IN THE MATTER OF AN APPEAL TO THE APPEAL COMMITTEE OF THE CANADIAN INVESTOR PROTECTION FUND

RE: [redacted], [redacted] AND [redacted]

Heard By Teleconference: December 2 and December 8, 2015

PANEL:

PATRICK J. LESAGE	)	Appeal Committee Member

APPEARANCES:

[redacted]	)	Appellant on behalf of himself,
	)	Appellant on behalf of herself,
	)	Appellant on behalf of herself.
GRAEME HAMILTON	)	Counsel for Canadian Investor Protection
	)	Fund Staff

DECISION AND REASONS

1. [redacted], [redacted] and [redacted] ("the Appellants"), were clients of First Leaside Securities Inc. ("FLSI"), an investment dealer through which over 1,200 customers made investments in various affiliated companies, trusts and limited partnerships (collectively the "First Leaside Group"). FLSI was registered with the Ontario Securities Commission ("OSC") and was a member of the Investment Industry Regulatory Organization of Canada ("IIROC"). It was also a member of the Canadian Investor Protection Fund ("CIPF" or the "Fund") until its suspension by IIROC on February 24, 2012, being the same date that FLSI was declared to be insolvent and the day after FLSI sought protection under the *Companies' Creditors Arrangement Act*. The relevant history leading up to these events and the role of CIPF with respect to claims to the Fund are set out

in detail in the Appeal Committee's decision in relation to an appeal heard on October 27, 2014, released on December 17, 2014.[1]

2. The hearing of this matter by teleconference was scheduled for December 2, 2015 at 2:30 p.m. At about 2:25 p.m., 5 minutes before the scheduled commencement, Counsel for CIPF Staff and I received a written submission via email from the Appellants. It probably had been sent somewhat earlier. Although it might be said that there was really nothing new in the four-page submission, it did take Counsel for CIPF Staff by surprise. When we commenced the Teleconference Hearing the matter of short service was raised by Counsel for Staff. It was very shortly thereafter agreed by all parties that the matter be adjourned to a later date to permit the consideration of the four-page document received and to permit Counsel for Staff to prepare, if they wished, a written response to that material. As a result, the matter was adjourned, on consent, to December 8, 2015 at 2:30 p.m.

3. On December 8, 2015 at 2:30 p.m., again via teleconference, the same parties who had made an appearance on December 2, 2015 were in attendance.

4. The Appellants' dealings with FLSI and with the First Leaside Group appear to have commenced in 1992. This of course was prior to FLSI becoming an IIROC registrant in March 2004. CIPF coverage could not apply to any transactions prior to March 2004.

5. The claims by the Appellants on CIPF were advanced by the mother, [redacted], $1,012,949.64; by [redacted], the son, $470,595.70; and by [redacted], the wife of [redacted], $16,014.09. The collapse of the First Leaside Group entities created a devastating financial loss for the [redacted] family. Their total claim is approximately $1.5 million.

6. CIPF Staff denied these initial claims concerning these losses by letters dated February 26, 2015. The Appellants appeal the decisions contained in those letters.

7. [redacted] filed comprehensive written submissions on behalf of the three Appellants. In addition, he provided an articulate oral argument at the Teleconference Hearing. The extensive written submissions are similar to a number of other appeals by other appellants.

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[1] This decision is available on the CIPF website and will be referenced throughout as the "October 27, 2014 decision".

8. The nature of these extensive written submissions presented by the [redacted], and as I mentioned used by other appellants, to a considerable extent was summarized in an earlier Decision by Anne La Forest, another committee member, in the matter of [redacted] *et al.* heard in February 2016 and the decision released on March 18, 2016. Ms. La Forest, summarized the extensive written submissions beginning at paragraph 8 of that Decision. I quote from those reasons at some length:

> 8. The principal argument in the written submissions is that the Appellants' losses occurred as a result of fraud and that CIPF Staff and the Appeal Committee in its decisions have incorrectly interpreted the Coverage Policy in a manner that excludes such losses. To support this argument, the Appellants' written submissions refer to statements made by the Mutual Fund Dealers Association in relation to their parallel compensatory scheme that expressly state that the conversion of property can encompass fraudulent actions. The Appellants also rely upon statements made by the Investment Dealers Association in reference to the CIPF to the effect that fraud is not an exclusion from CIPF coverage as long as insolvency has occurred and statements on the CIPF website discussing examples of coverage as follows:
>
> > "The *fraudulent schemes* have included officials at introducing firms who stole customer property that should have been sent to the carrying firms for the customers".
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> Furthermore, the Appellants' written submissions state that CIPF Staff and the Appeal Committee are ignoring earlier CIPF precedents that interpreted the Coverage Policy so as to cover fraud. In this regard, the written submissions refer to the Essex and Thomas Kernaghan matters. Finally, the written submissions state that the Appeal Committee in its October 27, 2014 decision improperly compared itself to SIPA; and in particular, the Appellants referred to the following quote from the *Madoff* decision:
>
> > It is not at all clear that SIPA protects against all forms of fraud committed by brokers. See *In re Investors Ctr., Inc.*, 129 B.R. 339, 353 (Bankr.E.D.N.Y.1991) ("Repeatedly, this Court has been forced to tell claimants that the fund created for the protection of customers of honest, but insolvent, brokers gives them no protection when the insolvent broker has been guilty of dishonesty, breach of contract or fraud.")
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> In the Appellants' contention, the Appeal Committee's reference is incorrect because on the actual facts of the *Madoff* case, the issue was not about whether coverage was to be provided but rather the issue was the manner in which "net equity" should be calculated given that the "fraudulent" brokerage statements reflected fictitious securities "that were never ordered" [my emphasis]. Stated more directly, the Appellant's argument is that in *Madoff*, fraud resulted in the investors' losses and coverage was provided and that a similar result should flow in the case of FLSI.

9. To summarize, the principal argument in the Appellant's written submissions is that the Appeal Committee's October 27, 2014 decision is in error because it excludes losses that arise from fraud from the Coverage Policy. The difficulty with this argument is that it arises from a misunderstanding of the October 27, 2014 decision. The Appellants in their written submissions refer to paragraph 32 of the October 27, 2014 decision:

> After careful consideration, we conclude that fraud, material non-disclosure and/or misrepresentation, *as alleged in this case* [my emphasis], are not covered by the words "including property unlawfully converted" under CIPF's Coverage Policy. The Appeal Committee does not find the phrase to be ambiguous.

In its October 27, 2014 decision, and indeed all of its decisions, the Appeal Committee is required to assess the facts of each Appellant's case and determine whether or not the alleged loss falls within the Coverage Policy. In this regard, the critical sentence in the Coverage Policy reads as follows:

> CIPF covers customers of Members who have suffered or may suffer financial loss solely as a result of the insolvency of a Member. *Such loss must be in respect of a claim for the failure of the Member to return or account for* securities, cash balances...or other *property, received, acquired or held by, or in the control of, the Member for the customer, including property unlawfully converted.*

The facts "as alleged" in the October 27, 2014 decision were that the Appellant had been induced by the principals of FLSI to invest in products of the First Leaside Group. The Appeal Committee does not and has not questioned that the principals of FLSI misrepresented the First Leaside Group products or CIPF coverage or even that there may have been fraud in this regard.

As noted in the October 27, 2014 decision, the Appeal Committee is not a court but we are aware of decisions that have been made by the OSC and IIROC in relation to the principals of FLSI. The problem for the Appellant in that decision and for the Appellants in this case is that they directed the purchase of the investments, the investments were purchased, and the investments were returned to them in the form of certificates or have been accounted for in the bankruptcy process. It is the failure to return or account for property including through unlawful conversion that triggers protection under the Coverage Policy. The Appellants are correct that fraud can result in coverage under the Coverage Policy but in all of the examples provided by the Appellants in their written submissions, the fraud resulted in a failure to return or account for property. Thus, for example in the Essex matter, the Member may have acted fraudulently but what triggered coverage is the fact that the Member misappropriated the customer's property; the Member used client funds without authorization on several occasions. That resulted in a failure of the Member to return or account for customer property which is why coverage was provided.

Similarly, in the *Madoff* decision, there never were investments made as directed by investors; the trades were fictitious and the funds invested were not used to purchase investments but rather were misappropriated. That is not this case. Here, in the case of each investment, the Appellants directed the purchase of the investments, the purchases were made, and the investments were returned or accounted for. ...

10. In their written submissions, the Appellants also argued that the Appeal Committee's focus on fraud in the October 27, 2014 decision was misplaced and that the real cause of their losses arose from insolvency as required by the Coverage Policy. Furthermore, the Appellants argued that their loss was a result of the insolvency and not a decline in the market value of their securities as argued by CIPF Staff. The Coverage Policy expressly provides for coverage of financial loss that arises solely as a result of the insolvency of the Member. As was noted in the October 27, 2014 decision, the Coverage Policy also expressly excludes losses that do not result from the insolvency of a Member such as "customer losses that result from changing market values of securities, unsuitable investments or the default of an issuer of securities". At paragraph 48, the Appeal Committee stated as follows: "Investments made in circumstances of fraud, material non-disclosure and/or misrepresentation, as suggested by counsel for the Appellant, would certainly be seen as unsuitable investments, which are excluded from the Coverage Policy".

11. The Appellants, ... also argued in their written submissions that by delivering their "off book" investments to them in certificated form, FLSI acted contrary to IIROC Member rules and that this facilitated an unlawful conversion by diverting securities from the Appellants' accounts. Furthermore, and connected to the last point, the suggestion was made that the certificated securities were not "securities" pursuant to the Coverage Policy. As noted in the CIPF Staff submissions, there is no IIROC Member Rule prohibiting securities being held in certificated form. The facts before me make clear that in all cases where the securities were held "off book", the Appellants' signed directions specifically requesting that the certificate be sent to them and that these certificates were in the possession of the Appellants as at the date of the insolvency. ...

12. The Appellants also raised concerns in relation to CIPF's failure to engage in regulatory oversight of FLSI. As I have noted in other decisions, CIPF is not a regulator and has no power to investigate or discipline members. That authority rests with the OSC or IIROC. Rather, CIPF is a fund providing coverage in accordance with the relevant coverage policy in effect at the time of insolvency of an IIROC member. It is of concern to the CIPF Board of Directors that its coverage has been misrepresented and that members of the public may misunderstand it. As has been noted in other decisions of the Appeal Committee, a review of CIPF's communication with investors through its website and brochures is being undertaken.

13. Finally, the Appellants made arguments in response to CIPF Staff written submissions in relation to the methodology by which the value of their securities is to be determined. Given that my conclusion in this case is that there has been no

failure to return or account for property, it is unnecessary to comment further on this point.

9. I agree with the comments and reasoning of Ms. La Forest in the above-cited appeal.

10. The oral submissions by [redacted] on behalf of the Appellants in this hearing, amongst other matters, dealt with the fact that the Appellants believed their investments were being used for a specific purpose(s) when First Leaside Group in fact used them for other purposes. This they submit is an unlawful conversion of their funds. As in Ms. La Forest's Decision the Appellants make significant reference to the Essex Capital Management Limited insolvency and the compensation payment by CIPF. They submit that their situation is no different than the Essex Capital Management case and therefore, if CIPF is being honest and consistent, it should compensate them for their losses just as it did for some of the clients in the Essex Capital Management case. At one point, it was expressed as follows: "the fallacy of CIPF's continual 'custodial argument' is in trying to convince investors (and themselves) that the misappropriation of the proceeds of the sale of security is not within CIPF Coverage Policy, when in fact, misappropriating such proceeds is a clear act of conversion of customer property. Essex is the prime example of this." Further, the Appellants submit that ... "CIPF has not even helped Appellants who claim to not be in possession of their certificates. This is my case with respect to some of my off-book assets such as Wimberly Apartments Ltd. partnership where I've never received a certificate. For both [redacted] (455.06 and 432.58 units) and myself (1,793.96 units) have First Leaside Fund (Series C) missing relevant documents in the record."

11. The Appellants also submitted that the CIPF Appeal Committee in earlier decisions misused U.S. decisions. Essentially the Appellants submit such references were (a) unrelated to the issues in question; (b) misinterpreted; (c) wrongly decided. They also submit that the MFDA Coverage Policy reflects a better example of what is and what should be covered.

12. Ms. La Forest's excerpted decision deals with the use of the U.S. decisions. I agree with her.

13. The comments concerning the MFDA coverage reflecting a better example of what is and what should be covered is not an argument that I am prepared to consider. It is the CIPF Coverage Policy we are dealing with, not the MFDA policy.

14. CIPF coverage basically is a custodial coverage. It ensures the return to the client of money, certificates or other assets that are in the custody of a registered broker at the time of insolvency, and compensation for any asset of the client that has been unlawfully converted by the broker.

15. Unlawful conversion is a form of theft. If the registered broker steals your assets you are entitled to make a claim on CIPF. If however, your broker misleads you in any fashion about the product he/she is obtaining for you that is fraud, which is not covered by CIPF. As I have written in earlier decisions...unlawful conversion at its simplest means the 'converting' of another person's property that is in one's possession for a purpose beyond the terms that govern that possession.

16. FLSI received the Appellants' money on terms that FLSI comply with the client's direction. When FLSI complies with that direction they are fulfilling the terms on which they received the client's money. When FLSI receives the indicia of that purchase from the entity in which the investment is made, usually in the form of certificate, shares, bonds, etc., their obligation is to deal with that documentation as directed by the client. That direction could be to hold 'on book', to 'transfer' to another dealer or to forward to the client or other person designated by the client. This is what happened. I recognize that some of the Appellants' dealings with First Leaside appear to go back to 1992, which of course in any event preceded, by 12 years, FLSI becoming an IIROC Registrant in March 2004. Any of those transactions would not be covered by CIPF, nor would CIPF have access to the records of FLSI prior to their becoming an IIROC Registrant.

17. I also recognize that there were stock dividends allocated to the Appellants that were not transferred to them by the receiver. The reason, which I accept for this failure, is because there is no record of those stock dividends ever having been received by FLSI.

18. The Appellants also submitted that some of the other certificates were not in FLSI possession. For example, page 267 of Volume 1 of the Appeal Record refers to 5,000 units of First Leaside Wealth Management Trust Fund, but FLSI held no corresponding certificates. This perhaps is explained by the Direction document authorizing that purchase found at Tab B-14 of

Volume 1, which directs the certificates to be forwarded to Penson ITF [redacted]. [redacted]'s purchase of a similar number of units of the same product within a few days of his mother's purchase also discloses that the direction is for that the certificates be forwarded to Penson ITF [redacted], see Volume 1, Tab A-12.

19. In the same vein, one sees at Volume 1, Tab B-1 and 2, that [redacted] directed the certificates of her significant purchases in September 2008, amounting to approximately $800,000.00, be forwarded to her home address. At Tab B-5, she directs those certificates be sent to Penson ITF [redacted]. At Tab B-9, in October 2009, her Direction requires the certificates be sent to her home address.

20. The Appellants also submitted that FLSI, after learning in early 2009 that First Leaside, was being investigated by the OSC, had a duty to disclose that information to their clients - and they most certainly had an obligation to do so from August 19, 2011 upon receipt of the Grant Thornton Report.

21. The OSC at paragraph 3 of its decision found Phillips' and Wilson's actions during the period August 22, 2011 and October 28, 2011 were..."deliberate and formed part of a wilful strategy to continue to raise capital for FLG in order to meet its obligations across the spectrum of its entities". At paragraph 4 of that same decision, the OSC Panel found that Phillips and Wilson made statements that were untrue or omitted information necessary to prevent their respective statements from being false or misleading in the circumstances... Later at paragraph 68, the OSC Panel described the conduct of Wilson and Phillips as being "engaged in or participated in ... course of conduct relating to securities that they knew would perpetrate a fraud on FLG sales investors ..." I agree with the Panel.

22. As has been noted in earlier decisions of the Appeal Committee, CIPF coverage does not extend to the acts of malfeasance, misfeasance or for a loss that flows from the diminution of the value of investments. It does cover unlawful conversion and return of monies or securities being held by the broker. It does not cover acts of deceit, falsehood, material representation, non-disclosure or other fraudulent conduct.

23. The Appellants, as mentioned, also raise the issue of the manner in which CIPF dealt with the coverage in relation to Essex Capital Management Limited insolvency and the Thompson Kernaghan cases several years ago.

24. As I understand the facts, there was no compensation to clients of Thompson Kernaghan, rather a payment was made by CIPF to the bankrupt estate to facilitate transfer of documents from the estate to the Trustee and that were eventually returned to clients.

25. The Essex Capital Management case did result in CIPF transferring some substantial funds to compensate 'only those clients whose funds had been unlawfully converted'. For example, a number of clients had their funds transferred to persons, places or entities when there had been no authorization or direction to so do from the client. In other words in those circumstances, there was unlawful conversion or more bluntly, theft, by the broker. There were also many circumstances of clients' funds being diverted or invested in a fund that really did not exist and for which there had been no such direction from the client. In addition, there was compensation paid to some clients who had provided the broker with instructions to invest funds in a purported entity which the broker was promoting. Those funds were invested by the broker in an entity that had no legal existence. It was, to express it bluntly a 'phantom' entity, which was conceived by the broker and was not a licensed or regulated deposit taker. CIPF Staff Counsel also points out, whilst there is a discrepancy in the amount CIPF paid out to clients in that case and the amount found to be 'unlawfully converted' by the IDA (predecessor to IIROC), that discrepancy is explained by the fact that the IDA Decision deals only with a small subset of Essex clients. Not all of the clients who subsequently made claims were included in that IDA Decision. I accept that explanation as the reason for the discrepancy.

26. What occurred with some clients in Essex was unlawful conversion in that the broker without any direction from the client invested their client's money. This is unlike the situation with FLSI where the investments were all made in entities that, although connected to FLSI, were separate independent entities legally authorized to accept those investments. It is also to be noted that the prospectus or the trust declarations of those companies set out the objects and purpose for which the investment was to be used. For instance, although the primary object of some of them was to … "acquire, invest in, holdings, transferring, disposing of and otherwise dealing with the

Master Sherman Notes and the participation rights granted in conjunction therewith", there existed in almost every case a paragraph that also described one of the objects of the investment was … "b) the acquiring, investing in, holding, transferring, disposing of and otherwise dealing with securities of, or lending to any First Leaside Group Member provided that such securities or lending activities by their terms, are no less favourable than the Master Sherman Notes." Examples of this are set out in Tabs 1, 2, 4, 5, 6, 7, 8, 9 of Volume 2 of the Appeal Record where such statements are found in … Confidential Offering Memorandum: Amended Consolidated and Re-stated Declarations of Trust: Schedule D of Canadian Partnership Agreement (in respect of Wimberly Apartments Limited Partnership) etc.

27. Although I have not set out in detail all of the submissions covered in the written 47-page submission plus attachments and the Appellants' oral submissions on this hearing, I have taken them all into consideration in deciding this matter. Some submissions seemed to me to have little relevance to the issues in this appeal; nevertheless, I have considered them in arriving at my conclusion.

28. The Appellants in this case provided 'Directions' to FLSI to purchase on their behalf units, etc. in specific First Leaside Group entities. FLSI did that. The certificates and other indicia of the ownership/investment in those entities, as far as can be seen from the existing documentation, were dealt with as directed by the Appellant purchasers. There was no theft or unlawful conversion by FLSI of the Appellants' assets.

29. Although the principals, Phillips and Wilson of FLSI, were found by IIROC and the OSC to have committed fraud, at least during the specific period of time when the Appellants were still making investments, fraud is not included in CIPF coverage.

30. As tragic as the consequences have been for the Appellants, I must accept the decision of Staff denying coverage.

31. These appeals must therefore be dismissed.

Dated at Toronto, this 4th day of May, 2016

Patrick J. LeSage