

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

RE: [REDACTED], [REDACTED], [REDACTED],
AND [REDACTED]

Heard: February 8, 2016

HEARD BEFORE:

ANNE W. LA FOREST

Appeal Committee Member

APPEARANCES:

Nicolas Businger

) Counsel for Canadian Investor
) Protection Fund Staff

[REDACTED]

) On his own behalf
and on behalf of [REDACTED], [REDACTED]

[REDACTED], and [REDACTED]
[REDACTED]

DECISION AND REASONS

Introduction and Overview

1. [REDACTED], [REDACTED], [REDACTED], and [REDACTED]
[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 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. FLSI was declared to be insolvent on February 24, 2012. 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 8, 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 took place at Neeson Arbitration Chambers in Toronto, Ontario. The Appellant, [REDACTED], was in attendance and made submissions on his own behalf as well as on behalf of the other Appellants.

Chronology of Events Relevant to the Appellants’ Claim

(i) The Appellants’ Investments and Claim

4. The Appellant, [REDACTED], claims the amount of \$591,252.77 with respect to his purchases of various First Leaside Group products purchased between December 19, 2005 and October 6, 2011. The Appellant, [REDACTED], claims the amount of \$310,455.11 with respect to her purchases of various First Leaside Group products purchased between May 4, 2007 and September 2, 2011. The Appellant, [REDACTED], claims the amount of \$75,000

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

with respect to its purchase of First Leaside Series II Preferred Shares on February 5, 2010. The Appellants, [REDACTED], claim the amount of \$77,778.83 with respect to their purchases of three First Leaside Group products purchased between May 4, 2007 and December 24, 2010. Many of the products were purchased by the Appellants during the period after the OSC began investigating FLSI in the fall of 2009 and some after the period after the Grant Thornton report was released in August of 2011.

5. Certificates representing the Appellant, [REDACTED]'s, purchases were either delivered to his possession or the units were transferred to an account in his name at Fidelity Clearing Canada ULC ("Fidelity") in December 2012. Units representing the Appellant, [REDACTED]'s, purchases were transferred to an account in her name at Fidelity in December 2012. A certificate representing the corporate Appellant [REDACTED]'s purchase was delivered to the corporation's possession. Units representing the Appellants, [REDACTED] [REDACTED]'s, purchases were transferred to an account in their name at Fidelity in December 2012. The materials filed before me establish this and statements made by the Appellant, [REDACTED], during the hearing confirm these matters.

(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 dated February 24, 2015, the Appellants were advised that CIPF Staff were unable to recommend payment of their claims. The relevant parts of the letter to the Appellant, [REDACTED], read as follows:

Regarding the claim for unlawful conversion, it does not appear to us that any property held by FLSI for you was converted or otherwise misappropriated. In addition, as a basis for explaining your claim, you stated:

"[...] The fact that all accounts were also fully covered by IIROC and CIPF assured us of the added security of our investments [...]"

“[...] I am humbly requesting CIPF to consider the nature of the investment, its complete non-liquidity, the deceit used by FLSI to generate this asset, and the full set of circumstances surrounding this claim.[...]

“Thus, based on IIROC’s decision re: Roger Schoer from 2011, it is obvious that David Phillips misappropriated funds and ran a Ponzi-scheme, constituting illegal conversion.”

“[...] this claim has full requirements for coverage eligibility: a) FLSI was/is a CIPF Member, b) FLSI was insolvent, c) FLSI had a registered cash/investment account on its books for me that it had full control over, d) monies in this account were unlawfully converted during and after investments were purchased (in more ways than one), and d) [sic] assets invested could not be returned to me.”

We take note of your explanations. However, 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, the 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.

With respect to the securities that you purchased [which were held on book], they were properly recorded in the books and records of FLSI at the date of insolvency. Those securities were transferred to accounts in your name at another IIROC Dealer Member subsequent to February 24, 2012.

In addition, at the date of insolvency, the securities [which were held off book] were not held by, or in the control of, FLSI. Therefore, the loss is not one that is eligible for CIPF coverage, as indicated above.

The letters to the other Appellants were substantially the same.

Analysis

7. The Appellants provided lengthy submissions in writing that were provided in advance of the hearing. Counsel for CIPF Staff informed me that these arguments were developed by a number of investors but primarily another CIPF Appellant ([REDACTED]) and that they had been relied upon in other appeals. The Appellant confirmed this point but asked that I consider these arguments.

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”.²

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 Kernaghan³ matters. Finally, the written submissions state that the Appeal Committee in its October 27, 2014 decision improperly

² Member's Section FAQ.

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

compared itself to SIPA⁴; 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

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.

⁴ 15 U.S.C. § 78aaa *et seq.*

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

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. 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. Given that the failure to return or account for property is necessary to found a claim for coverage, and that 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.

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 as 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 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, [REDACTED] and [REDACTED], 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. 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.

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.

14. In his oral submissions, the Appellant stated that the Coverage Policy had been interpreted narrowly by the Appeal Committee to the advantage of CIPF in circumstances where the investors were told that their investments were covered by CIPF and they had engaged in due diligence to ensure that there was "regulatory backing" of FLSI by IIROC and CIPF. As I have already indicated, my role is limited to reviewing the facts of each case and the arguments made by the Appellants against the wording of the Coverage Policy of September 30, 2010 that was in effect at the time of the insolvency of FLSI. Members of the Appeal Committee have no motivation to find claims ineligible for compensation or to narrowly review the Coverage Policy. I also have no doubt that the Appellant engaged in due diligence and I also appreciated the measured way in which he made his submissions. Unfortunately, I am unable to find that the Appellants' losses fall within the Coverage Policy.

Disposition

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

Dated at Toronto, this 18th day of March, 2016

Anne Warner La Forest