Mutual Fund Dealers Association of Canada
Association canadienne des courtiers de fonds mutuels

IN THE MATTER OF A DISCIPLINARY HEARING
PURSUANT TO SECTIONS 20 AND 24 OF BY-LAW NO. 1 OF
THE MUTUAL FUND DEALERS ASSOCIATION OF CANADA

Re: Arthur George Pretty

Heard: June 24-28, 2013, October 7-8, 2013 in Corner Brook, Newfoundland
Decision and Reasons (Misconduct): January 30, 2014

DECISION and REASONS
(Misconduct)

Hearing Panel of the Atlantic Regional Council:

Hon. D. Merlin Nunn, Q.C.	Chair
Susan Nixon	Industry Representative
Ann C. Etter	Industry Representative

Appearances:

Maria Abate Francis Roy	))	Enforcement Counsel, Mutual Fund Dealers Association of Canada
James Bennett	)	Counsel for the Respondent, Arthur George Pretty

The Allegations

1. By Notice of Hearing dated August 31, 2012, the Mutual Fund Dealers Association of Canada ("MFDA") alleged that Arthur George Pretty (the "Respondent") committed the following violations of the By-laws, Rules or Policies of the MFDA:

Allegation # 1: Between March 2005 and July 2008, the Respondent recommended and facilitated a leveraged investment strategy for at least 6 clients without performing the necessary due diligence to learn the essential facts relative to the clients, and without ensuring that the leveraged investment strategy was suitable for the clients and in keeping with the clients' investment objectives, contrary to MFDA Rules 2.2.1 and 2.1.1.

Allegation # 2: Between March 2005 and July 2008, the Respondent misrepresented or failed to adequately explain the benefits, risks, material assumptions and features of a leveraged investment strategy and its underlying investments to at least 6 clients, thereby failing to present the leveraged investment strategy to the clients in a fair and balanced manner, contrary to MFDA Rule 2.1.1.

Allegation # 3: Commencing September 14, 2010, the Respondent failed to comply with multiple requests to provide a written statement to the MFDA in response to client complaints and to attend at an interview requested by the MFDA during the course of the investigation, contrary to section 22.1 of MFDA By-Law No. 1.

The Respondent

2. The Respondent was registered in the provinces of Newfoundland and Labrador, Nova Scotia and Prince Edward Island as a mutual fund salesperson with Berkshire Investment Group ("Berkshire"), a (former) Member of the MFDA from October 2000 to July 1, 2008.

3. On July 2, 2008, Berkshire amalgamated with Manulife Securities International Ltd. ("MSIL") and the combined entity carried on business as Manulife Securities Investment

Services Inc. (“Manulife”), a Member of the MFDA.

4. Prior to his registration with Berkshire, from September 1995 to October 2000, the Respondent was registered as a mutual fund salesperson with Investors Group Financial Services Inc.

5. On May 25, 2010, the Respondent was terminated by Manulife as a result of the activities described herein.

6. When the Respondent joined Berkshire he signed an Agreement of Approved Person dated August 14, 2001, as well as, a letter dated July 29, 2002, from Berkshire to the Respondent, acknowledging that he was bound by and obliged to observe and comply with the By-Laws, Rules and Polices of the MFDA, that he would be compliant with Berkshire’s sales compliance manual and he would submit to the jurisdiction of the MFDA. (See Exhibit 9, Tab 1B)

7. As a result, at all times that the events alleged here occurred, the Respondent was an Approved Person as defined in section 1 of MFDA By-Law No. 1 and was subject to the MFDA Rules.

Pre-Hearing Motions

8. The Hearing on the Merits was preceded by a teleconference hearing on June 5, 2013 on a Motion by the MFDA to have an expert witness testify by video conference. The teleconference hearing was with the Chair only as the two Industry Representatives were unable to take part. Rule 5 of the MFDA Rules of Procedure provides that a Panel (“Hearing Panel”) may hold an electronic hearing of the nature applied for in the Motion and Rule 5.1(3) sets forth certain factors among any other relevant factors in the matter. Those certain ones are convenience, fairness, cost, efficiency and timeliness, public access, and appropriateness having regard to the evidence and the issues.

9. Staff of the MFDA ("Staff") provided an extensive presentation with supporting case authorities. Counsel for the Respondent objected to the Motion and presented his reasons, particularly relating to cross-examination and the importance of seeing the witness face to face.

10. However, this particular witness was primarily called only to provide the Hearing Panel with expert evidence on the operation and features of return of capital ("ROC") mutual funds and the effects of their use as part of a "leveraged investment strategy". He would not be asked to make any comment on the suitability of any of the investments in issue here or any of the Respondent's conduct.

11. The Affidavit of Ms. Abate sworn May 24, 2013 indicated that the expert witness, Professor Eric Kirzner, though contacted earlier, delivered his Expert Report (the "Kirzner Report") on May 14, 2013 and a copy was sent to Respondent's counsel. A very significant item in the affidavit was the fees to be charged by Professor Kirzner were to be $450 per hour from the time he left by plane to the time of his return, estimated by Staff to be in the range of $12,000 to $15,000 for a minimum of 24 to 30 hours without considering cost of airfare, hotels and incidentals for, perhaps ½ day of testimony.

12. The issues of the purpose of the expert's testimony, the fact that he would not be commenting on the Respondent's conduct and the very high cost to have him attend outweighed, in my opinion, any concerns expressed by the Respondent's counsel. Added to this, his evidence would be very helpful to the Hearing Panel and was without any prejudice to the Respondent.

13. Taking all this into consideration, I granted the Motion and at the Hearing on the Merits Professor Kirzner did testify by video-conference.

14. There was a second Motion by Staff at the June 5, 2013 teleconference and that was for an Order to abridge the time for service of the Kirzner Report to the Respondent and secondly, that, in accordance with Rule 6.1(2) of the MFDA Rules of Procedure, an Order that the Motion may be brought with less than the usual 10 days notice.

15. This Motion was also granted by me in these rather unusual circumstances. There is abundant authority in similar cases to support this decision.

16. I did indicate that a written decision would follow so the foregoing constitutes the written decision on the Motions.

Hearing on the Merits

17. As the Hearing on the Merits began, MFDA Staff produced and had marked as exhibits seven (7) large binders containing close to, if not more than, a thousand pages of documentary evidence.

18. Each witness was examined in minute detail in direct testimony as to each of their relationship and activities with the Respondent, their age, financial experience and reasons for entering mutual fund investments with the Respondent, speaking to many documents in the exhibits which related to them. So also was each cross-examination in great detail.

19. The witness MB testified for one (1) whole day, the witness CH was 1 ½ days and the witness PM was 2/3 of a day. The Panel accommodated the witnesses by sitting for longer times on each day.

20. Professor Kirzner testified for half a day on his Report. He currently is a Professor of Finance and John H. Watson Chair in Value Investing at the Joseph L. Rotman School of Management, University of Toronto. He also holds a number of positions in the investment world, including a Director of Equitable Trust and Chair of its Audit Committee, a member of the Canada Council of the Arts Investment Committee and lead external advisor to Hospital of Ontario Pension Plan. Previously he served as a Director of the Investment Industry Regulatory Organization of Canada.

21. He has expertise in investment suitability, asset allocation, investment product knowledge, leveraging strategies, valuation of securities, brokerage account management and

how investors make decisions.

22. He has testified as an expert before the Ontario Superior Court of Justice, the Supreme Court of British Columbia and the Investment Dealers Association District Council on the areas previously mentioned.

23. Based upon the evidence provided as to the areas of his expertise, Professor Kirzner was qualified to provide the Hearing Panel the benefit of his expertise relating to "return-of-capital" or "high pay-out" or "T-series" mutual funds, including the risks inherent to those types of investment, (Kirzner Report pp. 13 and 14) and the suitability issues an advisor must take into account when recommending the purchase of a ROC Fund.

24. As borrowing funds to purchase ROC Funds is significant in the present matter, Professor Kirzner discussed what he referred to as the six (6) most important factors that should be obtained and examined in assessing a client's situation, which are:

a) Age;
b) Income and net worth;
c) Investment knowledge;
d) Investment objectives;
e) Risk tolerance; and
f) Time horizon.

(See Kirzner Report pp. 15 and 16)

25. Of these, Professor Kirzner, indicated that, while all these factors are important, a client's investment knowledge is of particular significance in assessing the ability of the client to understand the nature of specific investments and strategies such as leverage, and to understand the manner in which investments can perform, including the possibility they can increase and decline in value.

26. As to ROC Funds or "T Funds" , Professor Kirzner states, on page 16 of his Report:

> Accordingly, when an advisor recommends the purchase of a ROC Fund it is essential that the advisor explains how ROC funds work, the specific risks associated with a declining asset base (discussed above) and the other risks associated with the fund.

27. Referring to leveraged strategies Professor Kirzner states again at page 16 of his Report:

> In my opinion, leveraged strategies using ROC funds are likely to be suitable only when the investor is sophisticated, has a long investment horizon, a very high risk tolerance, very aggressive investment objectives, understands the risks of leverage and has back up sources of income and net worth.

28. He concludes that ROC Funds or "T Funds" are particularly risky for use in leveraged strategies.

29. The Hearing Panel was impressed with Professor Kirzner's Report and his *viva voce* testimony which was most informative regarding these types of investments, their risks, their use in a leveraged situation and importance of the client's knowledge and understanding together with the suitability of such investments for the client.

THE INVESTOR WITNESSES

30. It is the Hearing Panel's intention to summarize the relevant evidence of each of the three investor witnesses as to their personal life situation, their reasons for investing and investment knowledge and their relationship with the Respondent in their investment activities.

MB

31. He was 39 years old at the time of the Hearing on the Merits and married to CB who was one year younger. They have two children, a son aged 10 and a daughter aged 8. He obtained a college Degree in the Natural Resources field in 1995 and his wife, CM, graduated from university in 1993. Both worked with the Ontario Department of Natural Resources at Thunder Bay, Ontario for a number of years, after which, in 2003, they moved to Deer Lake,

Newfoundland.

32. Neither he nor his wife had any financial experience nor did either of them ever work in the financial industry.

33. In 2005, he was 31 years old and his wife was 30 when they met the Respondent who was recommended to them by a friend. MB and CB told the Respondent of their finances, his net income of $27,759, and his wife, who was on maternity leave receiving EI, had a net income of $23,591. Their assets were a house assessed at $100,000 with a mortgage of approximately the same amount. In fact, the pay-out figure for this mortgage was $102,615, including a pay-out penalty of approximately $1650. As well, MB and CB owned a car and a pick-up truck, both of little value, and had a savings account of $2,000 and two RRSP's of about $1,000 each.

34. At this meeting, MB and CB made it very clear that the reason they were thinking of investment was to have money in the future for their children's education. At the same time MB and CB advised the Respondent that they had no financial investment knowledge.

35. For their first investment, the Respondent recommended that MB and CB re-mortgage their house by getting a Bank of Montreal mortgage to pay out the existing Scotiabank mortgage. The Respondent told MB and CB he had a good relationship with the Bank of Montreal. MB and CB agreed and obtained a mortgage loan of $119,340 which covered the Scotiabank balance owing, plus the pay-out penalty of $1650 and other costs of approximately $1100. The Respondent advised MB that it was better to pay these extra amounts because the investment money returns would easily cover these amounts.

36. From the new mortgage, MB and CB received $12,354.79 of which $12,000 was invested by the Respondent in Stone Flagship Growth, a mutual fund. According to MB, that decision was made by the Respondent with very little discussion and no details explaining the account were given by the Respondent. MB testified that he made it clear to the Respondent that he wanted his investments safe. He testified that all he knew was the money was invested and they, he and his wife, received a cheque every month for $131.70 which was deposited into their account as part

of their monthly income.

37. The other side of the coin regarding the mortgage was that the mortgage on their home was about $19,000 higher and monthly payments were $30 to $40 higher.

38. Three days later MB and CB borrowed $50,000 at the Respondent's behest, from Manulife Bank and the proceeds were invested by the Respondent on their behalf into five different Manulife segregated fund products. A year later MB and CB, again at the Respondent's behest, borrowed $50,000 from AGF Trust which the Respondent, on their behalf, invested in the Clarington Canadian Dividend Fund.

39. In total, the Respondent recommended and assisted MB and CB to obtain four (4) investment loans totalling approximately $150,000.

40. According to MB's testimony he and his wife signed numerous documents for the Respondent, all of which were pre-prepared by the Respondent and presented to them for signature. There was little or no discussion and they signed them because they trusted the Respondent, regarding him as a friend.

41. MB's testimony was very credible in that neither he and his wife had any investment knowledge, that whatever money they did invest must be safe and it was to mainly provide for the education of his children and possibly for their retirement, and most importantly that all this was not only told, but emphasized, to the Respondent.

42. Nevertheless, the Applicant/Annuit Information Forms, prepared by the Respondent contained several significant errors. CB's annual income was stated as $50,000 when the Respondent knew that she was on maternity leave and her actual income was approximately $24,000. See Exhibit 4, Tab 4.

43. As an aside, at this point the Respondent had full knowledge of their total income and finances. This is extremely significant in relation to any consideration of leveraging.

44. More importantly, the Applicant Forms were completed to show 100% Medium Risk Tolerance when, in fact, they had insisted on no risk. In fact, MB had told the Respondent that he had made some investments while he was in Ontario and he lost everything and did not want to repeat that in any new investments. He wanted his investments to be safe.

45. The same form had the Account Type block marked as "Leveraged" which MB said was never discussed with him and his wife.

46. The Respondent did not go over these documents with them rather they were merely presented for signature. The same approach applied to the Leveraging Disclosure Documents See Exhibit 4, Tab 9.

47. All of the foregoing documents were signed by MB and CB without explanation and without any real understanding of their contents, relying totally on the Respondent whom they trusted.

48. Staff in their submissions to the Panel, at page 9 referring to Exhibit 14 - Gain and Loss Statement for MB and CB indicate:

> "MFDA Staff calculated the loss incurred by the B's as a consequence of the Leveraged Investment Strategy recommended by the Respondent to exceed $11,000. Given the Respondent's representations to the clients to the effect that the funds' distributions were dividend income that they could use to fund their lifestyle, however, the B's actually spent most, if not all, of the excess distributions they received in cash ($28,548.11). As such, Staff submits that, when adding to the loss total the total amount of distributions received by the B's, their actual losses are $39,559.94."

49. The Hearing Panel finds that these amounts are as provided in the documentary evidence and agrees with the approach of Staff. Whichever figure was taken was a loss of a significant amount to MB and CB.

CH

50. CH and his wife TH moved to Labrador in 1954. He had a Grade 9 education while she had completed Grade 11, taking Secretarial courses. They have a son who is 55 years old, suffered from disabilities and was under their care.

51. CH had done varied work, mostly physical for many years but started a business (a hunting/fishing/charter service) which around the year 2000, they sold netting them a retirement fund over $1,000,000. Out of this, CH purchased a house in St. Johns and a vehicle and a boat.

52. Neither he nor his wife had any financial knowledge or experience. CH described themselves as "ignorant of events in the financial world".

53. However, CH testified that they then had some money and somehow came into contact with one Fred Coles of Berkshire Investment Group Inc. and initially invested $700,000, telling Fred Coles that he wanted his investment to make some money but to never put his investment at risk.

54. Around 2004, Fred Coles either retired or left Berkshire. In any event, he ceased as CH's financial advisor and CH received a phone call from the Respondent who indicated that he had taken over CH's Berkshire account. At this time CH and TH's total income was approximately $70,000, fluctuating from approximately $87,000 in 2006, to $98,000 in 2007, $72,000 in 2008 and $67,000 in 2009. These annual incomes included Canada Pension and Old Age Security for both CH and his wife.

55. Between these years from 2004 to 2008 the Respondent recommended, persuaded and assisted CH and TH to obtain at least three (3) investment loans totalling $650,000. At the time of the first of these loans CH was 70 years of age and TH was 71. They were both retired and debt free. They did, however, have a very significant obligation in caring for their adult son, costing $2000 to $3000 each month.

56. Essentially, CH and TH relied on their savings and the proceeds of their business to support them and their son for the rest of their lives and that was made clear to the Respondent. In their view their investment aim was to make money and never to lose their initial investment.

57. It is unnecessary to set out the details of these transactions though the full details are set out in Exhibit 6. As in the case of MB referenced above, the Application and Account Information Forms were pre-prepared and presented to CH and TH for signature without explanation. CH and TH indicated a risk tolerance of "100% medium" for both he and his wife and the Investment Objectives were "100% long term" i.e. 10+ years and that their Investment knowledge was "good". Though they signed these documents, CH testified that he, too, trusted the Respondent as his financial advisor and neither of these assessments were true. CH had made it clear to the Respondent that there was to be no risk to his initial investment and both he and his wife wanted a term no longer than seven (7) years and both had no investment knowledge.

58. CH and TH both also signed, at the Respondent's request, the Leverage Disclosure Document, though the testimony of CH indicated this document was not explained and they had no idea of what "leveraging" meant. CH and TH were never advised as to the content of these documents, never read them and only signed where the Respondent advised.

59. Similarly to MB, the investments made from the loan were either in ROC Funds or T funds. These terms were not explained and, if they had been fully explained, CH would not have his funds invested in them.

60. CH testified that the Respondent was a convincing speaker, always advising that his recommendations were in their best interests. The Respondent did promise and guaranteed that his plan was to make money and not to lose any principal. The Respondent conducted all fund purchases and never explained the funds purchased to them.

61. CH and TH did receive monthly distributions which, the Respondent advised CH and TH, was dividend income, most of which they spent.

62. At present, the total value of their investments, including some investments not made using investment loans, is significantly less than the amount they began with the Respondent. The evidence is clear that CH and TH borrowed a total of $800,000 with only $750,000 of that invested and only $650,000 of that was invested using the Leveraged Investment Strategy.

63. As with MB, Staff calculated the CH and TH losses from the Leveraged Investment Strategy at page 12 of its submissions, referring to Exhibit 14 - Gain and Loss Statement for CH and TH which indicates:

> "MFDA Staff calculated the loss incurred by the H's as a consequence of the Leveraged Investment Strategy recommended by the Respondent to exceed $23,000. Given the Respondent's representations to the H's to the effect that the funds' distributions were dividend income that they could use to fund their lifestyle, however, the H's actually spent most, if not all, of the excess distributions they received in cash. As such, Staff submits that, when adding to the loss total amount of distributions ($404,047.40) received by the H's their actual losses are $427,047."

64. The Hearing Panel finds that these amounts are consistent with the amounts in the documentary evidence (See Exhibit 14) and agrees with the approach of Staff. In either situation described, CH and TH suffered a significant loss.

65. CH and TH still owe the bulk of their loans they took on as a result of the Respondent's Leveraged Investment Strategy (approximately $800,000) and the value of their investments is insufficient to fully pay off such loans.

PM

66. PM aged 53 at the time of the Hearing on the Merits, and his wife, whose name initials are the same as his, PM, were married in the early 1990's and by the year 2000 they had three children. He worked at the local pulp and paper mill in Corner Brook for some time then tried one year at university. He decided he was more of a "hands on" person and left university returning to the mill where he became a senior person on his shift. His wife became a stay at home mom with the children.

67. The house he purchased in 1991 was paid for and mortgage free before his marriage and through hard work and discipline he also managed to save $80,000.

68. He had invested $72,000 in an Investors Growth Fund. He also had $26,000 in RRSP accounts at the Canadian Imperial Bank of Commerce. As well, he was debt free, owned his own house and had a truck and a car.

69. Sometime in the late 1990's the Respondent, who was with Berkshire, lived on the same street as PM, advised PM that through Berkshire he had many companies to invest in and he could do better for him. PM testified that he relied on the Respondent for his investments. However, he also testified he was not interested in losing money as he worked too hard to earn it. Though he was interested in safe investing, his knowledge of the financial investment world was very limited.

70. Interestingly, the Respondent, who pre-prepared the Account Information, indicated "Limited Investment Knowledge" in the 2001 Forms yet in the 2004 Forms he changed that to "good". On this point, PM testified that he had done nothing in that interim period to upgrade his knowledge or information of the financial industry.

71. He testified he never instructed the Respondent regarding risk and certainly never wanted 100% high risk and was always uncomfortable about losing money.

72. The Respondent, however, indicated he had a client investing $200,000 and making $2000 a month with no tax. The Respondent indicated that he was not happy with RRSP's as an investment. By this time the Respondent won over PM to allowing him to control his investments.

73. After the Respondent illustrated other situations where clients borrowed to invest and indicated the situations he was recommending were not high risk. In advancing his recommendation he advised that PM borrow from the Bank of Montreal and he would invest the

money and, in 12 years the loan would be paid off and his investment ($100,000 suggested) would still be there. PM testified that he said to the Respondent:

> "George, you have all the knowledge. That's what I pay you for."

74. He agreed to go ahead with this borrow to invest strategy and the Respondent made all the arrangements with the Bank of Montreal for this first loan of $75,000 and when obtained the Respondent did all the investing and PM received no documentation regarding the funds used. Two other loans totalling $150,000 were obtained on the Respondent's recommendation for the same purpose and the funds were invested by the Respondent in funds of his choice.

75. As the other witnesses PM and his wife signed all the Application Documents and the Leveraging Disclosure Documents but in neither case were these documents explained. They signed the documents at the Respondent's request as he was their advisor and they trusted him.

76. The result of the investments made with the borrowed money, which went bad in 2008, was that PM and his wife lost a significant amount of money, and today owe more on their investment loans than the value of their investments.

77. This has caused them immeasurable stress and resulted in part in the breakdown of their marriage.

78. As with the other investor witnesses in this proceeding, Staff calculated loss based upon the information provided in Exhibit 14 as follows:

> "MFDA Staff calculated the loss incurred by M's as a consequence of the Leveraged Investment Strategy recommended by the Respondent to exceed $24,000. Given the Respondent's representations to the clients to the effect that the funds' distributions were dividend income that they could use to fund their lifestyle, however, the M's actually spent most, if not all, of the excess distributions they received in cash. As such, Staff submits that, when adding to the loss total the total amount of distributions received by the M's, their actual losses are $76,204.89."

79. Again, the Hearing Panel finds these amounts to be consistent with the amounts in the documentary evidence (See Exhibit 14) and agrees with the approach of Staff. As with the others, whichever amount is looked at the M's suffered a significant loss.

GENERAL

80. The foregoing constitutes the basic findings of facts relating to the testimony of each of the three investor witnesses. No witnesses were called on behalf of the Respondent, who sat through the whole hearing and heard all of the testimony offered to prove the allegations. Without any contradictory evidence from the Respondent the Hearing Panel's acceptance of the investment witnesses, given under oath, cannot be questioned. These witnesses were credible throughout and the similarity of the Respondent's activities in obtaining their investments stands out as confirmation of their individual testimony. Further, all three witnesses had a particular common interest. They wanted to invest so as to make money without losing their original investment. This was often expressed by each of them to the Respondent. The Respondent was advancing and using the same leveraging strategy for each of the investors and assuring and/or guaranteeing them that his investments would meet their needs and would cover the investment loans with extra money for their own use. For each of them, this did not happen as their losses show.

THE APPLICABLE RULES AND LAW

MFDA Rules

81. 2.1.1 **Standard of Conduct.** Each Member and each Approved Person of a Member shall:

a) deal fairly, honestly and in good faith with its clients;
b) observe high standards of ethics and conduct in the transaction of business;
c) not engage in any business conduct or practice which is unbecoming or detrimental to the public interest; and

d) be of such character and business repute and have such experience and training as is consistent with the standards described in this Rule 2.1.1, or as may be prescribed by the Corporation.

2.2 CLIENT ACCOUNTS

82. 2.2.1 **"Know-Your-Client".** Each Member and Approved Person shall use due diligence:

a) to learn the essential facts relative to each client and to each order or account accepted;
b) to ensure that the acceptance of any order for any account is within the bounds of good business practice; and
c) to ensure that each order accepted or recommendation made for any account of a client is suitable for the client and in keeping with the client's investment objectives; and
d) to ensure that, notwithstanding the provisions of paragraph (c), where a transaction proposed by a client is not suitable for the client and in keeping with the client's investment objectives, the Member has so advised the client before execution thereof.

83. 2.2.2 **New Account Application Form.** A New Account Application Form must be completed for each new account of a client. If the New Account Application Form does not include know-your-client information, this must be documented on a separate Know-Your-Client form. Such form or forms shall be duly completed to conform with the requirements of Rule 2.2.1 and shall be signed by the client and dated. Account numbers must not be assigned unless they are accompanied by the proper name and address for the client and such name and address must be supported by the New Account Application Form.

84. These Rules are basic and essential to any Approved Person in dealing with clients and their investments.

85. Counsel for the Respondent contended that the MFDA Suitability Guidelines were only introduced in April 2008 (MFDA Member Regulation Notice (MR-0069)) and cannot be applied retroactively here.

86. There is no merit to this contention as the MFDA Rules are merely a codification of longstanding requirements of the investment industry that predate the April Notice (MR-0069) of which the Respondent must have been fully aware. He was in the industry long before the events here and these were basic requirements throughout the industry for many years. See Re DeVuono, MFDA File No. 201102, a Vancouver, BC decision and Re Arseneau, MFDA File No. 201115, a decision of the Atlantic Regional of the MFDA.

87. In each of the client situations here the New Account Applicant Forms ("NAAF") were pre-prepared by the Respondent, never discussed in any detail with these clients and merely presented to the clients for signature.

88. This defeats the very purpose of the NAAFs. They are designed so that the Approved Person obtains the client's investment objectives, financial situation and other pertinent personal information. The obligation to complete a new NAAF with each transaction is the device designed to keep the Approved Person up-to-date on the client's investment objectives and strategy behind each order.

89. The two key principles in Rule 2.2.1 are Know-Your-Client and suitability. As was said in *Re Daubney,*2008 LNONOSC 338(OSC) at paras 15, 16 and 17:

> 15. The Commission has recognized that the know-your-client and suitability requirements "are an essential component of consumer protection and a basic obligation of a registrant, and a course of conduct by a registrant involving a failure to comply with them is an extremely serious matter." (*Re E. A. Manning Ltd. et al.* (1995), 18 O.S.C.B. 5317 at 5339)
>
> 16. The Alberta Securities Commission (the "ASC") described these two obligations as follows:

> The "know-your-client" and "suitability" obligations are conceptually distinct but, in practice, they are so closely connected and interwoven that the terms are sometimes used interchangeably.
>
> The "know-your-client" obligation is the obligation to learn about the client, their personal financial situation, financial sophistication and investment experience, investment objectives and risk tolerance.
>
> The "suitability" obligation is the obligation of a registrant to determine whether an investment is appropriate for a particular client. Assessment of suitability requires both that the registrant understands the investment product and knows enough about the client to assess whether the product and client are a match. *(Re Marc Lamoureux* (2001), ABSECCOM 813127 (*"Re Lamoureux")* at 10.)

17. Canadian securities authorities have adopted a three-stage analysis of suitability, according to which a registrant is obliged to:

> a) use due diligence to know the product and know the client;
> b) apply sound professional judgement in establishing the suitability of the product for the client; and
> c) disclose the negative as well as the positive aspects of the proposed investment.
>
> See *Re Lamoureux* 2001 LNABASC 433.

90. Further comments in *Re Lamoureux* on the "three stage process" make the stages even more explicit at pages 18 and 19:

> **Three-Stage Process**
>
> Suitability is to be assessed prior to any investment recommendation by the registrant to a client. The process that culminates in a registrant's investment recommendation to a client has three component phases or stages that must occur in sequence.
>
> The first stage involves the "due diligence" steps undertaken by the registrant to "know the client" and to "know the product". Knowing the product involves carefully reviewing and understanding the attributes, including associated risks, of the securities that they are considering recommending to their clients. Knowing the client was discussed above.
>
> Only after the "due diligence" of the first stage is completed, can the registrant move to the second stage in which they fulfil their obligation to determine

whether specific trades or investments, solicited or unsolicited, are suitable for that client.

Suitability determinations, discussed in section IV(B) (d), will always be fact specific. A proper assessment of suitability will generally require consideration of such factors as a client's income, net worth, risk tolerance, liquid assets and investment objectives, as well as an understanding of particular investment products. The registrant must apply sound professional judgement to the information elicited from "know your client" inquires. If, based on the due diligence and professional assessment the registrant reasonably concludes that an investment in a particular security in a particular amount would be suitable for a particular client, it is then appropriate for the registrant to recommend the investment to that client.

By recommending a securities transaction to a client, a registrant enters the third stage of the process. Whether a particular transaction has in fact been "recommended" is to be determined objectively, taking into consideration the content, context and manner of communication from a registrant to the client, to assess whether it could reasonably be understood as a suggestion that the customer engage in a securities transaction. At this stage, when making the client aware of a potential investment, the registrant is obligated to make the client aware of the negative material factors involved in the transaction, as well as positive factors.

The disclosure of material negative factors in the third stage of the process is intended to assist the client in making an informed investment decision. It should be emphasized that such disclosure cannot ameliorate deficiencies in either of the first two stages of the process. If a registrant recommends securities that are not suitable for a particular client, then disclosure by the registrant during the third stage is irrelevant to their suitability obligation in stage two. The registrant's failure may have been the result of not knowing the client, or not knowing the securities, or an error in the suitability determination but, once the improper recommendation has been made, it does not matter whether or how the registrant discloses the material negative factors, or whether the client claims to understand and accept the risks involved in the investment. The registrant has failed to fulfil their obligations.

The Suitability Assessment

The British Columbia Securities Commission had occasion to describe the suitability obligation in **Foerster,** (1997) 13 CCLS 274 [at page 292] as follows:

> The second step in complying with the know your client rule is determining that the proposed investment is suitable for the client, that is, that it will achieve the investment objectives of the client while keeping within the level of risk determined by the client's comfort level and

overall circumstances.

91. Rule 2.2.1(a) requires an Approved Person, here the Respondent, to "use due diligence" to learn the essential facts relative to each client and to each order or account accepted.

92. "Due diligence" includes, at least, the obligation to know and fully understand the client's financial situation, current and continuing financial obligations, net worth, income, liquid assets, understanding the market, age relative to retirement, knowledge and understanding of borrowing to invest and of ROC mutual funds and the ability to repay the borrowed amounts in the event of market changes to the value of the mutual funds and/or their distributions. See *Re Arseneau* supra at para 43 (Tab 47 Staff Book of Authorities).

93. Here the Respondent did learn some of these facts but disregarded many of the most vital ones, particularly those relating to borrowing to invest and ROC funds and their risks.

94. From the evidence the Hearing Panel accepted the Respondent paid little or no attention to his clients' assertions of no knowledge of or experience with financial investments and the financial market.

95. He was either careless or deceitful in his pre-prepared New Account Application Forms (NAAFs) especially as to "Risk Tolerance", "Investment Knowledge" and "Term". All three investors MB, CH and PM insisted upon no risk, having no investment knowledge and not wanting long term (over 10 years). The NAAF citing TH's income was substantially overstated. On some others the Respondent recorded inaccurate or misleading information or failed to record vital information. For example, on the NAAFs relating to the Hs the Respondent did not include the fact that the clients had a disabled dependent son whom they assisted financially and for whose benefit they wished to bequeath a significant portion of their investments. On another, TH's employment information is wrong as it has her employed by an Ontario Company. CH's financial information is also wrong. Their telephone number is incorrect.

96. On the NAAF regarding CB, the Respondent stated her annual income as $50,000 when

he was quite aware that she was at home on maternity leave receiving only Employment Insurance (EI) benefits. This same incorrect information on income was included in the AGF Trust Investment Loan Application, completed by the Respondent, for a $50,000 loan to make an investment in the IA Clarington Canadian Investment Dividend Fund. The loan was obtained and the investment made.

97. All of this clearly proves that the Respondent's actions fall far short of his "due diligence" obligations with regard to the three investor families in the matter.

98. He has failed in his Know-Your-Client obligations. From his behaviour it would appear that for each investor he had only one strategy in mind, regardless of their situation, which was a "borrow to invest strategy" which he pursued with vigour, regardless of each client's situation and interest in investment. He betrayed their trust and absolute reliance on him as each ones' financial advisor. While he was receiving commissions on each transaction, he knew or should have known of his client's potential for significant loss with investments which they should never have undertaken, and which ultimately did occur for each investor.

99. In this proceeding, the signed NAAFs and the signed Leveraging Disclosure Documents by each of the witnesses and their wives cannot be offered by the Respondent as the complete answer to the allegations and thereby remove him from any wrongdoing. The signatures are meaningless as the NAAFs pre-prepared by the Respondent contain errors and misrepresentations of the information provided him and the Leveraged Investing Document was never adequately explained to assure its contents were understood and accepted.

100. Turning to the suitability obligations, these have been considered in numerous cases which establish the basic elements of this obligation. Essentially, the suitability obligation entails using the information from the client to fulfil the Know-Your-Client obligation and using it to identify investment products and strategies appropriate in the light of the client's personal and financial circumstances.

101. The suitability obligation rests solely on the Approved Person and cannot be substituted,

avoided or transferred to the client even by obtaining from the client acknowledgement that they are aware of negative material factors or risks.

102. The suitability obligation is a particularly important protection for clients whose investment experience and sophistication is insufficient to enable them to fully recognize or assess the risks inherent in an investment or strategy. Further, an investment product or strategy is not appropriate for a client unless the client has the sophistication necessary to understand the risk, the willingness to accept the risk and the capacity to withstand the potential adverse consequences.

103. As well, an Approved Person must know what probability of loss is acceptable to the investor, i.e. the Approved Person must truly "know his client". While only foreseeable factors fall into suitability determination, it ought to be reasonably foreseeable to any investment advisor that there might, at almost any time, be a market downturn that might prove to be of minor or major proportion and would impact, potentially substantially, the performance of an equity based mutual fund. Such an event would not necessarily be foreseeable to an investor.

104. These comments are all derived from a series of previous cases. See:

Re Lamoureux, supra
Re Daubney 2008 LNONOSC 338
Re Bilinski 2002 LNBCSC 1
Re Gareau 2001 LNOCRCVM 53
Rhoads v. *Prudential-Bache Securities Canada Ltd.* 63 BCLR (2d) 256

105. The foregoing obligations apply to each and every client investment made through an Approved Person. However, in the case of leveraged investments, there are a number of additional considerations, such as:

a) whether the client has sufficient income or unencumbered liquid assets to be able to:
    i. withstand a market turndown without jeopardizing their financial security;

    ii. satisfy all loan obligations associated with the strategy regardless of the performance of the investments purchased as a result of the strategy and

without relying on anticipated income from the investments; and

b) whether there is any reason to expect the client's current sources of income to be reduced in the short term bearing in mind the client's stage of life (age, anticipated retirement date), employment status and personal circumstances.

See *Daubne*y, supra, *Re Wealthstreet Inc.* 2011 LNABSC 290 at paras 135 and 136; and *Bilinski***,** supra

106. The testimony of MB, CH and PM clearly indicate what representations the Respondent made to them. They are:

a) the ROC mutual funds could be relied upon to make distributions to investors each month which would be at least equal to or greater than the borrowing costs associated with the clients' investment loans;

b) the ROC mutual funds' distributions were dividend or interest payments;

c) excess distributions made by the ROC mutual funds could be applied to pay down the principal of the investment loans on an accelerated basis or used by the clients as extra income;

d) the investment loans would be paid off entirely by the distributions from the ROC mutual funds;

e) the ROC mutual funds purchased with the investment loans would continue to grow in value over time and, once the investment loans were repaid, the clients would own the ROC mutual funds, which would continue to grow in value and continue to generate distributions for use by the clients; and

f) the Leveraged Investment Strategy was low risk.

107. However, the testimony is also clear as to what he did not advise them on:

a) they could not count on positive returns from the investments purchased with borrowed money and could not depend on returns from their investments to improve their standard of living;

b) even if the returns from the investments purchased with borrowed money were positive, they could lose money if their borrowing costs exceeded their investment gains;

c) the ROC mutual funds distributions consisted largely and primarily of a return of

the clients' invested capital;

d) even if distributions from the investments purchased with borrowed money remain consistent, an increase in interest rates could affect the sustainability of the strategy if additional sources of income could not be applied to pay the increased interest rates;

e) the value of the investments purchased with borrowed money could fall below the value of the loan;

f) even if the value of the leveraged investment falls, the loan would have to be repaid with interest;

g) if they were required to liquidate all or part of their portfolio in the short term, deferred sales charges on the amount redeemed would further reduce the proceeds available to satisfy their liabilities or other needs;

h) if the payment of distributions from the investments were reduced or discontinued and the clients could not cover the shortfall required to meet their loan payment obligations they might end up defaulting on the loan; and could lose any security including a home.

108. Based upon the testimony of the three investors here it is abundantly clear that none of them would have accepted the risks of the leveraged system nor would they have invested in ROC mutual funds.

109. MB testified he was investing to have money for his children's education so would not be interested in long term investments. He was either naive or easily persuaded as one episode involved the re-mortgaging his house at a much larger amount. His income was in the ordinary family range with no extras. Without further elaboration MB was not a leveraging candidate. So neither leveraging nor ROC mutual funds were suitable for him and the Respondent should not have been recommending them to him or his wife.

110. CH and his wife TH were 70 and 71 years of age, retired, and through hard work over a lifetime had managed to have very significant savings when they met the Respondent. They had a disabled son aged 55 they supported with substantial monthly payments. He never borrowed money except on one occasion and 2 days later he repaid it. His age, living situation with only Canada Pension and Old Age Security received by both they had no income to absorb any loss.

They certainly were not risk takers and would not have been interested in ROC mutual fund investments. The Respondent should have known this and had the Know-Your-Client obligation to do so. Clearly the leveraged strategy and ROC mutual funds were not suitable for CH's investment requirements.

111. PM and his wife, again through hard work and discipline had no debt, had a mortgage free house and savings in the range of $80,000. They had three children, two daughters, aged about 11 and 12 and a son about 5. PM's main interest in investing was to provide for their education. His income was in reasonably good range but certainly not large enough to suffer loss through risks. The Respondent obviously did not consider suitability in his recommendations to PM.

112. With all three investors the Respondent failed in his obligations to the investor witnesses in this matter by recommending and facilitating a leveraged investment for six (6) clients, the investor witnesses and their wives, without performing the necessary due diligence to learn the essential facts relative to the clients and without ensuring that the leveraged investment strategy was suitable for the clients and in keeping with the clients investment objectives, contrary to MFDA Rules 2.2.1 and 2.1.1 between March 2005 and July 2008. Allegation # 1 has been proven.

113. So also with Allegation # 2 that between the same dates the Respondent misrepresented or failed to adequately explain the benefits, risks, material assumptions and features of a leveraged investment strategy and its underlying investments to the six clients in this proceeding, thereby failing to present the leveraged investment strategy in a fair and balanced manner, contrary to MFDA Rule 2.1.1. Allegation # 2 has been proven.

114. The statement by Professor Kirzner earlier must be repeated to emphasize who might be suitable for a leveraged strategy using ROC mutual funds:

> "In my opinion, leveraged strategies using ROC funds are likely to be suitable only when the investor is sophisticated, has a long investment horizon, a very high risk tolerance, very aggressive investment objectives, understands the risks

of leverage and has back up sources of income and net worth."

Neither of the investors would fall under that description.

115. The third Allegation relates to the Respondent's failure to comply with multiple requests to provide a written statement to Staff in response to client complaints, and to attend an interview requested by Staff during the course of the investigation, contrary to Section 22.1 of MFDA By-Law No. 1.

116. Section 22.1 of MFDA By-Law No. 1 provides:

> **22. INVESTIGATORY POWERS**
>
> 22.1 For the purpose of any examination or investigation pursuant to this By-law, a Member, Approved Person of a Member or other person under the jurisdiction of the Corporation pursuant to the By-laws or the Rules may be required by the Corporation:
>
> (a) to submit a report in writing with regard to any matter involved in any such investigation;
> (b) to produce for inspection and provide copies of the books, records and accounts of such person relevant to the matters being investigated;
> (c) to attend and give information respecting any such matters;
> (d) to make any of the above information available through any directors, officers, employees, agents and other persons under the direction or control of the Member, Approved Person or other person under the jurisdiction of the Corporation;
>
> and the Member or person shall be obliged to submit such report, to permit such inspection, provide such copies and to attend, accordingly. Any Member or person subject to an investigation conducted pursuant to this By-law may be invited to make submission by statement in writing, by producing for inspection books, records and accounts and by attending before the persons conducting the investigation. The person conducting the investigation may, in his or her discretion, require that any statement given by any Member or person in the course of an investigation be recorded by means of an electronic recording device or otherwise and may require that any statement be given under oath.

117. The evidence on this aspect of the allegations is contained in the Affidavit of Michael S. Ford sworn March 8, 2013 and filed as an Exhibit in this proceeding and in his *viva voce*

testimony.

118. Between September 15, 2010 and March 1, 2011 a number of letters were sent by Mr. Ford to the Respondent by regular mail and registered mail which were not replied to and the registered letters were returned marked "refused by recipient". The third attempt was again by the two types of mail but this included "personal service" which was successful. Then a series of voicemails took place, one in which the Respondent indicated he had retained counsel and was unable to respond at this time (November 17, 2010). From this date, voicemails from Mr. Ford were requesting the Respondent to contact him. From this time on to March 1, 2013, there were twenty voicemails and three letters. The letters were from Mr. Ford, one of which set an interview date (January 27, 2011at Corner Brook). About a dozen of the voicemails were from the Respondent but none contained a telephone number where he could be reached and no real information was given.

119. On January 27, 2011, the date set by Mr. Ford, the Respondent telephoned that he would not be attending the interview.

120. Mr. Ford, on February 7, 2011, sent a letter to the Respondent by regular mail, registered mail and personal service. The letter reviewed the history of his attempts to meet with the Respondent and requested he contact him (Ford) immediately. The registered mail was not picked up, the regular mail returned marked "item refused by recipient and personal service was evaded though the letter was left at the front door of the Respondent's residence.

121. On March 1, 2011, a voice mail of the Respondent indicated that his meeting with his lawyer was rescheduled to March 5, 2011 and that he would contact Mr. Ford after that meeting. The name of the lawyer was never disclosed throughout the whole time period. No interview ever took place.

122. On cross-examination, Respondent's counsel indicated that Mr. Ford's September 15, October 7 and December 20 letters refers to a complaint that does not apply to the Respondent. Apparently these were errors arising out of some lack of care in using precedents and forms. In

any event, the first two were registered mail and were refused while the third was accepted but no response though there were further communications after relating to the January 27, 2011 interview date which was set forth in that letter.

123. We cannot give much weight to this information as there is no doubt the Respondent was aware of the complaints made against him, as well as, the MFDA Rules requiring his co-operation and he deliberately set out not to cooperate.

124. On the whole of the evidence on this point the Hearing Panel finds that Allegation # 3 has been proved on the balance of probabilities. The failures here by the Respondent to provide information, attend for an interview and offer no cooperation are certainly contrary to Section 22.1 of MFDA By-Law No. 1 and breaches the duty of all members of self-governing professions to cooperate with their governing bodies.

125. One might try to downplay the seriousness of these breaches of Section 22.1 of MFDA By-Law No. 1, however this breach is serious misconduct as it subverts the ability of the MFDA to perform its regulatory function and undermines the integrity of the self-regulatory system and the effectiveness of its operations and is detrimental to the public interest. (See *Re Tonnies* 2005, File No. 200503).

126. That the Respondent did not testify nor did he call other witnesses is a very significant matter as none of the testimony has been challenged and on all key points the Hearing Panel is satisfied that the investor witnesses' statements as to their experience with the Respondent are credible and honest portrayals of those experiences.

127. Other than Penalty, the only final matter for the Hearing Panel to decide is the question raised by the Respondent's counsel that the *Canadian Charter of Rights* should apply to protect his client from the MFDA investigation and any sanctions that may be imposed on him by this Hearing Panel.

128. The Hearing Panel agrees with and incorporates into this decision Staff's submissions at

para 79 stating:

> 79. The applicability of the *Charter* in proceedings of self-regulatory organizations such as the MFDA has been considered and consistently rejected by Canadian courts and prior MFDA Hearing Panels. The MFDA is not created by statute. Rather, it is a voluntary, private organization whose regulatory authority over its members and those who agree to be bound by its rules, by-laws and policies derives from contract. It is therefore not subject to public law remedies, including those prescribed by the *Charter*.
>
> > *Sellars* v. *Mutual Fund Dealers Association of Canada***,** [2012] N.B.J. No. 422 (QBTD). In this decision, the N.B. Court of Queen's Bench rejected the applicability of the *Charter* in MFDA proceedings after careful review and analysis of the significant Canadian decisions which considered same. See in particular paras. 28 to 32, 39-42 and 51.
> >
> > See also *Ronald Lindsay Brown*, [2010] MFDA Central Regional Council, MFDA File No. 200808, Hearing Panel Decision dated December 8, 2010 at paras. 42 to 49.

DATED this 30th day of January, 2014.

"D. Merlin Nunn"

Hon. D. Merlin Nunn, Q.C.,
Chair

"Susan Nixon"

Susan Nixon,
Industry Representative

"Ann C. Etter"

Ann C. Etter,
Industry Representative

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