FMF;
 - (c) discussed the results of the regulatory due diligence memorandum with the participating underwriters;

- (d) ensured that the FMF Capital loan files reviewed by BMONB's agents were not selected solely by FMF Capital; and
- (e) contacted institutional loan purchasers who purchased loans from FMF Capital.

(a) Declining Gain on Sale Margins

- 18. FMF Capital earned 80% to 90% of its income from the gain on sale premium earned from the sale of pools of loans to institutional investors. The net gain on sale represented the amount by which the premiums earned on sales exceeded the direct costs of originating the loans.
- 19. In the course of its due diligence, BMONB and FMF discussed that FMF Capital's margin on sales of loans was decreasing as FMF Capital's sub-prime mortgage originations grew.
- 20. BMONB requested: (i) detailed historical information on net income, EBITDA and total revenue margins; and (ii) historical premiums earned on a monthly, quarterly and yearly basis over the last 3 years. This information does not appear to have been received by BMONB prior to the FMF Prospectus being filed with the Commission on March 16, 2005.
- 21. In the course of its due diligence, BMONB should have: (i) obtained the requested historical financial information; and (ii) analyzed the declining gain on sale margins on a per loan basis experienced by FMF Capital and its competitors in the months leading up to the IPO in order to properly assess the materiality of this information.

(b) Distributable Cash Flow Model

- 22. FMF prepared a distributable cash flow model to assess whether FMF Capital's projected cash flows over a 12 year period were sufficient to pay distributions on the IPS units and interest on the Subordinated Notes and to repay the remaining debt at the end of the 12 year term of the Subordinated Notes.

23. In the course of its due diligence, BMONB should have obtained a final and complete version of the distributable cash flow model which included missing historical financial information that was requested and should have conducted further testing of the two versions of the model received from FMF.

(c) Due Diligence Memorandum

24. On or about November 23, 2004, BMONB retained Buckley Kolar LLP (“BK”), a Washington, D.C. law firm, as U.S. regulatory counsel to act as its agent in connection with the IPO. BMONB retained BK for its expertise and experience in conducting regulatory due diligence in the United States relating to loan files, compliance and other regulatory matters at FMF Capital.

25. On February 22, 2005, BK delivered its final due diligence memorandum dated February 15, 2005 (the “BK Memorandum”) to BMONB and BMONB’s Canadian counsel. The BK Memorandum concluded, in part, based on BK’s regulatory due diligence that: (i) FMF Capital’s compliance with federal and state law appears inconsistent; (ii) FMF Capital’s compliance procedures and policies require significant development and standardization; and (iii) FMF Capital’s compliance with state law appears to be slightly below average and state compliance controls are weak.

26. BK reviewed and revised portions of four drafts of the FMF Prospectus. Specifically, BK was asked to comment on the industry section of the FMF Prospectus and the disclosure of the risks associated with non-compliance with state and federal laws. FMF retained its own regulatory counsel.

27. Following the provision of BK’s draft report, BK specifically advised BMONB that there was no reason not to file the preliminary prospectus. FMF represented to BMONB that improvements including automation of systems were planned and expected.

28. FMF Capital's compliance weaknesses referred to in the BK Memorandum were not specifically disclosed in the FMF Prospectus and BMONB did not raise the BK Memorandum with the participating underwriters for discussion. BMONB agrees that the BK Memorandum ought to have been discussed with the participating underwriters in order to fully assess the materiality of this information and to consider whether further steps were warranted.

(d) Review of Loan Files

29. As part of the BK review, FMF Capital's loan files were reviewed by BMONB's agents, BK and Clayton Services inc. ("Clayton"). However, BMONB's agents did not select the FMF Capital loan files to be reviewed and relied solely on FMF Capital to select the loan files to be reviewed.

30. In the particular circumstances of the BK review, the loan files to be reviewed by BK or Clayton should not have been selected solely by FMF Capital. BMONB accepts it had the ultimate responsibility for the manner in which its agents conducted the review.

(e) Institutional Loan Purchasers

31. FMF Capital sold approximately 90% of its loans to five institutional loan purchasers in 2004.

32. BMONB obtained names of contact persons at each of these institutional loan purchasers from FMF Capital and prepared a list of questions for the institutional loan purchasers. Ultimately, BMONB did not contact or make inquiries of any of the institutional loan purchasers prior to the IPO.

33. In the course of its due diligence, BMONB should have contacted and made inquiries of the institutional loan purchasers prior to the IPO.

PART IV – CONDUCT CONTRARY TO THE PUBLIC INTEREST

34. By engaging in the conduct described above, BMONB has acted in a manner contrary to the public interest.

PART V – BMONB’S POSITION

35. BMONB proceeded with the FMF Offering in good faith but nonetheless accepts that some aspects of its conduct were not consistent with reasonable underwriting practices.
36. The FMF Prospectus however, was FMF’s as issuer. FMF certified that the FMF Prospectus constituted full, true and plain disclosure of all material facts. BMONB relied on FMF in the course of its due diligence and preparation of the FMF Prospectus. FMF’s ultimate decision to wind-up in March 2007 was the result of many factors including the decline of the subprime lending industry.
37. BMONB co-operated fully throughout Staff’s investigation.
38. During the course of the Staff’s investigation, BMONB waived privilege over its solicitors’ files relating to FMF offering, including the BK file and co-operated with Staff with respect to obtaining information and documents from BK.
39. BMONB participated in the settlement of three class action lawsuits related to the FMF Offering. BMONB contributed \$1.75 million to the settlement of these class actions.
40. BMONB, at its own initiative, carried out a review of its underwriting practices and procedures and implemented revised and updated policies and procedures. The procedures include internal reviews by senior members of BMONB not directly involved in the due diligence process and are conducted at certain key stages of the underwriting. In addition, BMONB conducted training for staff regarding due diligence requirements and procedures.
41. These revised policies and procedures have been in place at BMONB for over two years and resulted from a comprehensive review conducted with both internal and

external resources. The review was designed to ensure that BMONB's underwriting practices and procedures reflect current industry practice. These practices and procedures are subject to periodic continuing review in order to maintain their currency.

PART VI – TERMS OF SETTLEMENT

42. BMONB agrees to the terms of settlement listed below.
43. The Commission will make an order pursuant to subsection 127(1) and section 127.1 of the Act that:
 - (a) the settlement agreement is approved;
 - (b) BMONB be reprimanded;
 - (c) BMONB make a payment of \$3,000,000 to be allocated under s. 3.4(2)(b) of the *Act* to or for the benefit of third parties; and
 - (d) BMONB pay \$300,000 as a contribution towards the costs of Staff's investigation.

PART VII – STAFF COMMITMENT

44. If the Commission approves this Settlement Agreement, Staff will not commence any proceeding under Ontario securities law in relation to the facts set out in Part III of this Settlement Agreement, subject to the provisions below.
45. If the Commission approves this Settlement Agreement and BMONB fails to comply with any of the terms of the Settlement Agreement, Staff may bring proceedings under Ontario securities law against BMONB. These proceedings may be based on, but are not limited to, the facts set out in Part III of this Settlement Agreement as well as the breach of the Settlement Agreement.

PART VIII – PROCEDURE FOR APPROVAL OF SETTLEMENT

46. The parties will seek approval of this Settlement Agreement at a public hearing before the Commission scheduled for November 10, 2010, or on another date agreed to by Staff and BMONB, according to the procedures set out in this Settlement Agreement and the Commission's *Rules of Practice*.
47. Staff and BMONB agree that this Settlement Agreement will form all of the agreed facts that will be submitted at the settlement hearing on BMONB's conduct, unless the parties agree that additional facts should be submitted at the settlement hearing.
48. If the Commission approves this Settlement Agreement, BMONB agrees to waive all rights to a full hearing, judicial review or appeal of this matter under the *Act*.
49. If the Commission approves this Settlement Agreement, neither party will make any public statement that is inconsistent with this Settlement Agreement or with any additional agreed facts submitted at the settlement hearing.
50. Whether or not the Commission approves this Settlement Agreement, BMONB will not use, in any proceeding, this Settlement Agreement or the negotiation or process of approval of this agreement as the basis for any attack on the Commission's jurisdiction, alleged bias, alleged unfairness, or any other remedies or challenges that may otherwise be available.

PART IX – DISCLOSURE OF SETTLEMENT AGREEMENT

51. If the Commission does not approve this Settlement Agreement or does not make the order attached as Schedule "A" to this Settlement Agreement:
 - i. this Settlement Agreement and all discussions, negotiations and documents exchanged between Staff and BMONB before the settlement hearing takes place will be without prejudice to Staff and BMONB; and

- ii. Staff and BMONB will each be entitled to all available proceedings, remedies and challenges, including proceeding to a hearing of the allegations contained in the Statement of Allegations. Any proceedings, remedies and challenges will not be affected by this Settlement Agreement, or by any discussions or negotiations relating to this agreement.
52. Both parties will keep the terms of the Settlement Agreement confidential until the Commission approves the Settlement Agreement. At that time, the parties will no longer have to maintain confidentiality. If the Commission does not approve the Settlement Agreement, both parties must continue to keep the terms of the Settlement Agreement confidential, unless they agree in writing not to do so or if required by law.

PART X – EXECUTION OF SETTLEMENT AGREEMENT

53. The parties may sign separate copies of this agreement. Together, these signed copies will form a binding agreement.
54. A fax copy of any signature will be treated as an original signature.

Dated this 8th day of November, 2010.

“Peter Meyers”
BMO NESBITT BURNS INC.

”Michael Petrocco”
Witness

“Tom Atkinson”
Director, Enforcement Branch