

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

RE: [REDACTED] and [REDACTED]

Heard: February 18, 2016

HEARD BEFORE:

BRIGITTE GEISLER

Appeal Committee Member

APPEARANCES:

Nicolas Businger

) Counsel for Canadian Investor
) Protection Fund Staff

[REDACTED]

) On his own behalf and representing
) [REDACTED]

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”) 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. On February 18, 2016, an Appeal Committee Member of CIPF's Board heard an appeal to determine whether to depart from the decision of CIPF Staff. The appeal hearing was held at Neeson Arbitration Chambers in Toronto, Ontario. [REDACTED] ("[REDACTED]"), represented himself and the corporate Appellant at the appeal hearing.

Chronology of Events Relevant to the Appellants' Claim

(i) The Appellants' Investments and Claim

4. The claim arises from the Appellants' purchase of various First Leaside Group products, namely: First Leaside Progressive Limited Partnership; First Leaside Properties Fund (Class B) and First Leaside Expansion Limited Partnership units for a total investment of \$25,000 in the case of [REDACTED] and \$125,000 in the case of [REDACTED]. These claim amounts were reduced by distributions received by the Appellants, being \$6,004.18 and \$10,149.66, respectively.

5. Certificates representing the Appellants' investments were delivered into the possession of [REDACTED], pursuant to his direction.

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

(ii) *The Appellants' Application for Compensation*

6. The Appellants applied to CIPF for compensation for their losses in investments made through FLSI. By letters dated February 17, 2015, the Appellants were advised that CIPF Staff were unable to recommend payment of their claims. The relevant parts of the letters read as follows:

...losses caused by dealer misconduct, compliance failures or breach of securities regulatory requirements in respect of the distribution of securities are not covered by CIPF. The securities that were 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, the loss appears to have been a loss caused by a change in the market value of the investments and not a loss resulting from the insolvency of FLSI.

Analysis

7. The Appellants had provided extensive written submissions in advance of the hearing, including an additional submission which was received just prior to the hearing. However, at the hearing itself, [REDACTED] confined himself to some brief comments as set out in the written submissions and then left the hearing room stating that denial of his claim was a foregone conclusion.

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. In addition, the Appellants rely on 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.²

9. 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 Capital Management Ltd. ("Essex") and Thomas Kernaghan³ matters. Finally, the written submissions state that the Appeal Committee in its October 27, 2014 decision improperly compared itself to SIPA,⁴ 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.")⁵

10. 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 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.

11. 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 October 27, 2014 decision. The Appellants in their written submissions refer to paragraph 32 of the October 27, 2014 decision:

² Member's Section FAQ.

³ In the Thomas Kernaghan case, CIPF did not provide compensation to customers of the member.

⁴ 15 U.S.C. § 78aaa *et seq.*

⁵ *In re Bernard L. Madoff Investment Securities LLC, Debtor*, (2011) 654 F.3d 230 at 239 (2nd Circ.).

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.

12. 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.* [emphasis added]

13. 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, 2014 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 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.

14. 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 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.

15. Similarly, in the *Madoff* decision, investments were never 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 delivered to the possession of the Appellants. 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.

16. In their written submissions, the Appellants also argue 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 argue that their loss was as a result of the insolvency and not a decline in the market value of their securities as argued by CIPF Staff.

17. The Coverage Policy expressly provides for coverage of financial loss that arises solely as result of the insolvency of the Member. It does not provide coverage for the insolvency of an issuer.⁶ 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

⁶ For example, First Leaside Progressive Limited Partnership is an issuer; in other words, it raised investment money from the public, in exchange for which it issued shares.

for the Appellant, would certainly be seen as unsuitable investments, which are excluded from the Coverage Policy”.

18. The Appellants submitted that there was fraudulent action by the FLSI with respect to the investor funds. The written submissions states:

CIPF is hiding behind the various Offering Memoranda written by FLSI, justifying them as blanket documents that essentially allow Member firms to legally conduct fraudulent actions with investor funds. CIPF is essentially saying that as long as the intended security is purchased, other than this, there is no minimum requirement for any Member firm’s conduct with respect to how these funds are used.

Respectfully, the oversight of investor funds with the issuers 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.

19. The Appellants, as have many others, failed to distinguish between FLSI - the Member firm - and the other First Leaside Group entities. Although there was an overlap in the roles of the principals of FLSI and the First Leaside Group, the entities were separate and were separately regulated. The Appellants’ confusion is understandable as many entities also bore the name “First Leaside” and many also entered into insolvency at approximately the same time. This may account for the comments in the paragraph above.

20. The Appellants also argue 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. The IIROC rules require that securities transactions be recorded on the books and records of the Member, however, this does not preclude the delivery of certificates to the customer. The Appeal Record provides copies of the

Appellants' signed directions specifically requesting that the certificate be sent to them.⁷ 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.

21. The Appellants also raise 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.

22. In their submissions, the Appellants address comments made by another Appeal Committee Member with respect to the limitations of his exercise of discretion.⁸ The Appellants suggest 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.

23. It is important to emphasize that CIPF's mandate and its coverage is 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.

⁷ See Appeal Record Volume 1, Tab A- 1, Tabs B-1, B-3 and B-5.

⁸ Appeal Committee Decision dated June 19, 2015.

The Appellants have received their property; their issue with its valuation is not within the CIPF mandate.

24. The Appellants' written submissions were extensive; however, I conclude that they are not persuasive and do not give rise to a successful claim for compensation from CIPF.

Disposition

25. The appeals are dismissed. The decisions of CIPF Staff is upheld.

Dated at Toronto, this 15th day of March, 2016.

Brigitte Geisler