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

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

Heard: October 6, 2015

PANEL:

PATRICK J. LESAGE	)	Appeal Committee Member

APPEARANCES:

[redacted]	)	for himself and for [redacted] and
	)	[redacted]
Maureen Doherty	)	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 CIPF was established to provide certain coverage in the event of losses arising from dealer insolvency. 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]

BACKGROUND

2. The Appellants began investing in First Leaside Group ("FLG") entities, through FLSI, a dealer, in October 2008 and continued to invest periodically until August, 2011. In total, they invested more than $590,000. Although the Appellants made a number of investments with FLG, [redacted] argument focused specifically on their August 2011 FLG investments totalling approximately $53,000. The Appellants signed a direction to purchase those investments on August 17,2011. On August 19, 2011, FLSI and the OSC, among others, received a report from Grant Thornton (the GT Report or the Report) that disclosed FLG was in a precarious financial position. FLSI nonetheless proceeded with the [redacted] investment purchases on August 23, 2011.

3. The Appellants filed a claim with CIPF on the basis that their losses flowed from FLSI's insolvency. By letters dated February 17, 2015, Staff of CIPF denied compensation to the Appellants on the basis that their 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.

4. At the hearing, the Appellants requested I consider their written material, the able oral submissions of [redacted], as well as any relevant background information that has been presented at earlier appeal hearings and the arguments raised by Representative Counsel for investors of FLSI referred to in earlier hearings.

5. [redacted] pointed out that the Ontario Securities Commission began investigating the FLG entities in the fall of 2009. In November 2010, the OSC sought third-party evaluations of the FLG entities, following which, in March 2011, at the urging of the OSC, FLG retained GT to review the FLG entities. GT delivered its Report on August 19, 2011. That Report concluded that FLG was in a precarious financial situation. FLG was using new investment monies to pay existing obligations rather than investing them as intended by the investors. [redacted] submitted that FLSI and FLG knew that monies invested, certainly after August 19, 2011, if not long before, were not being used for investment but rather for already-incurred expenses and/or to prop up a multitude of FLG

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

entities. On October 31, 2011, the OSC implemented a Cease Trade Order. In early November 2011, at the request of the OSC, FLG wrote to investors advising that it was being investigated by its Regulators and also informing the investors of the August 19, 2011 GT Report. FLSI was declared insolvent on February 24, 2012.

APPELLANTS' SUBMISSIONS

6. [redacted] made a number of submissions to support his position that the Appellants had a valid claim against CIPF for coverage.

7. First, I turn to [redacted] argument based on material non-disclosure of the financial state of the FLG entities described above. In his articulate and thoughtful submission, [redacted] stressed that investors in particular and the public in general were entitled to have been advised that the FLG entities were under investigation by Regulators during the 2009 to 2011 period. In addition, he argued, they were entitled to be advised that, flowing from the OSC investigation, internal and external reviews were initiated to investigate the Regulators' concerns about the financial soundness of FLG entities. [redacted] submitted that not only did the OSC and IIROC have an obligation to advise of these investigations of FLG entities, but CIPF was also under an obligation to inform investors. In support of this argument, [redacted] observed that CIPF's logo led investors to believe that they were "protected" by the Canadian Investor Protection Fund.

8. [redacted] points out that his and his wife's last FLG investments of more than $53,000 in Flex Fund (Class C) units were made through the FLG dealer, FLSI. FLSI facilitated these investments on August 23, 2011, four days after the damning GT Report was delivered to FLG and the Regulators. With the delivery of the GT Report, there could be no question of the Regulators' obligation to advise. Had the Appellants been aware of the GT Report and its contents, [redacted] observed, they would, of course, never have invested the final $53,000 on August 23, 2011. Although [redacted] signed the direction to purchase FLG entities on August 17, 2011, he would have cancelled the direction before August 23, 2011 had he known of the intervening August 19 GT Report. This would have reduced their losses by $53,000.

9. In brief, [redacted] argues that the failure of the Regulators, the dealer, the FLG and CIPF to disclose FLG's known precarious financial situation entitled the Appellants to CIPF protection for their $53,000 loss.

10. Second, [redacted] relies on section 81.1.(1)(b) of the *Bankruptcy and Insolvency Act* (BIA), which permits suppliers of goods delivered within 30 days of bankruptcy/insolvency to reclaim those goods. His position is that they delivered (through FLSI) goods (in the amount of $53,000) to FLG on August 23, 2011 at a time when FLG was de facto insolvent. It was [redacted] position that FLG was obliged to return that money to FLSI and in turn FLSI would be obliged to return the funds to the Appellants, failing which the Appellants would have a valid claim on CIPF coverage.

11. Third, [redacted] submits, when FLSI transferred his monies to FLG after the GT Report with full knowledge of FLG's true financial situation (insolvency), that FLSI was unlawfully converting the Appellants' $53,000. Any unlawful conversion would be included in CPIF coverage.

12. Fourth, the Appellants submit that the valuations of FLG's assets in the insolvency proceedings were inadequate and that the Appellants are entitled to compensation for the losses they suffered as a result of those inadequate valuations.

13. In addition to their substantive arguments, the Appellants, like so many other claimants, stressed that CIPF needs to better explain to investors and the public what they cover and what they do not cover. This explanation needs to be in plain language both on its website and in its brochure. The Appellants further submitted that CIPF needs to explain what is meant by 'unlawful conversion'. The public understanding of the protection provided by CIPF is very different from CIPF's now expressed view of that coverage. The Appellants also said that safeguards are needed to protect investors from dealers/salespersons who provide an explanation of CIPF coverage that is intentionally, or even unintentionally, false.

ANALYSIS

14. Before addressing each of the Appellants' arguments in turn, it is important to understand the nature of CIPF coverage. CIPF coverage relates only to the custodial relationship between the

investor client and the IIROC regulated dealer, including unlawful conversion. It does not provide coverage for malfeasance, misfeasance or for losses that flow from the diminution of the value of investments. I now turn to the gist of the Appellants' submissions.

15. The Appellants' first argument was that, at the very least, their loss flowing from their August 23, 2011 $53,000 purchase of the Flex Fund should be covered by CIPF on the basis that the Appellants were defrauded by reason of material nondisclosure as described above by FLSI, the FLG entities and by IIROC and the OSC's failure to take action in light of FLG's precarious financial situation. The Appellants submit that CIPF is equally negligent in that it knew or ought to have known of the precarious financial situation of the FLG entities, including FLSI, and failed to take action to notify investors and to remove its coverage for FLSI and to make that removal known publicly.

16. As has been noted in earlier appeals committee decisions, CIPF is not a regulator like IIROC and/or the OSC. CIPF has no regulatory or supervisory authority over dealers. CIPF coverage is a custodial coverage. It covers unlawful conversion and return of monies or securities being held by the broker. It does not provide coverage for deceit, falsehood, material misrepresentation or nondisclosure or other fraudulent means.

17. The Appellants' also submit that their $53,000 loss ought to be covered by CIPF based on the provision of the Bankruptcy and Insolvency Act. This is an interesting argument. However, any claim made pursuant to the BIA for return of "goods" supplied would be a claim made to the Receiver, not to CIPF. This argument cannot succeed as part of their claim on CIPF.

18. The Appellants also allege unlawful conversion of their $53,000 August 2011 investments on August 23, 2011 four days after FLSI received the GT Report when, the Appellants submit, FLSI knew the FLG entities were de facto insolvent. I do not accept that this conduct comes within the meaning of unlawful conversion. The undisputed fact is that on August 17, 2011 the Appellants signed a direction to FLSI to purchase the units and FLSI did just that on August 23, 2011. The fact that, on August 19, 2011, FLSI was aware of the GT Report (and its critical comments of the FLG entities) may make FLSI and its personnel guilty of fraud or material nondisclosure or other violations of IIROC and OSC rules and regulations. However, acts of fraud, misrepresentation, material nondisclosure and deceit are not covered by CIPF. They are not unlawful conversion. As

has been described in earlier decisions of the appeal committee, CIPF is principally a custodial coverage plan. It does not cover deceit, falsehood and other fraudulent means such as the misconduct upon which the OSC and IIROC found the principals of FLG, David Phillips and John Wilson, liable for egregious conduct that violated rules, regulations and statutes that governed their professional involvement with the FLG entities. As a result, the Appellants claim of unlawful conversion is not made out.

19. I turn to the Appellants' submission that they are entitled to recover from CIPF the losses they (and obviously similar investors) suffered as a result of inadequate valuations of the assets by the Receiver. [redacted] position is that, if correct evaluations of the assets of the insolvent FLG entities had been made, the investors would have received a larger payout. If there were a valid substantiated claim to be made in this regard, it would be a matter between the investor and the insolvent entity and the receiver. Such a loss would be an investment loss, not a broker loss that might be covered by CIPF. Any inadequate receiver valuations or resulting losses are not covered by CIPF.

20. I understand and appreciate the Appellants very significant losses and their rancour with the conduct of FLG, including FLSI, in dealing with the Appellants. However, my task is to determine whether the CIPF coverage applies to the Appellants. The CIPF brochure makes clear that the diminution, loss of value of the entity in which the investment was made is not covered by CIPF. The Appellants do not claim that FLSI failed to return cash, certificates or other indicia of ownership to them. In the circumstances, the Appellants have not established a covered loss.

21. While I have sympathy for the Appellants' position, it does not change the fundamental fact that this appeal does not meet the requirement of establishing a valid legal claim for coverage under the terms of the CIPF policy.

RESULT

22. The appeal must therefore be dismissed. The decision of the CIPF Staff is upheld.

Dated at Toronto, this 26th day of January, 2016

Patrick J. LeSage