Re Phillips & Wilson

IN THE MATTER OF:

The Dealer Member Rules of the
Investment Industry Regulatory Organization of Canada (IIROC)

and

David Charles Phillips

and

John Russell Wilson

2013 IIROC 52

Investment Industry Regulatory Organization of Canada
Hearing Panel (Ontario District)

Heard: September 16 and 17, 2013 in Toronto, Ontario
Decision: October 2, 2013

Hearing Panel:
Terrance Sweeney, Chair, Charles Macfarlane and Stuart Livingston
Appearances:
Diana Iannetta, Senior Enforcement Counsel, IIROC
Rob DelFrate, Enforcement Counsel, IIROC
Messrs. Phillips and Wilson did not appear nor were they represented by Counsel

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DECISION OF THE HEARING PANEL

OVERVIEW

¶ 1 David Charles Phillips and John Russell Wilson (the "Respondents"), through their deceitful practices, ruined the financial security of hundreds of families.

¶ 2 They gained the trust of their clients and were able to use that trust to convince them to purchase poorly diversified holdings of high risk funds, despite the fact that the resulting portfolios were far riskier than the clients' New Account Application Forms ("NAAFs") required.

¶ 3 Although the Offering Memorandums ("OMs") and Prospectus detailed many of the dangers of investing in the First Leaside funds, probably most of the clients did not read those documents and relied on the recommendations of their First Leaside advisers (including Phillips and Wilson).

¶ 4 The advice given to the clients regarding the character and risk levels of the funds ranged from confused and confusing to lies.

¶ 5 The misrepresentation was bolstered by one-page marketing documents, which were misleading and seemed to guarantee a monthly distribution rate.

¶ 6 Clients were led to believe that the investments within the funds were successful and healthy and were generating the funds for the distributions. In fact the Funds' underlying value had been diluted by outrageous fees and were worth far less than the $1 per unit value Phillips placed on them. In actual fact the regular

monthly distributions could only be sustained by using contributions from other clients.

¶ 7 Phillips, in addition, placed himself in an unworkable conflict of interest given the number of roles he played in the various First Leaside entities, and the various ownership positions he had in the FL group. He should have just completely avoided those conflicts but, of course, this would have prevented him from diverting so much of his clients' funds into his own pocket.

¶ 8 Phillips and Wilson thoroughly abused their clients' trust for their own benefit. They are an embarrassment to our capital markets.

BACKGROUND

¶ 9 We were constituted as a Hearing Panel of the Ontario District Hearing Committee of the Investment Industry Regulatory Organization of Canada (IIROC) to consider a complaint against the Respondents.

¶ 10 Phillips is a Registered Representative ("RR"). He owns over 99 percent of the issued shares in First Leaside Wealth Management Inc. ("FLWM"). He and Wilson were directors. It controls over 100 entities. First Leaside Securities Inc. ("FLSI") is the Dealer Member. During the relevant time, Phillips was its president and director. F.L. Securities Inc. is an exempt market dealer.

¶ 11 Wilson had been with FLSI since 2004. He had no prior experience in the investment industry. He was the "Director, Investor Relations". He was the senior person in the sales group and, by far, its biggest producer. He was paid a bonus of $800,000.00 for his services in 2010. Among other positions in the FL Group, he was a director of First Leaside Realty II, which was the General Partner of several First Leaside Limited Partnerships.

¶ 12 The FL Group manufactured, marketed and sold units in Limited Partnerships ("LPs") and Funds primarily for real estate property investments (together, the "FL Products"). Each year, new LPs were formed and sold to clients.

¶ 13 With one exception, the FL Products were sold by Offering Memorandum ("OM") as exempt securities.

¶ 14 All investors who purchased FL Products did so through client accounts at FLSI and Phillips approved every trade.

¶ 15 On February 24, 2012, IIROC staff made an application to an IIROC Hearing Panel and was granted an order suspending FLSI's membership on the basis that it was in such financial or operating difficulty that it could not be permitted to continue to operate without risk of imminent harm to the public, other Dealer Members or the Corporation.

¶ 16 On December 7, 2012, a judge of the Ontario Superior Court of Justice granted an Order appointing a Receiver of all of the assets, undertakings and remaining property of the First Leaside entities subject to the Order. This Order did not include Wimberly Apartments Limited Partnerships ("WALP"), the aggregator of Texas properties ultimately owned by the FL Group.

¶ 17 By a Notice of Hearing dated October 2, 2012, IIROC alleged four contraventions against Phillips and Wilson and one additional contravention against Phillips as follows:

Misrepresentation of Fund Products

i. Between January 2009 and October 2011, David Charles Phillips ("Phillips") misrepresented, and allowed First Leaside Securities Inc. (FLSI") sales staff to misrepresent to clients, that the proprietary fund products recommended and sold by the firm were low or medium risk, when, in fact, they were high risk, contrary to Dealer Member Rule 29.1;

ii. Between January 2009 and October 2011, John Russell Wilson ("Wilson") misrepresented to clients that the proprietary fund products which he recommended and sold were low or medium risk, when, in fact, they were high risk, contrary to Dealer Member Rule 29.1;

Marketing Materials

iii. Between November 2009 and September 2011, Phillips authorized the preparation and issuance of

marketing materials for investment products sold at FLSI, which included statements which were misleading and failed to fairly present the potential risks of those products to the client, and provided these marketing materials to his clients, contrary to Dealer Member Rule 29.7(1);

iv. Between November 2009 and September 2011, Wilson provided marketing materials for investment products sold at FLSI to his clients and potential clients, which included statements which were misleading and failed to fairly present the potential risks of those products to the client, contrary to Dealer Member Rule 29.7(1);

Risk Tolerance on NAAF

v. In and throughout 2009, 2010 and 2011, Phillips and Wilson failed to ensure that the recommendations which were made and orders which were accepted were in accordance with the risk tolerance stated on clients' New Account Application Forms ("NAAF"), contrary to Dealer Member Rules 1300.1(o), (p) and/or (q);

Sales of Properties Fund

vi. Between January 1, 2010 and May 1, 2011, Phillips and Wilson solicited sales of First Leaside Properties Fund from clients, while failing to ensure that those transactions were suitable for the clients or within the bounds of good business practice, and preferred their own interests ahead of the clients, contrary to Dealer member Rules 1300.1(o) and (q) and 29.1; and

Conflict of Interest

vii. Between January 2007 and October 2011, Phillips as the General Partner ("GP") of certain First Leaside Limited Partnerships ("LPs") was in a conflict of interest with clients who invested in those LPs, which was not addressed in a fair and equitable manner and in a manner that considered the best interests of the clients, contrary to Dealer Member Rule 29.1 and NI 31-103.

¶ 18 Counsel for Phillips and Wilson filed a Response dated November 2, 2012. However, by letter dated August 8, 2013 addressed to Staff and the Hearing Panel, Counsel for the Respondents advised that Phillips and Wilson would not attend this hearing.

¶ 19 At the opening of the hearing, the Hearing Panel made the following rulings:

a. The hearing would proceed in the absence of the Respondents;[1]

b. The names and records of individuals affected by the actions of Phillips and Wilson would be kept confidential;[2]

c. The Hearing Panel would accept hearsay evidence.[3]

¶ 20 The Hearing Panel marked the following exhibits:

a. IIROC Staff Hearing Book;[4]

b. Affidavit of Brian Connell-Tombs dated September 12, 2013. He is a Senior Investigator in the Enforcement Branch of IIROC and headed the team which investigated the Respondents. Attached to his affidavit are 10 volumes of documents.[5]

c. Affidavit of Michelle Bernardi dated September 10, 2013.[6] Ms. Bernardi is a paralegal with IIROC. She attests to the notices provided to Counsel for the Respondents in respect of this hearing.

[1] IIROC Rule of Procedure 13.5
[2] Dealer Member rule 20.2(1)
[3] *Ibid*, Rule 20.2(2)
[4] Exhibit 1
[5] Exhibit 2
[6] Exhibit 3

¶ 21 Mr. Connell-Tombs was sworn and testified for one-and-a-half days. He impressed the Hearing Panel with his knowledge of the facts in the case. He was of considerable assistance to the Hearing Panel in understanding a very complex matter. A measure of the amount of work he put into the case is that he spent nearly 700 hours interviewing Phillips, FL Group clients, and supervising others who worked on the file.

¶ 22 The Hearing Panel is also indebted to Counsel for IIROC for her presentation of the evidence, her oral submissions and the fulsome written argument which she produced.

DECISION

¶ 23 The Hearing Panel has carefully considered all of the evidence, the submissions of Counsel and her written argument. IIROC has proved its case against Phillips and Wilson on a balance of probabilities. They will, therefore, among other things, be permanently removed from the capital markets as IIROC registrants. Detailed reasons for our decision follow.

THE CASE FOR IIROC

Allegation 1: The Misrepresentation of the Fund Products

¶ 24 Mr. Connell-Tombs by his affidavit and in his oral testimony addressed this matter. The investigation started in November 2011. He and/or members of his staff interviewed the Respondents, nine employees of the FL Group and over 100 clients of the FL Group. Most of the clients were at or approaching retirement age. They were often high net worth individuals but were in the low range of investment knowledge.

¶ 25 Phillips controlled the FL Group through his over 99 percent share interest in the top company, FLWM. All transactions went through FLSI, the Dealer Member.

¶ 26 Mr. Connell-Tombs described the FL Products as illiquid with no secondary market. In fact, the Funds, except for the Mortgage Fund, shared the following factors which made them speculative and/or high risk:

i. Their only assets were unsecured promissory notes from another FL entity;

ii. Payment of the interest was not guaranteed;

iii. The debtor company, at its discretion, could forego the interest payment and add the interest payable to the principal amount of the notes;

iv. There was no secondary market for the units; and

v. There was a credit risk. FL Group members who received loans from the Funds may not be able to repay those loans when due.

¶ 27 The cornerstone of the FL Group was Wimberly Apartment Limited Partnership ("WALP"). This was an Ontario Limited Partnership established in 1992 and in 2011 held, directly or indirectly, eleven apartment complexes in Texas, U.S.A.

¶ 28 The financial statements for WALP, however, for 2006 to 2009 contained a "going concern" note indicating that it would have difficulty meeting its obligations.

¶ 29 Notwithstanding the foregoing, Phillips and Wilson described the Funds in the FLSI NAAF as "Balanced/Medium Risk" and "Balanced/Moderate Risk". Phillips and Wilson prepared spreadsheets for potential customers where a Fund Product would be described as 'MEDIUM RISK-Income". The OM for the Mortgage Fund described it as "speculative", yet Wilson and others classified it as "low risk" on the spreadsheets.

¶ 30 The sales team at the FL Group was inconsistent in its assessment of the risk of the Products. Some said they were 50 percent medium risk-50 percent high risk. Wilson himself said they were medium risk when interviewed by IIROC Staff. Phillips in his interview said that all FL Products were high risk.[7] The due diligence committee of the FL Group, which included Phillips and Wilson as members, on two occasions,

[7] Exhibit 2, Vol. 7, Tab 1, p. 63

described certain FL Funds as "risky".[8]

Allegation 2: Misleading Marketing Material

¶ 31 Mr. Connell-Tombs identified a 2010 "One-Pager" for F.L. Universal Limited Partnership.[9] He said it is typical of the type of "One-Pager" each potential investor received before he invested. The largest font shows "6%" as the "Annual Distribution Rate". It does not say that it is not guaranteed. Moreover, the document says that, "Wimberly Apartments Limited Partnership still generates - after 18 years - continuous monthly cash distributions for hundreds of investing partners." It fails to note that the cash distributions are not coming from earnings in WALP but, largely rather, from new investor money.

¶ 32 The document also shows the logo of the Canadian Investor Protection Fund ("CIPF") which might cause some investors to believe that their investment would be covered by CIPF. However, because the LPs were not carried on book at FLSI, any losses incurred would not be eligible for CIPF protection.

¶ 33 Other "One-Pagers" include the phrase "… provides excellent potential for significant capital appreciation".

¶ 34 Mr. Connell-Tombs testified that most clients thought that the underlying investments in the Funds were earning sufficient income to pay their distributions.

Allegation 3: Phillips and Wilson Failed to Give Consideration to the NAAFs

¶ 35 Mr. Connell-Tombs and his staff prepared a chart comparing a FL Group client's risk tolerance on his NAAF with his actual holding.[10] In a sample of 69 clients, 59 were 100 percent in high risk FLSI Products when their NAAFs said they were to have no more than 50 percent in high risk investments.

¶ 36 Mr. and Mrs. W. opened accounts with Phillips in 2007 when he was 64 and she was 63. By November 2011, 70 percent of Mr. W's cash account was invested in FL Products when his NAAF indicated he was only prepared to accept 50 percent high risk. He told Staff during his interview that he did not know that the LPs were speculative. Had he known he would not have invested in them. Mr. and Mrs. W. have lost nearly $2.7 million by investing in FL products.

Allegation 4: Phillips and Wilson Put Their Own Interests First in Soliciting Sales of First Leaside Properties Fund

¶ 37 First Leaside Properties Fund ("FLPF") issued a prospectus on March 19, 2009. It was successfully completed. This was the only FL Product sold by prospectus.

¶ 38 In 2010 and 2011, FLSI had clients who were non-accredited investors with cash in their accounts. Phillips and Wilson then solicited sales of units of Properties Fund from their clients so that non-accredited clients could buy them. About 40 clients were induced by Phillips and Wilson to sell their units in Properties Fund. Most purchased First Leaside Fund with the proceeds.[11]

Allegation 5: Phillips Was in a Conflict of Interest

¶ 39 A "blind pool" is defined as follows:

> A blind pool is a Limited Partnership with no stated goal for the funds that are raised from investors. In a blind pool money is raised from investors usually trading on the name of a particular individual or firm but few restrictions or safeguards are in place for investor security.[12]

¶ 40 Between January 2007 and October 2011, Phillips promoted four blind pools as limited partnerships and raised more than $30,000,000.00. In each limited partnership, he was the president and director of the general

[8] Exhibit 2, Due Diligence Worksheets Vol. 2.2, Tabs 32-34
[9] Exhibit 4
[10] Exhibit 2, Vol. 4.1, Tab 1A
[11] Exhibit 2, Vol. 5, Tab 3
[12] Wikipedia, 2013

partner. In each case, 35 percent of the investors' contribution went to Phillips-related companies as a "Selling Fee", "Business Development Fees" and "Promotion". Moreover, in each case, additional large fees were paid to FL companies for things like "Acquisition Analysis" and "Market Feasibility".

¶ 41 Mr. Connell-Tombs and his staff analyzed the results and produced two charts. One chart[13] itemized the actual related party expenses of each blind pool. They ranged from 45.5 percent to 61.6 percent of the net contribution from investors. The other chart[14] tracked the revenue producing asset owned by the blind pool as a percentage of gross contribution. One blind pool's ratio was zero as it did not buy an asset. Another was only 11 percent of the investors' contribution.

¶ 42 The moneys were spent on loans to related companies, related company fees and distributions to individuals owning LP products.

ANALYSIS

¶ 43 … managing money on behalf of others is a sacred trust. To be worthy of that trust goes far beyond simple honesty and integrity. It demands exceptional knowledge and experience … .[15]

Setting the Standard for Investor Care.[16]

¶ 44 These words are taken from the 2010 brochure for FLWM. Notwithstanding these pious platitudes, Phillips and his complicit colleague Wilson sought to gain the trust of elderly, gullible people. Once they obtained that trust they abused it to enrich themselves.

Allegation 1: The Misrepresentation of the Fund Products

Business Conduct

¶ 45 IIROC Dealer Member Rule 29.1 and the Code of Ethics can be distilled into a single principle: A Dealer Member must deal honestly with its investors.

¶ 46 One IIROC Hearing Panel[17] described the duty as follows:

> People who work in the investment industry have occasion to control other people's money. The most fundamental expectation is that they do so honestly.

¶ 47 A Dealer Member also has a duty to provide potential investors with an objective assessment of risk. In *Bilinski*,[18] the Hearing Panel said, in part, as follows:

> Assessment of risk must be based on a realistic and objective assessment of the circumstances of the investment and the investor. Clients are entitled to receive from their registrant an objective assessment of risk.

¶ 48 Phillips and Wilson, and indeed others in the FL Group, failed miserably to meet this basic principle. No reasonably intelligent RR would describe the FL Units and FL Debts as anything other than high risk. Yet, Phillips and Wilson did just that so that the new money necessary to keep the FL Group afloat would continue to flow in.

Allegation 2: Misleading Marketing Material

¶ 49 Dealer Member Rule 29.7, in essence, prohibits a Dealer Member, among other things, from issuing to the public sales literature which:

> (a) contains any untrue statement or omission of a material fact or is otherwise false or misleading;

[13] Exhibit 2, Vol. 6, Tab 1, p. 1
[14] Exhibit 2, Vol. 6, Tab 2, p. 2
[15] Exhibit 2, Vol. 1, Tab 6, p. 2
[16] *Ibid*, p. 1
[17] *Peroni (Re)*, [2006] I.D.A.C.D. No. 27 at para. 60
[18] 2002 LNBCSC 1

(e) fails to fairly present the potential risks to the client.

¶ 50 The evidence in this regard is persuasive. Phillips approved all marketing material.[19] Wilson was a senior person in the FL Group and, thus, probably knew that the marketing materials were misleading. The "One-Pagers" were used to induce people to invest in FL Products rather than give them an objective assessment of the risks therein.

¶ 51 A few examples will suffice to show this.

1. The "Annual Distribution Rate" is displayed in the largest font on the "One-Pager". There is no indication that the rate is not guaranteed, may be a return of capital and was largely dependent not on earnings but on new money coming in.

2. The CIPF logo was cynically used. For example, a brochure from FLWM reads, in part:

> IIROC membership enables the firm to participate in the Canadian Investor Protection Fund … set up by the investment industry to ensure the return of customers' securities …. if an investment dealer that is a CIPF member is not able to do so because it is bankrupt.

¶ 52 This Hearing Panel rules that it was more likely than not that Phillips and Wilson knew that FL Products were not covered by CIPF. They were not held "on book" as they were distributed to the clients.

¶ 53 The FLWM Inc. Brochure reads:

> Partners in its pioneering deal, Wimberly Apartments Limited Partnership, have enjoyed a monthly paid cash flow … with total returns averaging more than 9 per cent annually … .

¶ 54 However, the evidence establishes that, from at least 2007 to 2010, WALP was making losses rather than profits. Nevertheless, WALP paid substantial amounts to the unitholders of WALP and the WALP Funds. We know now that the source of those payments was, to a large extent, money borrowed from other FL Group entities which received funds from other investors.

Allegation 3: Phillips and Wilson Failed to Give Consideration to the NAAFs

¶ 55 The Hearing Panel refers to the chart prepared by IIROC Staff, referred to in paragraph 35 above. The Hearing Panel accepts this chart as a reasonable approximation of the instances in which Phillips and Wilson blithely ignored the risk tolerances of clients as set forth in their NAAFs. Eighty-five percent in the sample held investments which were inconsistent with the risk tolerance percentages recorded on the NAAFs. Fifty-four percent of the accounts in the sample had double the level of high risk that the clients had indicated they were prepared to accept.

¶ 56 Phillips and Wilson, therefore, offended against Dealer Member Rules 1300.1(o)(p) and (q). These Rules require a Dealer Member to use due diligence to ensure that a recommendation to buy a security is suitable for the client taking into account, among other things, his risk tolerance. Moreover, the responsibility to use due diligence, in recommending a security to a client, rests solely with the registrant. It cannot be transferred to the client even if the client acknowledges that he is aware of the risks associated with the investment.

¶ 57 As an illustration of the depths to which Phillips and Wilson typically sank, consider the case of Mr. A. He is legally blind. Mr. Connell-Tombs testified that it was very evident that he had serious sight issues. Understandably, he instructed Wilson that he was a "low" to "medium" risk investor. But, Wilson, by September 2011, had 59 percent of Mr. A's money in high risk FL Products even though Mr. A's NAAF read that he was to be no more than 10 percent in high risk.

Allegation 4: Phillips and Wilson Put Their Own Interests First in Soliciting Sales of First Leaside Properties Fund

¶ 58 Phillips and Wilson had non-accredited clients with cash in their accounts at the FL Group. They

[19] Exhibit 2, Vol. 7, Tab 1, p. 32

induced some of those clients who owned units in Properties Fund to sell those to clients who had cash. Phillips and Wilson then suggested that the sellers invest the proceeds in another FL Product.

¶ 59 Phillips and Wilson did not consider the suitability of the Properties Fund as an investment for those unfortunate clients who were in cash. Rather, they focused on their need to expand the pool of investors, and thus money, so that they could access it for their own selfish ends.

¶ 60 As discussed in Allegation 3, Phillips and Wilson breached Dealer Member Rules 1300.1(o) and (q) and Dealer Member Rule 29.1, as they ignored their duty to exercise due diligence to ensure that their recommendation was suitable for clients.

Allegation 5: Phillips Was in a Conflict of Interest: The Blind Pools

The Blind Pools

¶ 61 National Instrument 31-103 discusses, in great detail, the circumstances as to when a conflict between a registered firm and its clients may arise and how to deal with it.

¶ 62 No rule is required to find that Phillips was in a conflict of interest. Common sense is sufficient. He controlled FLWM, the top company in the FL Group. He was a director and president of the General Partner in each blind pool. It was in his interest and contrary to that of his clients that he induced them to invest in the blind pools. He, thus, assured himself that he could extract the rapacious fees from these blind pools (described above in paragraphs 39 and 40), which ultimately would accrue to him as the controlling shareholder in FLWM.

¶ 63 The Hearing Panel notes that his various roles were disclosed in the OMs. However, this was insufficient since by then his unfortunate clients were firmly within his thrall. As he said, "… when I called they bought."[20]

¶ 64 An ethical RR in the situation of Phillips would have avoided this conflict entirely, Of course, by now, the Hearing Panel recognizes that this was beyond him His greed trumped his ethics.

¶ 65 The facts in this case illustrate the all too familiar story. Unsophisticated investors were gulled into relying on those whom they trust while ignoring warnings in public documents, like the OMs in this case. Had they not relied exclusively on Phillips and Wilson, and read the documents closely, one might reasonably suppose that they would not have bought any FL Group Product

SANCTION

¶ 66 We have considered the evidence in the case, the law, the Sanction Guidelines and Counsel's submissions, both written and oral. The Hearing Panel is well aware of the factors to be considered in fashioning an appropriate sanction. Any sanctions imposed should be preventive, protective and prospective in nature.

¶ 67 The evidence establishes, on a balance of probabilities, that Phillips and Wilson abused the trust placed in them by their clients and enriched themselves at the expense of those clients most of whom were vulnerable elderly people. Phillips and Wilson are beyond redemption and should suffer substantial penalties. But, in addition, the penalties imposed herein are intended to deter others who might be tempted to engage in such scandalous behaviour.

¶ 68 We believe that the sanctions imposed in the Order below are within the reasonable range of appropriateness and will meet the mandate reposed in us to enforce high quality regulatory and investment industry standards, protect investors and maintain competitive and efficient capital markets.

¶ 69 Counsel submitted a bill of costs.[21] We accept her request which is reflected in the Order.

ORDER

¶ 70 This Panel hereby orders that:

[20] Exhibit 2, Vol. 7, Tab 1, p. 53
[21] Exhibit 6

1. Mr. Phillips is permanently barred from approval with IIROC;
2. Mr. Phillips is ordered to pay a fine in the amount of $2,000,000;
3. Mr. Wilson is permanently barred from approval with IIROC;
4. Mr. Wilson is ordered to pay a fine in the amount of $500,000;
5. Mr. Phillips and Mr. Wilson shall pay IIROC $230,000 in respect of costs of the investigation and hearing of this matter, on a joint and several basis.

¶ 71 Staff has advised that it will not seek to enforce the fine or costs against Mr. Phillips and Mr. Wilson until the determination of investor claims through the Receivership proceedings.

Dated at Toronto, Ontario this 2nd day of October 2013.

Terrance A. Sweeney,

Chair

Charles Macfarlane,

Panel Member

Stuart Livingston,

Panel Member