

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

RE: [REDACTED] AND [REDACTED]

Heard: November 30, 2015

HEARD BEFORE:

ANNE W. LA FOREST

Appeal Committee Member

APPEARANCES:

James D.G. Douglas

) Counsel for Canadian Investor
) Protection Fund Staff

[REDACTED]

) Counsel for [REDACTED] and
) [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”, making it a “CIPF

Member”) until its suspension by IIROC on February 24, 2012, being 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. 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 November 30, 2015, 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 took place at by way of a teleconference. The Appellants were represented by counsel who made submissions on their behalf.

Chronology of Events Relevant to the Appellants’ Claim

(i) The Appellants’ Investments and Claim

4. The Appellant, [REDACTED], claims the amount of \$575,725.91 with respect to his purchases of various First Leaside Group products purchased between September 25, 2009 and September 27, 2011. The Appellant, [REDACTED], claims the amount of \$1,165,858 with respect to its purchases of various First Leaside Group products purchased between May 31, 2011² and September 27, 2011. All of these products were purchased by the Appellants during the period after the OSC began investigating FLSI and many were purchased either during the period in which Grant Thornton had been retained to review, report on, and make recommendations in

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

² The date in which units in First Leaside Expansion LP, First Leaside Fund (Series B), First Leaside Wealth Management Fund Series II Preferred Shares and First Leaside Mortgage Fund were transferred to the account of [REDACTED]. See Appeal Record, vol 1, p.88.

relation to the First Leaside Group's operations, or, after their report of August, 2011.

5. Certificates representing the Appellant [REDACTED] 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. Certificates representing the corporate Appellant ([REDACTED] [REDACTED])'s, purchases were delivered to the corporation's possession. The materials filed before me establish and 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 August 27, 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 [REDACTED] was converted or otherwise misappropriated. The securities that you [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, your [the] loss appears to have been a loss caused by a change in the market value of your [the] investments and not a loss resulting from the insolvency of FLSI or the conversion of your [the] property. 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.

With respect to the securities that you purchased and 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 IROC 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.

Analysis

7. As outlined at the beginning of the hearing, the Coverage Policy requires at a minimum, the fulfillment of three elements:

- a. the claimant must have been a customer of an insolvent CIPF Member;
- b. the loss must have been caused by the insolvency of the CIPF Member; and
- c. the loss must have been due to the failure to have property held in the customer's account at the date of insolvency returned to the customer. That includes property that has been unlawfully converted by the CIPF Member.

There is no question that the Appellants were customers of an insolvent CIPF Member and as such, the relevant questions for this Appeal Committee are whether the Appellants' losses were caused by the insolvency of FLSI and whether the loss was due to the failure to have property returned to the Appellants included property that was unlawfully converted by FLSI.

8. The Appellants were represented by counsel. In their written submissions, the Appellants did not directly address the issue of whether the loss was caused by the insolvency of FLSI on the basis that in their view, this point had been conceded. CIPF Staff for their part made it clear both in their written and oral submissions that this point is not conceded and that in their view, the loss was not caused by the insolvency of FLSI. There was no further discussion of this matter at the hearing.

9. The main position advanced by the Appellants both in writing and at the hearing was that funds given to FLSI to invest in securities of the First Leaside Group were unlawfully converted by FLSI and as such, the Fund should provide coverage to the Appellants.

10. The Appellants' position is that they were induced to make investments in units in the First Leaside Group on the basis that their funds would be used for real estate backed investments. However, counsel for the Appellants submitted that by the time they began to make their investments in the First Leaside Group they were no longer funds engaged in real estate backed

investments. There was instead a Ponzi scheme in which investments made by Appellants were utilized not for real estate backed investments but to support other entities in the First Leaside Group and in particular, to pay off other investors. Counsel for the Appellants referred to the decision of IIROC in *Re Phillips and Wilson*³ as follows:

“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.”

None of this was disclosed to investors. Counsel for the Appellants argued that this Ponzi scheme amounted to a taking of the Appellants’ cheques by trick and that the contracts to purchase the units in the First Leaside Group were thus void “*ab initio*” such that the title in the cheques never passed to FLSI and that the Appellants are entitled to their cash back. The unlawful conversion then is that the cash cannot be returned to them because it was transferred to related companies that are now insolvent. In sum, by the time the Appellants began investing with FLSI, it was soliciting money to invest in real estate backed investment instruments but was in fact using it to finance its previous debt load and distributions to other investors and this constituted unlawful conversion.

11. Counsel for the Appellants also encouraged me to review the *Madoff*⁴ decision (cited in the October 27 decision) because in that case, there had been a Ponzi scheme in the form of misappropriation or larceny by trick and that the question in that case wasn’t whether investors should be compensated by SIPC (a compensation scheme in the United States that is similar to CIPF) but rather the manner of valuating investor loss. In his oral submissions, counsel for the Appellants acknowledged that in the *Madoff* case, the broker had never invested the customer funds but had instead generated fictitious paper account statements and trading records in order to conceal the fact that he engaged in no trading activity whatsoever. However, he suggested that when the Appellants invested in the First Leaside Group, the business was a fiction.

³ 2013 IIROC 52, para. 6.

⁴ *In re Bernard L. Madoff Investment Securities LLC, Debtor*, 654 F. 3d 230 (2011).

12. Counsel for CIPF Staff began by reviewing the Appellants' investments and the offering material associated therewith and made several points. The first was that the investments were not fictitious. Second, the use of the funds relied upon by the Appellants to establish their claim of unlawful conversion was in fact authorized. Counsel for CIPF Staff then argued that the facts in this case are virtually identical to those at issue in the October 27, 2014 decision and referred extensively to that decision. Finally, counsel for CIPF Staff referred to their submissions and made the overall point that the arguments advanced by the Appellants were more appropriately characterized as seeking a remedy for fraud rather than for unlawful conversion and that fraud is simply not included under the Coverage Policy.

13. The facts before the Appeal Committee in the October 27, 2014 decision are very similar to the facts in this appeal. In the October 27, 2014 decision, the claimant made two investments, one in June of 2011 and one in September of 2011. It is worth noting that this is the same time frame at issue here and indeed the Appellant, [REDACTED], made an investment on the same day in June of 2011 and in the same fund that the claimant did. More importantly, the Representative Counsel who appeared before the Appeal Committee in the October 27, 2014 decision made an almost identical argument to the one presented here by counsel for the Appellants. Representative Counsel there argued that the phrase "unlawfully converted" was ambiguous and should be interpreted as the changing from one form to another in a manner that is "wrong" whether by the standards of moral turpitude or otherwise not authorized by law. More specifically, Representative Counsel argued that by using the claimed funds in a manner that was inconsistent with the intention of the claimant's and on the basis of material non-disclosure, FLSI wrongfully converted the claimant's funds including using them not to primarily invest in real estate but rather to fund operating losses and distributions. Counsel for CIPF Staff responded to Representative Counsel's argument by stating that the purchase of units of the funds was not a conversion of the claimant's investment monies but rather an exchange of money for the investment certificates which were evidence of his investments.

14. In the October 27, 2014 decision, the Appeal Committee responded to the arguments of Representative Counsel as follows:

32. After careful consideration, we conclude that fraud, material non-disclosure and/or misrepresentation, as alleged in this case, 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. It is clear that the intent of the Coverage Policy is to return property in the Customer’s account to the Customer in the event of the insolvency of the Member. The inclusion of the phrase simply recognizes that circumstances may arise where the Customer has provided investment funds or other property to the Member for deposit to their account, but the funds were not posted to the Customer’s account; in other words, the property has be “unlawfully converted”.

33. In the view of the Appeal Committee, it is not intended that the phrase “including property unlawfully converted” be interpreted in a manner that would, in effect, create a new head of coverage. Rather, the phrase is merely meant to ensure inclusivity in the final phrases of the latter half of the passage quoted above: “or other property, *received, acquired or held by, or in the control of, the Member for the customer, including property unlawfully converted.*”

15. In the Appeal Committee’s decision in relation to a case heard on October 28, 2014⁵, the Committee rejected more firmly the argument presented here by counsel for the Appellants. In that case, the investor purchased units in the Special Notes Units on October 13, 2011, approximately four months prior to FLSI being declared insolvent. A certificate for the Special Notes Units was issued to the investor and delivered out on October 20, 2011. The Appeal Committee stated as follows:

19. The Appellant’s submissions focused on the second sentence in the Coverage Policy, and in particular, the words “including property unlawfully converted”. The argument is that the Appellant gave cash to FLSI and that it was then converted into the Special Notes Units. In turn, the conversion was unlawful because the Appellant did not consent to his cash being converted into First Leaside Group products in circumstances where he was not made aware of the absence of underlying assets and when the viability of his investment was dependent on receipt of new investors’ money. Counsel submitted that while CIPF could have used language clearly excluding misrepresentation and deceit, it chose not to do so and instead referred to “property unlawfully converted”. The Appellant submitted that the *contra proferentum* rule of contractual interpretation applies to contracts of adhesion and should apply in this case because of the ambiguity in the meaning of the phrase “including property unlawfully converted”.

⁵ Decision rendered on 13 February 2015.

20. The Appeal Committee is of the view that the Appellant's claim is one of fraud, material non-disclosure and/or misrepresentation and does not fall within the meaning of the phrase "including property unlawfully converted". Such an interpretation would in effect create a new head of coverage. Furthermore, we have concluded that the phrase is not ambiguous and simply recognizes that circumstances may arise where a customer has provided investment funds or other property to a member firm for deposit but the funds were not posted to the customer's account.

16. Characterizing the situation as a Ponzi scheme does not add to or alter the outcome in this case. The fact is that in this case, and as noted under the heading "The Appellants' Investments and Claim", the Appellants signed directions in relation to the investments at issue and the units were either held on book by Fidelity or were delivered out in certificate form. The Offering Memorandums and Declarations of Trust outlined the risks associated with and the allowable business of the investments. In this regard, it is worth referring to the decision of IIROC relating to Phillips and Wilson⁶ which stated at the outset:

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 the First Leaside advisers (including Phillips and Wilson)."

17. Here, the Appellants relied upon the principals of FLSI in purchasing units in the First Leaside Group. Unfortunately, this fraud, misconduct, or misrepresentation does not provide a foundation for an action in unlawful conversion as that term is utilized in the Coverage Policy. Unlawful conversion would include the use of a customer's money to effect unauthorized purchases of securities. The materials before me make it clear that the purchases were authorized. FLSI's act in relation to the Appellants' funds was to purchase the securities as directed. As we have outlined on a number of occasions, the Coverage Policy covers unlawful conversion but it does not cover investments made in circumstances of fraud, material non-disclosure and/or misrepresentation.

⁶ 2013 IIROC 52, para. 3.

Conclusion

18. The October 27, 2014 decision deals extensively with the Appellants' argument. This Appeal Committee adopts the reasoning in the October 27, 2014 decision. As in the October 27, 2014 decision, while the Appeal Committee has considerable sympathy for the Appellants' position, I conclude that the submissions in this appeal are not persuasive and do not give rise to a successful claim for compensation from CIPF.

Disposition

19. The appeal is dismissed. The decisions of CIPF Staff are upheld.

Dated at Toronto, this 23rd day of December, 2015

Anne Warner La Forest