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

RE: [redacted] and [redacted]

Written Appeal Scheduled: May 5, 2016

APPEAL CONSIDERED BY:

BRIGITTE GEISLER Appeal Committee Member

DECISION AND REASONS

Introduction and Overview

1. [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", making it a "CIPF Member") 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.[1]

2. The Appellants sought recovery from CIPF on the basis that FLSI was a Member of CIPF and as such the Appellants were entitled to protection through the Fund which was established to provide coverage in the event of insolvency. CIPF Staff made a decision denying compensation to the Appellants on the basis that the Appellants' losses did not arise as a result of the insolvency of FLSI and thus were not covered under the CIPF Coverage Policy dated September 30, 2010.

3. The Appellants requested that their appeals be considered on the basis of written materials which they provided.

Chronology of Events Relevant to the Appellants' Claim

(i) The Appellants' Investments and Claim

4. The claim arises from the Appellants' investments in various First Leaside Group products as follows:

- [redacted] ("[redacted]"): a total net claim of $558,970.94, which includes claims for stock dividends ($1,940), and also for undocumented amounts ($34,771.93). His claim has been reduced by $83,496.41 representing amounts received as return of capital and distributions received from the Insolvency Trustee;
- [redacted] ("[redacted]"): a total net claim of $1,285,211.01, which includes claims for stock dividends and exchanges ($5,783), and also for undocumented amounts

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

($107,788.14[2]). This claim has been reduced by $272,876.17 representing amounts received as a return of capital and distributions received from the Insolvency Trustee and also a relatively minor discrepancy in the purchase price of First Leaside Fund (Series B); and

- [redacted] ("[redacted]"): a total net claim of $16,871.53, which includes a claim for a credit balance of $1,374.53 which has been withdrawn from [redacted] account.

5. Certificates representing the Appellants' purchases were transferred to accounts in the names of the Appellants at Fidelity Clearing Canada ULC or were delivered to the possession of the Appellants, with the exception of the securities which are undocumented and for which records are unavailable.

(ii) The Appellants' Application for Compensation

6. The Appellants applied to CIPF for compensation for their losses in investments made through FLSI. By separate letters to [redacted] and [redacted] dated February 18, 2015, and in the case of [redacted], dated November 20, 2014, the Appellants were advised that CIPF Staff were unable to recommend payment of their claims. The relevant parts of the letters read as follows:

> Regarding your claim for unlawful conversion, it does not appear to us that any property held by FLSI for you was converted or otherwise misappropriated….losses caused by dealer misconduct, compliance failures or breaches of securities regulatory requirements in respect of the distribution of securities are not covered by CIPF. The securities that you purchased were subject to the disclosure of an offering memorandum or other offering documentation which, among other things, disclosed the risks relevant to the purchase and the investment. These investments, like any securities, were subject to market forces and, unfortunately, your loss appears to have been a loss caused by a change in the market value of your investments and not a loss resulting from the insolvency of FLSI.

[2] The undocumented amounts includes the amount of $22,000, an investment in First Leaside Properties Limited Partnership. Records indicate that this investment was sold on December 1, 2009, however, the Appellant has included this amount in her claim.

Analysis

7. In their written submissions, the Appellants raised numerous arguments derived from various sources such as representative counsel's arguments regarding the interpretation of the phrase "including property unlawfully converted" in the Coverage Policy, and submissions originating from another First Leaside Group investor, [redacted]. The former arguments are similar to those advanced at the October 27, 2014 appeal hearing. The Appellants submitted that they intended the funds they invested be applied to proprietary First Leaside products for the primary purpose of funding the acquisition and/or development of various real estate projects; instead, these funds were unlawfully converted by FLSI for its own use.

8. These arguments have generally been advanced with respect to purchases by investors of the First Leaside Group products following the commencement of the OSC investigation in the fall of 2009. The Appellants, however, suggest that these arguments should be applicable to all investments made with the First Leaside Group, presumably going back to 2005. The Appellants [redacted] and [redacted] have claimed investments which have not been documented and it is not known if that is because the investments were made prior to 2004 when FLSI became a member of the IDA (now IIROC). In any event, Appellants submit that the timing of the investments is not relevant as the "misconduct occurred throughout FLSI's eight year tenure as a Member of CIPF."[3] In that same submission, however, the Appellants suggest that the actions of the OSC caused FLSI to cease operations and that had this intervention not occurred, "the securities would have continued to hold their value, income and other monetary benefits would have continued to flow to the investors."[4]

9. These submissions would appear to be inconsistent on their face. If the complaint is that funds were being diverted from their intended purpose, it does not seem likely that the First Leaside Group's operations would have continued unimpeded and without impact on investors. With

[3] See Appeal Record Volume 1, page 111.
[4] See Appeal Record Volume 1, page 112.

respect to an appeal to CIPF, however, the conduct of the OSC does not have an impact. The OSC is a regulatory body created under the *Ontario Securities Act*. CIPF, on the other hand, is a private, not-for-profit organization financed by members of IIROC to ensure the return of investor assets in the event of an insolvency. It has no regulatory or disciplinary powers over its Members. Nor does CIPF have any authority over the OSC and its fulfilment of its duties and obligations.

10. As was fully discussed in the October 27, 2014 decision, the Appellants' arguments of the possible misuse of investors' funds do not lead to the conclusion that what happened in this case falls within the meaning of the phrase "including property unlawfully converted" as set out in the Coverage Policy. That phrase is intended to address the situation where there is a failure to return property to the customer because it has been improperly confiscated by the broker, an issue which has not been raised in this Appeal. To apply the interpretation suggested by these written arguments would, in effect, create a new head of coverage relating to fraud, material non-disclosure and misrepresentation. The October 27, 2014 decision deals extensively with the written arguments raised on this appeal. This Appeal Committee adopts the reasoning in the October 27, 2014 decision.

11. Prior to the commencement of the OSC investigation, there was no evidence of misconduct within the First Leaside Group of companies. In fact, the OSC prosecution of the principals of the First Leaside Group of companies focused on an even more limited time period in 2011; during this period the Grant Thornton Report was received, but not communicated to the public, and the First Leaside Group continued to raise investment funds.

12. The Appellants have placed much emphasis on the issue of "off-book" investments and control of those investments. The Appellants submit 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.[5] As noted

[5] The purpose of the IIROC Rule is to ensure that all transactions have occurred on the books and records of the Member, which was the case for the investments made by the Appellants. The delivery of the certificates to the Appellants does not violate this rule.

in the CIPF Staff submissions, there is no IIROC Member Rule prohibiting securities being held in certificated form. The Appeal Record provides copies of the Appellants' signed directions specifically requesting that certificates be sent to them.[6] As the securities were held in the possession of the Appellants, the securities could not be transferred or disposed of without the Appellants' authorization. As such, they were the ones who had control over the certificates. The Appellants' submission that FLSI had control over the securities regardless of the fact that certificates were delivered to the Appellants does not have relevance to the claim. There is no issue with respect to control of the certificates other than their being accounted for either through delivery of the certificates to the Appellants or being held in their accounts. The Appellants' suggestion that the purpose of delivery of certificates to investors was to void CIPF coverage is not the point. The Coverage Policy provides that CIPF ensures that securities are accounted for, which has been the case.

13. The Appellants' materials included additional submissions which were included with the materials for the Appellant [redacted]; however, I will consider them in application to all of the Appellants. These additional submissions appear very similar to those submitted by [redacted] in his appeal. The principal argument in the written submissions is that the Appellants' losses occurred as a result of fraud and that CIPF Staff and that in its decisions, the Appeal Committee has 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."

[6] There are numerous examples of this in Appeal Record Volumes 1 and 2.

14. 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[7] matters. Finally, the written submissions contend that the Appeal Committee in its October 27, 2014 decision improperly compared itself to SIPA[8] 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.")[9]

15. In the Appellants' contention, our 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 Appellants' 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.

16. In summary, the Appellants' principal argument is that the 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 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

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[7] In the Thomas Kernaghan case, CIPF did not provide compensation to customers of the member.

[8] 15 U.S.C. § 78aaa *et seq*.

[9] *In re Bernard L. Madoff Investment Securities LLC, Debtor*, 654 F. 3d 239 (2011).

Committee does not find the phrase to be ambiguous.

17. 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.* [my emphasis]

18. The facts presented 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, decision, we are 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 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.

19. 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 at issue resulted in a failure to return or account for property. Thus, for example in the Essex matter, the CIPF Member may have acted fraudulently but what triggered coverage is that 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.

20. 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. In this case, the Appellants directed the purchase of the investments, the purchases were made, and the investments were either held in the Appellants' accounts or certificates representing their purchases were delivered to them. The Coverage Policy thus does not exclude losses arising from fraud but the fraud that is alleged must result in a failure to return or account for property. As there is no such failure in this case, the appeal fails on this basis alone. Nonetheless, I will briefly respond to the other arguments made by the Appellants.

21. 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 losses were as a result of the insolvency and not a decline in the market value of their securities as argued by CIPF Staff.

22. The Coverage Policy expressly provides for coverage of financial loss that arises solely as result of the insolvency of a CIPF Member. It does not provide coverage for the insolvency of an issuer. As was noted in the October 27, 2014 decision, the Coverage Policy 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".

23. The Appellants submitted that there was fraudulent action by the FLSI with respect to the investor funds. The Appellants, as have many others, failed to distinguish between FLSI - the

CIPF Member firm, and the First Leaside entities. This is understandable as many entities also bore the name "First Leaside" and many also entered into insolvency at approximately the same time. Respectfully, the oversight of investor funds is a role for the Boards of Directors of the companies or its auditors, and not something that a non-regulator such as CIPF would, or could, properly undertake. CIPF has no jurisdiction over, or relationship with issuers, only with the CIPF Member.

24. The Appellants also raised concerns in relation to CIPF's failure to engage in regulatory oversight of FLSI. 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.

25. The Appellants addressed the comments made by another Appeal Committee Member with respect to the limitations of his exercise of discretion.[10] They suggested that the comments are indicative of a bias towards the denial of claims because of the potentially large impact on the CIPF Fund. The Appellants are incorrect in two aspects. Firstly, the comments were made only to illustrate that discretion must be exercised within the bounds of the Coverage Policy, as noted above. Secondly, the Appellants suggested that Appeal Committee Members see their role as protecting the Fund, which, I can assure them, is not the case.

26. The Appellants made reference to the IIROC disciplinary decision involving Messrs. Philips and Wilson, the principals of FLSI. They quoted numerous comments by the Hearing Panel about the conduct of the principals, which was roundly condemned. It must be noted, however, that the regulatory infractions brought against Messrs. Philips and Wilson largely focused on suitability issues in the marketing of the investments, the failure to properly describe risk factors, which included marketing materials, and the conflict of interest with respect to "blind pools" which were

[10] Appeal Committee Decision dated June 19, 2015.

promoted by Mr. Philips. While these are serious allegations, these are not the same as the complaints made by the Appellants, which seem more concerned about improper conduct within the issuers, or other issues such as "off-book" transactions.

27. It is important to emphasize that CIPF's mandate and the coverage it affords are custodial in nature; in other words, to ensure that the clients of an insolvent member have received their property. This custodial coverage is set out in CIPF's mandate, which is approved by the OSC and other provincial securities regulators. The mandate is restricted to this coverage, and does not extend to coverage for fraud, material non-disclosure and/or misrepresentation or a change in value of the investment. The Appellants have received their property; their issue with its valuation is not within the CIPF mandate. It is most unfortunate that the value of the property is uncertain; however, the Coverage Policy clearly states that CIPF does not cover changing market values of securities, unsuitable investments, or the default of an issuer of securities.

28. The Appellants submit that the marketing materials provided by the First Leaside Group contained assurances that they were covered by CIPF.[11] We have heard from many Appellants who have stated that they were told that their investments were safe because there was CIPF coverage. It is correct that their investments were safe, in that property held in a customer's account of a CIPF Member firm would be returned to the customer in the event of an insolvency, but it seems that it was implied and believed by many investors that the coverage extended far beyond a return of property and included a "guarantee" of the principal of their investment. It does not. It is not an insurance scheme to cover fraud, like the one that can be found in Quebec. In fact, the existence of the Quebec fund confirms the narrowness of CIPF coverage in that the Quebec government realized that there was a gap in coverage for investor losses as a result of fraud and has provided limited coverage.

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[11] See, as an example, the promotional material for "Flex Fund" found at Appeal Record Volume 1, page 136. This brochure includes a marked off square which states that the agent for the sale of these securities is FLSI, and includes the IIROC and CIPF logos. It is understandable that customers may have concluded that CIPF coverage extended beyond FLSI itself.

29. I have considerable sympathy for the losses suffered by the Appellants; however, I conclude that the Appellants' submissions in this appeal are not persuasive and do not give rise to a successful claim for compensation from CIPF.

Disposition

30. The appeals are dismissed. The decisions of CIPF Staff are upheld.

Dated at Toronto, this 25th day of May, 2016.

Brigitte Geisler