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: David H. Karas

Heard: October 20 and 22, 2014, March 30 and 31, 2015 in Toronto, Ontario
Decision and Reasons: June 1, 2015

DECISION AND REASONS

Hearing Panel of the Central Regional Council:

The Hon P. T. Galligan Q.C.	Chair
Teri Ryan	Industry Representative
Robert C. White	Industry Representative

Appearances:

Charles Toth	)	For the Mutual Fund Dealers Association of Canada
David H. Karas	)	Not present nor represented by counsel

1. By Notice of Hearing dated July 2, 2013, MFDA made the following allegations against the Respondent:

> **<u>Allegation #1</u>:** Between 2002 and 2008, the Respondent misrepresented, failed to fully and adequately explain, or omitted to explain the risks, benefits, features and costs of leveraged investment recommendations that he made to at least 18 clients, thereby failing to ensure that the leveraged investment recommendations were suitable for the clients and in keeping with their investment objectives, contrary to MFDA Rules 2.2.1 and 2.1.1.
>
> **<u>Allegation #2</u>:** Between 2002 and 2008, the Respondent failed to ensure that his leveraged investment recommendations were suitable for at least 18 clients and in keeping with their investment objectives, having regard to the clients' "Know-Your-Client" information and financial circumstances, including but not limited to the clients' ability to afford the costs associated with the investment loans and withstand investment losses, contrary to MFDA Rules 2.2.1 and 2.1.1.

PRELIMINARY MATTERS

2. The first appearance took place on September 18, 2013. The Respondent appeared by counsel. On consent the hearing was fixed to proceed over a three-week period commencing June 2, 2014. A few months later the Chair died. The Hearing Panel had to be reconstituted. The originally scheduled date of June 2, 2014 could not be accommodated by a member of the reconstituted Hearing Panel. Accordingly, on March 11, 2014, we met with counsel for the parties by telephone conference call to fix a new date for the hearing. At that meeting the Respondent was represented by his counsel. The Respondent's counsel suggested that three weeks be fixed for the hearing beginning October 20, 2014. On consent we fixed the hearing date accordingly. We ordered that the Respondent file his reply by May 30, 2014.

3. Subsequently, the Respondent brought a motion to adjourn the hearing. The motion to adjourn was heard on August 26, 2014. At the completion of the argument we dismissed the motion and directed that the hearing begin, as scheduled, on October 20, 2014. We were advised

that the Respondent had not filed his Reply, on May 30, 2014, as had been directed. We then ordered that he file his Reply by September 19, 2014.

4. The Respondent did not file his Reply on September 19, 2014 and has not done so since.

5. On September 29, 2014 counsel for MFDA received an email from Respondent's counsel stating that the Respondent "will not be preparing for or participating in any way in the upcoming hearing." On October 20, 2014 when the hearing convened neither the Respondent nor his counsel appeared. We began the hearing in their absence. The hearing continued on October 22, 2014.

6. On October 22, 2014, during the afternoon recess, a panel member received an urgent communication advising that an immediate family member had suffered a sudden and acutely grave medical incident. The hearing was suspended so that the panel member could urgently return home. Ultimately the continuation of the hearing was scheduled for March 30, 2015.

7. On March 30, 2015 the hearing resumed and continued on March 31, 2015. At the end of the evidence and of the submissions on the merits by counsel for MFDA we reserved our decision. We advised that a written decision and reasons for it would be released at a later time. We then invited MFDA counsel to make submissions respecting penalty which would be considered by us only in the event that we should decide that the allegations had been proven.

8. The members of the panel have consulted together and have reached our decision. What follows is our decision and our reasons for it.

THE EVIDENCE IN THE CASE

9. The Respondent did not serve a Reply nor did he appear at the hearing. In such a case section 20.4 of By-law No. 1 authorizes a Hearing Panel to accept the facts alleged by MFDA in the Notice of Hearing as "having been proven". Moreover Rules 7.3(1) and 8.4(1) additionally authorize a Hearing Panel to accept the conclusions drawn by MFDA in the Notice of Hearing

“as proven”. In the exercise of the authority granted by those provisions we accept as proven the facts and conclusions contained in the Notice of Hearing. Those facts and conclusions are contained in paragraphs 1 to 120 of the Notice of Hearing. For convenience of reference we attach those paragraphs as a schedule to these reasons for decision.

10. Pursuant to Rule 13.4 counsel for MFDA requested permission to allow the evidence of certain persons to be given by sworn statement. We allowed the evidence of five former clients of the Respondent to be given by affidavit, and admitted into evidence the affidavits of L.E., S.S., M.R., T.W. and W.V. The affidavits of L.E., S.S., and W.V. were given for their spouses as well as for themselves. There was, therefore, affidavit evidence describing the Respondent’s activities respecting eight of the persons identified as his former clients in the Notice of Hearing. In this decision we refer to those eight persons as the “affiants”. In addition we allowed the evidence of MFDA’s senior investigator, Daniela Capozzolo, to be given by affidavit.

11. A former client, G.F., testified in person at the hearing.

12. We admitted into evidence a document containing 26 extracts from the Respondent’s interviews with Staff, which were held pursuant to section 22 of By-law No. 1. A number of other documents were filed as exhibits.

13. We are satisfied with the reliability of all of the evidence which was presented to us.

THE ALLEGATIONS

14. The allegations are set out in paragraph one above. It is not necessary to review them in detail. Allegation No. 1 essentially alleges a failure on the part of the Respondent to properly explain the significant risks inherent with leveraged investments to his clients and therefore failed to ensure that the investments which he recommended to them were suitable for them. Allegation No. 2 alleges that he failed in his duty to know his clients with the result that he recommended leveraged investments which were not suitable for them.

15. The concepts “know your client” and “suitability” are different but the interrelationship between them is so frequent and so fundamental that the two concepts tend to be used interchangeably. The complaint against the Respondent, as expressed in the two allegations, is, in essence, that he recommended leveraged investments to a number of his clients which were unsuitable for them.

16. Leveraging is involved in this case. We are aware that leverage is something which is used in the capital markets. It is no part of our task to comment upon the use of leveraging in appropriate circumstances. While leveraging is involved in it, the case is not about leveraging. The case is about the suitability of leveraging for the 18 clients referred to in the Notice of Hearing.

THE RESPONDENT

17. For many years the Respondent operated an investment business in Barrie, Ontario under the name of Money Concepts Barrie. He was widely known. Before the financial downturn in 2008 his personal book of business had approximately 1,100 client families with assets under administration of approximately $178 million. His business, Money Concepts, had approximately 3,800 client families with assets under administration of approximately $328 million. Sixty per cent of the Respondent’s assets under administration were leveraged investments. We find that he was a strong promoter of leveraged investments.

THE DUTY OF THE RESPONDENT TO HIS CLIENTS

18. That duty is set out in MFDA Members’ Rules as follows:

> **2. RULE NO. 2 – BUSINESS CONDUCT**
>
> **2.1 GENERAL**
>
> 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

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.

19. MFDA Rules 2.1.1 and 2.2.1 impose a high standard of conduct upon Members and Approved Persons. That standard has been discussed in many cases by different Hearing Panels. We adopt as authoritative the analysis of that standard of conduct which is found in the decision of the Hearing Panel of the Pacific Regional Council in *Enzo De Vuono* [2012], at paras. 52-57:

> 52. MFDA Rule 2.2.1, codified 'Know-Your-Client' and 'Suitability' obligations that have consistently been recognized as 'an essential component of the consumer protection scheme of [securities legislation] 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.'

E.A. Manning Ltd. et al (Re), 1995 LNONOSC 377 (OSC) at p. 37

Daubney (Re), 2008 LNONOSC 388 (OSC) [‘*Daubney’*] at para. 15

53. The Alberta Securities Commission has stated that:

> 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.’

54. MFDA Rule 2.2.4 confirms the obligation of an Approved Person to maintain up-to-date records of Know-Your-Client information. Even if an Approved Person receives inaccurate information or forms a mistaken impression about a client early in the relationship, as soon as the Approved Person becomes aware that Know-Your-Client information has been inaccurately recorded, the Approved Person has an obligation to update the Know-Your-Client records and correct errors.

The Three Stage Analysis

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

(a) use due diligence to know the product and know the client;

(b) apply sound professional judgment 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.

Daubney, supra at para. 17

56. In *Lamoureux*, the Alberta Securities Commission explained in detail, the three stage process that an advisor must follow to fulfill their suitability obligations, stating that:

> ‘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 the client.
>
> Suitability determinations… 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 judgment to the information elicited from ‘know your client’ inquiries. 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… 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.’
>
> *Lamoureux, supra* at p. 18

57. The Ontario Securities Commission has characterized a particular investment approach such as a leveraging strategy as part of the ‘product’ and determined that the evaluation of the suitability of such an approach for a particular client is part of the registrant’ suitability obligations In particular, the registrant must assess whether the client would have the ability to meet debt obligations and tolerate losses in the event of a market downturn. Furthermore, because leveraging can magnify losses, the registrant is required to ensure that the client understands the risks of borrowing to invest.

Daubney, *supra* at paras 24-25

20. While a registrant, in all cases, must live up to the standard required by Rules 2.1.1 and 2.2.1 we think that the exercise of that duty attracts the most careful scrutiny when a registrant is recommending leveraged investments. Leverage is attractive because, if successful, profits can be increased. One of the dangers is that, if it is not successful, the investor can be subject to investment losses while remaining liable on the loan. From 2001 through 2008 the Respondent was registered with Aegon Dealer Services Canada Inc. ("Aegon"). During that time Aegon had a Conduct and Practices Guide with which the Respondent ought to have been acquainted. That Guide contained the following:

> Leveraging magnifies losses as well as profits. In an attempt to maximize profits in a short time, investors can get into serious trouble by borrowing more money than they can afford. As a registered representative, <u>you must ensure that your clients not only understand the risks associated with their investment choices but also the risks inherent with leveraged investing. All leveraged investments require a heightened duty of care and must be monitored accordingly</u>.
>
> Registered representatives are required to <u>ensure their clients understand the consequences of leveraging, and must ensure that they review client information to ensure leveraging is a suitable investment alternative</u>. Registered representatives must discuss with their clients all consequences associated with leveraged purchasing… <u>It is the Registered Representative's responsibility to ensure that this is a suitable investment for their client</u>. [Emphasis added.]

Capozzolo Affidavit, para. 27

21. For some people, depending upon their resources and earning capacity, the result of leveraged investing can be catastrophic. Thus before recommending a leveraged investment a registrant must exercise the greatest of prudence.

22. The Respondent recommended to his clients leverage investments in Return of Capital Funds ("ROCs") as well as in conventional mutual funds. The former can be even more hazardous than the latter. The Hearing Panel in *Enzo De Vuono*, *supra*, dealt at some length with that type of investment in relation to the facts of that case. We think that helpful guidance is found at paragraphs 49-51 where the following appears:

49. Professor Erik Kirzner was called as an expert witness. His qualifications were very impressive including his current position of John H. Watson Chair in Value Investing, Professor of Finance, Rotman School of Management, University of Toronto.

50. The Professor opined on various aspects of the actual investment at issue here. Some of the matters he testified to are:

> ‘In my view both the high yield and the tax advantaged promises are illusory. The high yield and alleged tax advantage is achieved simply by paying the investor back their capital or by selling assets within the pool and depleting assets.
>
> Since ROC [Return of Capital] funds generally promise a regular, level and typically relatively high cash-on-cash yield there are two associated on-going risks, namely (i) that the fund will not earn a rate of return equal to the promised payout rate and (ii) that the value of the underlying assets in the pool decline possibly due to weak market conditions and/or poor security selection. Under these not unusual conditions, the fund manager would be impelled to shore up the fund by selling assets, borrowing, using net inflows or using its cash reserves to help fund distributions. These strategies all have costs that would reduce the fund’s return and NAVPU [Net Asset Value Per Unit]. In some cases, the fund would have to reduce or suspend distributions.
>
> In summary, the risks of ROC funds are that the fund earns a rate of return below the promised payout rate and/or the risk that the underlying assets depreciate in value. Both risks, should either materialize could result in a reduction or suspension of the promised distributions.
>
> While all these factors are important, a client’s investment knowledge is of particular significance. Investment knowledge is important for 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 that investments can increase and decline in value. Since clients have different ages, wealth levels, investment knowledge, objectives, risk tolerance and time horizon, all investment advice must be geared specifically for the client. That is why the KYC [Know-Your-Client] rule exists.
>
> 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.

> 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.

51. The Professor listed a number of risks associated with such an investment and in conclusion, in part he wrote as follows:

> '(e) Leveraging strategies increase the risk for mutual fund investors. The risks include (i) inability to meet interest payments and (ii) loss of some, all or more than all of the client's equity. A 2 for 1 loan triples the equity risk.
>
> (f) Given the high payout nature of ROC or T funds they are particularly risky for use in leveraged strategies. The fund has to earn a rate of return at least equal to the promised distribution plus fund expenses. Furthermore the net asset value has to hold steady or the loan to value ratio will be impaired, resulting in a margin call. Maintaining a high rate of return in a low interest rate environment is very difficult, as many investors discovered in periods such as 1998, 2000, 2001, 2002 and 2008.
>
> (g) Leveraged strategies using ROC funds are likely to be suitable only when the investor is sophisticated with a high level of investment knowledge, 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.
>
> (h) <u>Accordingly I consider a strategy of buying ROC funds and using leverage with high loan/value ratios to be an inherently flawed strategy.'</u>
>
> (Emphasis added)

OVERALL FACTUAL CONCLUSIONS

23. The oral testimony, the documentary evidence, the affidavits of the clients and the facts and conclusions taken "as proven" establish beyond controversy that the Respondent recommended leveraged investments to each of the 18 clients particularized in the Notice of Hearing. Only one of them had ever borrowed money to make investments before they became clients of the Respondent.

24. The Respondent's description of leveraged investing was simple. It was attractive. He told clients that they should borrow money. He would arrange the loans. They should invest the borrowed money in mutual funds (and sometimes segregated funds). The distributions from the mutual funds would cover the costs of borrowing. Over time the value of the mutual funds would appreciate and eventually be worth more than the outstanding balance of the loan. The ultimate result would be that the client had obtained a worthwhile securities portfolio without having paid anything for it with his/her own money.

25. In his presentation to clients the Respondent made the following argument in favour of the leverage strategy:

USING OTHER PEOPLE'S MONEY

> No one has ever become wealthy without using 'Other People's Money (OPM)'. Stop and think about it. Do you know of anyone who has become wealthy without using OPM? Do you know a farmer who hasn't used OPM to help become successful? Do you know of a business person that has started a business, and had kept it going without OPM?
>
> If OPM helps create wealth, how come ninety percent of Canadians are afraid to do so? If you can borrow money at five percent and invest it at six percent, you are making one percent on other people's money. It gets better, the interest you pay is tax-deductible. Think about it. If you borrow money at five percent and use it for investment purposes it becomes tax-deductible. If you are close to the 50 percent tax bracket that means the 'true cost' of borrowing is only 2.5% (after the tax deduction). Now invest in an 'ownership' type investment, that only earns five percent in either dividend or capital gains (or a combination of each) which bears a lower rate of tax, you are still ahead by at least one percent per year, even though you borrowed at five percent and only gained five percent.
>
> I personally use nothing but mutual funds for investing my borrowed monies. And those funds have a proven past performance over the past many years averaging 15-20 percent per year. Those facts are not debatable; those are published facts and can be found regularly in your financial newspapers. So, today I can borrow money from banks and trust companies at seven percent. Maybe it's your money that's in on deposit in a GIC or bond. (If so, I thank you for putting it there). Because it's tax deductible, my true cost is 3.5 percent (after taxes). Invested in investment funds that average just 10 percent, it means I make 6.5 percent on

> Other People's Money (OPM). Needless to say I like using OPM; maybe you should too.
>
> David Karas, CFP, R.F.P, RFC
> President, Money Concepts Barrie

26. We are satisfied that, before any of the clients borrowed money to invest with the Respondent, he made the following representation to them:

> a) the mutual funds purchased with the proceeds of the investment loans could be relied upon to generate proceeds each month which would be greater than, or at least equal to, the costs associated with the investment loans, such that the clients would not need to incur any out-of-pocket expenses in order to sustain the leverage investment strategy; and
>
> b) the mutual funds purchased with the investment loans would grow in value over time and create an investment portfolio at no cost to the client.

27. The Respondent provided to some, or perhaps all, of his clients a document running on average to 220 pages, entitled Personal Financial Review. Some of those documents imply that the profits from the leveraged investment strategy could be stunning.

28. All of the 18 clients accepted the Respondent's advice and engaged in his leveraged investment strategy. We accept the sworn testimony of G.F., the information contained in the affidavits filed and the facts and conclusions which are before us pursuant to section 20.4 of By-law No. 1 and Rules 7.3(1) and 8.4(1), and find that at no time did the Respondent explain to any of those clients adequately, or at all, the serious risks inherent in the leveraged investment strategy which he was recommending to them. Quite the contrary. With various degrees of emphasis he led them to think that if there was any risk at all it was minimal. We quote from the affidavit of T.W.:

> 27. First, Karas did not explain that there was a real risk that the mutual funds purchased with the borrowed monies might reduce, suspend or cancel the payment of proceeds to investors due to declining market conditions, poor performance of the investments held in the mutual funds or other reasons. Instead, Karas advised me that the Leverage Investment Strategy was a fool proof way to lower my taxes, that all costs associated with the investment loans would always

> be covered by the distributions, and that the Leverage Investment Strategy would only backfire or become a problem if the whole world fell apart which will never happen. As a result, I was not aware that there was a real risk that the mutual funds might not general sufficient proceeds to pay the costs of the investment loans. This was an important factor as I was not in a position to afford monthly costs of the investment loans if they did not pay for themselves as Karas represented they would.

Also illustrative is an extract from the testimony of G.F.:

> Q. In your discussions with Mr. Karas, what did you understand and what did he tell you about the benefits of borrowing monies from banks?
>
> A. Just that it would make more money that way.
>
> Q. Make more money than if you didn't borrow money from the bank?
>
> A. Yes.
>
> Q. What did he say could happen to the value of the investments that you were purchasing? What were you expecting those to do?
>
> A. According to him, we didn't have anything to worry about.
>
> Q. What do you mean by that? In terms of the value of the fund?
>
> A. That he had been doing it for a long time and he knew how to make it work, that we wouldn't have to worry about it going down too much.
>
> Q. Did he ever explain how he could make it work so that it wouldn't go down too much?
>
> A. No, he never explained how.
>
> Q. Did he describe any risks with borrowing money to invest?
>
> A. Not that I remember.

29. The other clients, who gave their evidence by way of affidavit, all said that the Respondent left them with the impression that there was no real risk involved with the leverage strategy. In fact he told G.F. that he was "crazy" if he did not borrow to invest.

30. All of the clients took out loans and invested in mutual funds. Most also invested in segregated funds. There were multiple loans and they were of significant amounts. At the hearing we were provided with specific details of the amounts and dates of all of those loans taken out by the affiants and by G.F. We have decided that it is not necessary to recite that detail in these reasons for our decision. We have, however, decided that an overview of each client's ratio of investment loans to net worth should be shown. We also will show each client's ratio of debt service obligations to their monthly household income. Those ratios will be shown as at the date of each client's last investment loan.

31. Also the cost of carrying loans for segregated funds investments is relevant to a client's total debt obligations. In addition, the Respondent sold insurance to some clients to protect their investments. He also sold some of them a service from one of his associated companies, Victory Financial Associates. The insurance provisions and service costs are also relevant to determine what a client's total monthly debt obligations amounted to.

32. In the course of recommending the leverage investment strategy to clients, the Respondent arranged for the clients to sign risk disclosure documents describing some of the risks associated with the use of leverage. All of the clients provided evidence that the Respondent did not discuss the contents of the risk disclosure documents with them. The Respondent provided the risk disclosure documents as part of a larger distribution of materials to the clients (such that the clients did not notice the risk disclosure documents amongst the many documents they received), and the clients did not review the risk disclosure documents prior to signing them.

33. Moreover, it appears that the Respondent prepared KYC forms which clients signed without reading or understanding them, relying on their confidence in him and that he knew what he was doing. An example is found in Exhibit 10, Tab 12, which is a KYC form signed by G.F. It shows that he had an annual income of "more than $150,000". G.F. testified that never in his life had he ever had an annual income of over $60,000 and usually it was much less. One is lead to wonder whether exaggerated incomes were put in KYC forms so that the Member, with whom the Respondent was registered, would not become concerned about the suitability of certain

investments for certain clients. We are unable to attach any weight to documentation emanating from the Respondent's business which is intended to support the suitability of any of the leveraged investments recommended to any of his clients.

34. Beginning at the time of the market down turn each client suffered significant losses. We will return to those losses later in these reasons.

35. Some of the clients participated in a class action brought against the Respondent and others. The action was settled. We understand that those clients who participated in it recovered amounts roughly equivalent to about 10% of their losses. It is not known whether the Respondent made any contribution to the settlement fund.

THE CIRCUMSTANCES OF INDIVIDUAL CLIENTS

36. As noted in paragraph 29, we will set out loss to net worth ratios and debt service obligations to income for each of the 18 clients. Before doing so, however, there are certain observations which must be made.

37. The Respondent put some of his clients' investments into segregated funds. We have no jurisdiction over segregated funds and make no comment about them. However, in order to know one's client and judge the suitability of an investment for that client an advisor must be aware of the client's total loan obligations. Therefore we include loans for segregated funds when we state the loan to net worth ratio at the time of each client's last loan for investment.

38. The following sets out the ratios respecting each client.

<u>G.F.</u> Age 61. Total loans $1,019,196. Ratio of loans to net worth, 68%. Ratio of the monthly debt obligations to household income, 183%.

<u>T.W.</u> Age 48. Total loans $325,000. Ratio of loans to net worth, 90%. Ratio of monthly debt obligations to household income, 32%.

P.M. and L.M. Ages 51 and 48. Total loans $580,000. Ratio of loans to net worth 170%. Ratio of monthly debt obligations to household income, 50%.

S.W. and S.W. Ages 52 and 51. Total loans $300,000. Ratio of loans to net worth, 80%. Ratio of monthly debt obligations to household income, 14%.

D.M. and J.M. Ages 71 and 67. Total loans $840,000. Ratio of loans to net worth, 250%. Ratio of monthly debt obligations to household income, 68%.

L.E. and K.E. Ages 66 and 54. Total loans $1,040,000. Ratio of loans to net worth, 202%. Ratio of monthly debt obligations to household income, 54%.

W.V. and H.V. Ages 81 and 77. Total loans $325,000. Ratio of loans to net worth, 59%. Ratio of monthly debt obligations to household income, 43%.

M.R. Age 44. Total loans $200,000. Ratio of loans to net worth, 73%. Ratio of monthly debt obligations to household income, 24%.

J.W. Age 82. Total loans $338,000. Ratio of loans to net worth, 40%. Ratio of monthly debt obligations to household income, 21%.

J.E. and D.E. Both age 74. Total loans $350,000. Ratio of loans to net worth, 50%. Ratio of monthly debt obligations to household income, 50%.

S.S. and C.S. Ages 48 and 43. Total loans $390,000. Ratio of loans to net worth, 42%. Ratio of monthly debt obligations to household income, 42%.

The ratios for G.F. and the affiants are taken from Exhibit #11. The ratios for the other clients are taken from the Notice of Hearing paragraphs 66, 72, 78, 102 and 108. The ages of all clients are as at the date of the Notice of Hearing.

THE THREE-STAGE ANALYSIS

a) Know the product and the client

39. If the Respondent was truthful when he told his clients that his leverage strategy – the product – was foolproof, when he assured them that they had nothing to worry about, and when

he gave them the impression that there was no real risk, then he clearly did not know his product. In the matter of *Arthur George Pretty*, [2014] MFDA 201128 at para. 103, the Hearing Panel observed:

> … it ought to be reasonably foreseeable to any investment advisor that there might at almost any time, be a market downturn that might be of minor or major proportion and would impact, potentially substantially, the performance of an equity based mutual fund.

This product had obvious and serious risks. He was seriously negligent if he thought that the product was risk-free.

40. If he was not being truthful when he said those things then his conduct towards his clients was so egregious that it beggars description.

b) <u>Sound judgment in determining suitability</u>

41. We think that in order for a leveraged investment to be suitable for a client, at the very least, the client must be capable of affording the expense of carrying the loan in the event that distributions become insufficient to do so. At the most basic, consideration of the ratio of debt obligations to income and the ratio of total investment debt to net worth are very relevant and important.

42. So far as we are aware, there is no jurisprudence which gives guidelines about what the minimum ratios ought to be. The MFDA has not issued any such requirements. It follows that each case must be judged on its own particular facts. Ratios which might make an investment unsuitable for a person with a low tolerance for risk may not be a bar to the same investment being suitable for someone with a high tolerance of risk. Therefore in each case sound professional judgment is required to be exercised.

43. Whatever the appropriate general ratio might be, we see, in this case ratios, which defy common sense. G.F. had a loan to net worth ratio of 68% and monthly debt obligations to his

income of 185%. P.M. and L.M. had a loan to net worth ratio of 170% and monthly debt obligations to household income ratio of more than 50%. D.M. and J.M. had a loan to net worth ratio of 250% and monthly debt obligations to household income ratio of 68%. L.E. and K.E. had a loan to net worth ratio of 200% and monthly debt obligations to household income ratio of 37%.

44. It is unnecessary to refer to any of the others which have lower ratios. What these facts show is that far from exercising sound professional judgment the Respondent exercised no judgment. It is impossible to comprehend on what basis the Respondent determined that the investments were suitable for the particular clients.

c) <u>Disclosure of negative aspects of proposed investments</u>

45. The evidence is unequivocal that the Respondent did not explain to his clients the negative aspects of his leverage strategy. The most serious default was his failure to ensure that each client fully understood what would happen if distributions became insufficient to carry their loans. He failed to tell them how a reduction in distributions might come about.

46. We find that these clients would never have participated in this leveraged investment strategy had the Respondent fulfilled his obligation of disclosure to them. We also find that the final leveraged investments, as a package, were not suitable for these clients.

HARM TO THE CLIENTS

47. There are two types of harm that the 18 clients have suffered.

a) <u>Quantifiable Harm</u>

48. Daniela Capozzolo, in the course of her investigation, calculated that the total loss of clients, G.F., T.W., L. and K.E., W. and H.V., M.R. and S. and C.S. would amount to $579,714. Basically those were the losses resulting from the decline in the value of their securities. There is

no evidence upon which the losses of P. and L.M., S. and S.W., D. and J.M., J.W., and J. and D.E. can be calculated with any degree of accuracy. However, having regard to their investments we estimate that their losses would be somewhat similar to the losses calculated by Ms. Capozzolo for the other clients.

49. We think it reasonable to expect that the total of the losses for the 18 clients would be in excess of $1,000,000.

b) <u>Incalculable Harm</u>

50. The need to make up the shortfall to service the loans when the distributions declined caused harm, other than the loss of value of their securities. All of the clients had to find means to service their loans. A number of them converted their registered retirement saving plans (“RRSP”) into registered retirement income funds (“RRIF”). They used the income from their RRIFs to carry their investment loans. That process could have unpleasant tax consequences. The early conversion of an RRSP into a RRIF could upset a person’s retirement plans. One client had to postpone his planned retirement and continue to work to carry his loans. One couple took money out of life insurance policies and out of their business to support their loans. Doubtless there had to be foregoing by many of some of the pleasures of life because of the need for funds to prevent default on the loans. While it is impossible to calculate or evaluate, in money, those types of harm, they were very real to those who had to bear them.

51. In summary, this Hearing goes to the very heart of the fiduciary responsibilities of an Approved Person in servicing clients. Put very simply, an Approved Person’s fundamental responsibility is to “know the client” and “know what products would be suitable for the client” and to use this information in providing professional advice that will lead to prudent, well thought through decisions that are in the client’s best interest. In this case, the Respondent was negligent in not obtaining this information and in steering the clients in exactly the opposite direction. He recklessly advised clients to take risks through an investment strategy (leveraging) that was clearly beyond the bounds of their prudent financial means, their risk tolerance and their level of financial sophistication. It is also very clear that in doing so the Respondent put his own

financial interests ahead of the interests of his clients and, as a result, they suffered severe financial and other losses.

CONCLUSION ON THE MERITS

52. The totality of the evidence has satisfied us that the Respondent failed to explain the risks of leveraged investments to his 18 clients. It also has satisfied us that he failed to ensure that his leveraged investment recommendations were suitable to his 18 clients. We find, therefore, that each allegation against the Respondent has been established to the requisite degree of proof.

PENALTY

53. We start by echoing what has been stated in many cases. The fundamental goal of a discipline process is the protection of the investing public. That process should lead to the public having confidence in the securities industry. See *Pezim v. British Columbia (Superintendent of Brokers)*, [1994] 2 SCR 557 at para. 59. In addition to protecting the investing public and generating confidence in the securities industry the penalty should act as both a specific deterrent and as a general deterrent. See *Headley (Re)*, 2006 LMCMFDA 3 at para. 83.

54. When deciding upon the merits of allegations contained in the Notice of Hearing a hearing panel is narrowly restricted to the facts which are relevant to the specific allegations. In assessing penalty the focus can be broadened somewhat. In this case it is appropriate, when contemplating the penalty, to consider the standing which a respondent has in the industry, in his community and the effect which his misconduct must have upon the confidence which the public should have in the securities industry.

55. The Respondent was well known and a media personality in the Barrie area. He has published books promoting the use of leverage to purchase investments. He told an MFDA investigator, during his interviews under s. 22.1(c) of By-law No. 1, that leveraging is “one of the most powerful financial planning tools that you can use …”. His promotion was very successful. Before the downturn of the financial markets in 2008 he serviced approximately

1,100 client families. He had assets under administration of at least $178,000,000. It is noteworthy that approximately 60% of those investments were leveraged. Obviously leveraging was his stock in trade. He attracted many people to his business. He was successful and prominent. Presumably many people looked to him as representative of the reliability and the integrity of the financial services industry.

56. As a result of certain answers which the Respondent gave during his interviews, we have reached the conclusion that he either did not know, or willfully disregarded, one of the most fundamental duties of an Approved Person – to use due diligence to ensure that an investment is suitable for the client. We will refer to a number of specific instances where he demonstrated that fact.

57. It is our opinion that in deciding whether a particular leverage mutual fund investment is suitable for a client an Approved Person should know whether the client can afford the loan if distributions become insufficient to carry it. Useful tools in determining whether the client can afford the loan are ratios of debt service obligations to income and loans to net worth. When the Respondent was asked if he calculated them in determining whether a particular loan "was suitable for the client?" he replied "No. We weren't asked to".

58. The transcript of the interviews contains the following exchange:

> MS. CAPOZZOLO: Do you know if there was some sort of common knowledge of what the total debt service ratio was, the percentage?
>
> MR. KARAS: No. I never did anything like that, because I wasn't asked to. You know, as far as we were concerned, it was the lender's job to manage that process. The lender is the one that has debt service ratios and their cash flows and their debts, he would deal with that. It's not my job, my job was if a client wants to do a structure, here's a structure, lender, do you approve it or not? And the lender has their own --- and different lenders would --- you know, it's marginally different things that they would do, obviously.

59. What that exchange demonstrates is not only a grotesque lack of comprehension of his fundamental duty to assess suitability, but also a delegation of his duty to assess the suitability of

the loan to the lender. There are other exchanges, during the interviews, which are illustrative of the Respondent's attitude towards his obligation to assess the suitability of an investment for a client.

> MR. TOTH: But my question again, quite simply, is when you were making the loan recommendations, were you determining whether they were suitable?
>
> MR. KARAS: The financial plan is the controlling document.
>
> MR. TOTH: How does that answer that question? I don't --- I'm apparently confused by how the ---
>
> MR. KARAS: <u>The client decides</u>.
>
> MR. TOTH: The client decides whether the loan is suitable?
>
> MR. KARAS: The client decides because the document that they dealt with in their financial plan they're implementing. It's their financial plan. They can implement their financial plan whatever way they want to implement their financial plan.
>
> (Emphasis added)
>
> *   *   *
>
> MR. TOTH: Do you know who recommended this loan [to L.E.]?
>
> MR. KARAS: I'll give you the same answer I gave you, we don't recommend loans, what we do is we provide options to clients and they choose what they want.
>
> *   *   *
>
> MR. TOTH: Do you recall whether you recommended this loan in particular [to S.W.]?
>
> MR. KARAS: Well, he says I did, but what I probably did was offered him the product, and I wanted to find the difference between offering and recommending. … the word 'recommend' is a strong word. I would say we offer it to them and let them make their own decision.

60. Those exchanges demonstrate that the Respondent delegated to his clients themselves his duty to ensure suitability.

61. There is one final exchange to which we wish to refer. In May 2005 the Respondent's clients L.E. and K.E. were considering making a leveraged investment of $350,000:

> MR. TOTH: … Do you recall why four loans were applied for on the same date from two different leaders?
>
> MR. KARAS: Because they have different products available. The $50,000 loans are given out to everybody, so you can get $50,000 here, $50,000 there, it's easy to collect, there is no underwriting, it's easy to gather. They're very easy to access. So Manulife had four --- Manulife had a $50,000 mutual fund loan, a $50,000 segregated fund loan available per client. So you could get one easily without going through a lot of underwriting.

62. The Respondent's explanation for applying for four loans appears to have been that some lenders had loans of relatively small amounts which they would make without underwriting. By avoiding the lender's underwriting the Respondent was able to avoid having anyone assess whether the loans, an essential part of the leveraged investment product, were suitable for his clients.

63. We have reached the conclusion that the object of the Respondent's diligence was to sell leveraged product not to ensure that an investment was suitable to the client. He avoided his responsibility by delegating it to the lender or by abdicating it to the client. In the alternative he would place the loans in a fashion whereby the suitability of the total loans acquired for the leveraged investment strategy was considered by no one.

64. We adopt as authoritative the statement made by the Hearing Panel in *Headley (Re), supra*, at para. 81:

> **81** In our view, any sanctions which we impose should be preventative, protective and prospective in nature. One of the main objectives of securities regulation is to prevent harm to investors and the capital markets. In this regard, the Supreme Court of Canada recently found that the role of the OSC, under its public interest jurisdiction, is:

> '… to protect the public interest by removing from the capital markets those whose past conduct is so abusive as to warrant apprehension of future conduct detrimental to the integrity of the capital markets.'
>
> (Authorities omitted)

65. In matters involving the MFDA our role is identical to that of the Ontario Securities Commission. Because the conduct of the Respondent was so egregious, so persistent, so general and was so contrary to the fundamental responsibility of the financial advisor, it is our opinion that the Respondent must be permanently removed from any securities business over which the MFDA has jurisdiction. Accordingly we propose to impose a permanent prohibition.

66. This case also calls for a fine in addition to a prohibition. In some respects this case bears a striking similarity to that of *Re Thomas G. Arseneau*, [2012] Atlantic Regional Council, MFDA File No. 201128. The Hearing Panel imposed a fine of $500,000 in addition to a permanent prohibition. We find the decision to be a very helpful guide. In that case there were 20 clients who were particularized in the proceedings. In this case the number is very similar, 18. However as appears from the decision of the Superior Court of Ontario approving the settlement of the class action, which was referred to in paragraph 34 hereof there were approximately 756 persons with claims against the respondent arising out of his leveraging recommendations. In *Arseneau* there were 120 persons involved.

67. We have no way of assessing the amount of commissions which the Respondent derived from the leveraged investments which he recommended to his clients. We conclude that the amount must have been a very substantial one indeed. His cavalier treatment of his duty to ensure the suitability of investments leads us to conclude that his motivation was an increase in commissions and in so doing he put his own financial interests ahead of the interests of his clients.

68. We think that a fine must be sufficient to act as a specific and general deterrent. We think that it must also be sufficient to make it clear to the members of the public who unfortunately suffered serious losses as a result of the Respondent's recommendation of leveraged investments that the MFDA deals very severely with the type of conduct which was evident in this case.

69. We have reached the conclusion that the appropriate fine in this case is $750,000.

70. We accept enforcement counsel's suggestion that an award of $20,000 by way of costs would be appropriate.

DISPOSITION

71. For the reasons set out above:

a) We find that the allegations contained in the Notice of Hearing have been established to the requisite degree of proof;
b) We impose a permanent prohibition on the authority of the Respondent to conduct securities-related business in any capacity over which the MFDA has jurisdiction, pursuant to s. 24.1.1(e) of MFDA By-law No. 1;
c) We impose a fine of $750,000 pursuant to s. 24.1.1(b) of MFDA By-law No. 1; and
d) We award costs of $20,000 to MFDA pursuant to s. 24.2 of MFDA By-law No. 1.

DATED this 1st day of June, 2015.

"P. T. Galligan"

The Hon. P. T. Galligan, Q.C.
Chair

"Teri L. Ryan"

Teri L. Ryan
Industry Representative

"Robert C. White"

Robert C. White
Industry Representative

<u>**SCHEDULE “A”**</u>

<u>**PARTICULARS**</u>

NOTICE is further given that the following is a summary of the facts alleged and intended to be relied upon by the MFDA at the hearing:

Registration History

1. As particularized below, the Respondent was registered as a mutual fund salesperson from July 1988 to April 2010, and as a branch manager from August 1993 to April 2010, with Money Concepts Group Capital Corp. (“Money Concepts”), AEGON Dealer Services Canada Inc. (“AEGON”) and Investia Financial Services Inc. (“Investia”).

2. From July 11, 1988 to October 2001, the Respondent was registered in Ontario as a mutual fund salesperson with Money Concepts. The Respondent became registered in Ontario as a branch manager on August 22, 1993.

3. In about July 2001, AEGON Canada Inc. acquired Money Concepts. In October 2001, AEGON Canada Inc. changed the name of Money Concepts to AEGON. AEGON became a Member of the MFDA on February 8, 2002.

4. From October 2001 to about September 2008, the Respondent was registered in Ontario as a mutual fund salesperson and branch manager with AEGON. The Respondent was registered as a mutual fund salesperson in Nova Scotia on January 13, 2004, in British Columbia on January 16, 2004 and in Alberta on April 12, 2007.

5. On July 1, 2008, Investia’s parent company acquired AEGON. On September 30, 2008, AEGON amalgamated with Investia. Investia became a Member of the MFDA on June 7, 2002.

6. From about September 2008 to April 12, 2010 when he was terminated, in part, as a result of the events described below, the Respondent was registered as a mutual fund salesperson and branch manager with Investia.

7. The Respondent is not currently registered in the securities industry in any capacity.

8. The Respondent has been licensed in the insurance industry since about July 1987.

The Respondent and Money Concepts Barrie

9. The Respondent is a well-known media personality in the Barrie, Ontario area. He has published books promoting the use of leverage[1] to purchase investments.

10. At all material times, the Respondent conducted business using the approved business name, Money Concepts Barrie, and operated out of offices located in Barrie and Toronto, Ontario.

11. The Respondent was the President, a controlling mind, and the majority owner of Money Concepts Barrie either directly or indirectly through corporations, partnerships and trusts in which the Respondent and his family members held interests.

12. Two additional Approved Persons, James Stephenson ("Stephenson") and Michael Dumond ("Dumond"), were minority owners of Money Concepts Barrie, either directly or indirectly through corporations, partnerships and trusts in which they and their family members held interests.

13. As described in greater detail below, prior to the downturn of the financial markets in 2008, the Respondent serviced directly or indirectly approximately 1,000 client families (the

[1] "Leverage" refers to the use of borrowed monies to purchase investments.

"Karas clients") and had assets under administration of at least $115 million. Approximately $70 million (60%) of the Respondent's assets under administration were leveraged.[2]

14. As described in greater detail below, the Respondent was involved, directly or indirectly, in the servicing of all Karas client accounts.

15. In the course of making investment recommendations to the Karas clients, the Respondent prepared, or arranged for other mutual fund salespersons at Money Concepts Barrie to prepare, financial plans for each of the clients. These financial plans were lengthy documents purported to be tailored to a client's investment objectives and financial circumstances. The financial plans recommended that clients use leverage to invest as a significant component of a financial plan.[3]

16. Due to the large volume of clients, the Respondent employed other mutual fund salespersons at Money Concepts Barrie to assist him in servicing the Karas clients. These other mutual fund salespersons would, on occasion, act as a secondary, alternate, or additional advisor to the Karas clients to assist them in conducting securities related business in their accounts, including implementing leverage recommendations made by the Respondent and/or described in the financial plans.

17. The Respondent maintained a commercial interest in the Karas clients through a system of pooling and sharing of fees, commissions and other revenues relating to the clients and accounts with the other mutual fund salespersons at Money Concepts Barrie assigned to the accounts. With the exception of Stephenson and Dumond, the other mutual fund salespersons received a salary, with a limited entitlement to a bonus or additional compensation. The Respondent, Stephenson and Dumond received the profits from the fees, commission and other

[2] Meaning the clients had borrowed monies to purchase the investments.

[3] During its investigation, MFDA Staff requested copies of the financial plans from the Respondent. Despite the Respondent's claim that the financial plans provided the basis for all leverage recommendations, the Respondent was able to produce a copy of only one financial plan pertaining to the clients at issue in this proceeding.

revenues generated by the operations of Money Concepts Barrie, either directly or indirectly through corporations, partnerships or trusts to which the monies were paid.

18. All of the clients at issue in this proceeding relied upon the Respondent to ensure that any recommendations, including leverage investment recommendations, whether made to them directly by the Respondent or communicated to them by one of the other mutual fund salespersons assigned to their accounts, were suitable and in keeping with their investment objectives.

19. At all material times, the Respondent knew, or ought to have known, the nature of the business conducted in the accounts of the Karas clients by the other mutual fund salespersons assigned to the accounts.

Allegation #1: Misrepresentation and failure to explain leverage investment recommendations

20. Between 2002 and 2008, the Respondent recommended and facilitated the implementation of a leverage investment strategy (the "Leverage Investment Strategy") in the accounts of at least 18 clients whereby the clients applied for and obtained multiple and/or successive investment loans totaling more than $4.8 million[4] and used the loan proceeds to purchase mutual funds for their accounts.

21. As a consequence of the implementation of the Leverage Investment Strategy in the clients' accounts, the number of investment loans the clients held, the total amount of monies they had borrowed to invest, and the total amount of monies they were required to pay each month to service the investment loans, increased substantially over time.

[4] This figure does not include loans obtained by some of the clients to purchase segregated funds from the Respondent. During the same period of time, the Respondent also recommended, and assisted clients to obtain, multiple investment loans in order to purchase segregated funds. This Notice of Hearing refers to a client's purchases of segregated funds only where it is relevant to providing a complete and accurate picture of a client's total debt load and debt-service obligations at the material time.

22. Almost all of the investment loans recommended by the Respondent consisted of interest-only loans.[5]

23. The Leverage Investment Strategy was based on the premise that the mutual funds purchased with the borrowed monies would generate proceeds each month which would be greater than the costs associated with the investment loans and, as such, the Leverage Investment Strategy would pay for itself.

24. In the course of recommending the Leveraged Investment Strategy to the clients, the Respondent or the other mutual fund salespersons assigned to the accounts made the following representations, among others, to the clients:

(a) the mutual funds purchased with the proceeds of the investment loans could be relied upon to generate proceeds each month which would be greater than, or at least equal to, the costs associated with the investment loans, such that the clients would not need to incur any out-of-pocket expenses in order to sustain the Leverage Investment Strategy;

(b) to the extent that the proceeds generated by the mutual funds exceeded the monthly costs associated with the investment loans, the Leverage Investment Strategy would provide a source of income for the clients to pay living expenses or purchase additional products or services from the Respondent, such as life insurance policies;

(c) the mutual funds would grow in value over time such that the value of the mutual funds would eventually exceed the outstanding principal amount of the investment loans; and

(d) the clients could exit the Leverage Investment Strategy at any time.

[5] An "interest-only" loan is a loan where the borrower is only obligated to pay the interest owing on the principal balance of the loan monthly, bi-weekly, etc. The borrower is not required to make any payments on account of principal until the loan is retired or the lender is entitled to make demand for repayment.

25. As described in greater detail below, the Respondent's representations to the clients with respect to the Leverage Investment Strategy, whether made to the clients by him directly or indirectly by the other mutual fund salespersons assigned to the accounts, were misleading, failed to fully and adequately explain the risks, benefits, features and costs inherent in the Leverage Investment Strategy, or omitted to explain those elements of the strategy.

26. Generally, the Respondent or the other mutual fund salespersons assigned to the accounts focused on the positive aspects of the strategy, without:

(a) disclosing or discussing all of its risks and potentially negative outcomes;

(b) discussing the likelihood of any of the risks that they did disclose materializing; and

(c) ensuring that the clients understood the nature of the risks that were disclosed and the potential consequences to the clients if the risks did materialize.

(a) Risk that the mutual funds may reduce, suspend or cancel distributions

27. The Respondent misrepresented, failed to fully and adequately explain, or omitted to explain, that there was a real and substantial risk that the mutual funds purchased with the investment loans might be required to reduce, suspend or cancel altogether the payment of proceeds to investors due to declining market conditions, poor performance of the underlying investments or other reasons, such that the mutual funds may not generate sufficient proceeds to pay the costs of the investment loans or provide additional cash flow to meet other needs of the clients.

28. Commencing in 2008, the mutual funds purchased by the clients began to reduce the proceeds paid to investors. As described in greater detail later in this Notice of Hearing, the proceeds paid to each of the clients at issue in this proceeding were insufficient to pay the costs of their investment loans and the clients were forced to incur out-of-pocket expenses in order to service the loans and sustain the Leverage Investment Strategy.

(b) Unfair and unbalanced presentation of investment return projections

29. The financial plans provided to clients (described in paragraph 15 above) contained performance projections indicating that the Leverage Investment Strategy could be expected to generate returns of between 8% and 12% per year depending on the types of the underlying investments held by the mutual funds.

30. The presentation of these investment return projections was not fair and balanced in that Respondent or the other mutual fund salespersons assigned to the accounts failed to include performance projections based on more conservative rates of return, including a negative rate of return (i.e., investment losses), which would have demonstrated to the clients the potential range of outcomes that might arise if they chose to implement the Leverage Investment Strategy and in particular, the consequences to the clients if the Leverage Investment Strategy did not generate proceeds sufficient to cover the clients' costs of borrowing.

(c) Risk that the mutual funds would decline in value over time

31. The Respondent misrepresented, failed to fully and adequately explain, or omitted to explain the risk that the mutual funds might decline in value over time, particularly if the clients did not reinvest in the mutual funds the proceeds paid to them by the mutual funds.

32. When the Respondent recommended that clients purchase return of capital ("ROC") mutual funds[6], the Respondent did not explain (adequately or at all) the nature or operation of the ROC mutual funds, and clients were not aware or did not understand that the proceeds paid by the mutual funds to investors could include a portion of the principal the investors had invested in the ROC mutual funds.

[6] ROC mutual funds are structured so that a portion of the proceeds paid to investors by the fund may include a return of the capital originally invested. According to the promoters of ROC mutual funds, the ROC portion of the distribution paid by the fund is not immediately taxable in the hands of the investor receiving it. Instead, the ROC is deducted from the investor's adjusted cost base, which gives rise to a larger capital gain (or smaller capital loss) when the investment is ultimately sold.

33. In the event the returns generated by the underlying investments held by the mutual funds were not sufficient to cover the proceeds paid by the mutual funds to investors, the mutual funds may be required to make up the shortfall by returning a portion of the investors' principal to them, which would reduce the value of the units of the mutual funds held by the clients and the clients would therefore incur investment losses. This potential risk would be compounded in the event the clients elected to use the proceeds paid to them to pay the costs of the investment loans or other expenses, rather than reinvesting the proceeds in the mutual funds.

34. At about the same time as the mutual funds purchased by the clients reduced the amount of proceeds to investors in 2008, the value of the units held by investors in the mutual funds also declined.

35. The clients were not aware that the Leverage Investment Strategy exposed them to significant financial losses.

(d) Risks of exiting the Leverage Investment Strategy

36. The Respondent misrepresented, failed to fully and adequately explain, or omitted to explain the risks associated with exiting the Leverage Investment Strategy. In particular, the Respondent did not explain to the clients (adequately or at all) that:

(a) the clients would incur investment losses if they were required to sell the mutual funds they had purchased at a time when the mutual funds were worth less than the clients had paid for them; and

(b) the clients would sustain financial losses if they were required to sell the mutual funds they had purchased at a time when they were worth less than outstanding principal amount of the investment loans, in which event the client would be required to use personal savings, sell other investments or assets, or borrow additional monies in order to pay down the outstanding balance of their investment loan(s).

(e) Failure to reasonably present alternative investment strategies

37. The Respondent or the other mutual fund salespersons assigned to the accounts led the clients to believe that the Leverage Investment Strategy was the only viable means for achieving the client's financial goals. To the extent the Respondent or the other mutual fund salespersons may have also presented more traditional or conservative investment strategies to the clients, they did so in a manner which downplayed the merits of those strategies, discouraged or dissuaded the clients from giving them serious consideration, and portrayed the Leverage Investment Strategy in a more favorable light by comparison.

38. The Respondent or the other mutual fund salespersons also did not reasonably or adequately discuss with the clients whether the clients' financial goals, which the implementation of the Leverage Investment Strategy was intended to achieve, were reasonable having regard to the clients' personal and financial circumstances.

(f) Failure to meaningfully explain risk disclosure documents

39. To the extent that the Respondent or the other mutual fund salespersons arranged for clients to sign risk disclosure documents describing some of the risks associated with the use of leverage, the Respondent did not explain (adequately or at all) the contents of the risk disclosure documents to the clients in a way in which the clients would reasonably understand the risks associated with using borrowed monies to invest, and the clients did not review and understand the contents of the risk disclosure documents before signing them.

40. In summary, as described above, the Respondent misrepresented, failed to fully and adequately explain, or omitted to explain the risks, benefits, features and costs of the Leverage Investment Strategy that was implemented in the accounts of at least 18 clients, and thereby failed to ensure that the leveraged investment recommendations were suitable for the clients and in keeping with their investment objectives, contrary to MFDA Rules 2.2.1 and 2.1.1.

Allegation #2: Unsuitable leverage recommendations

41. The Leverage Investment Strategies implemented by the Respondent or the other mutual fund salespersons assigned to the accounts were not suitable for the clients having regard to the clients' "Know-Your-Client" information and financial circumstances, including but not limited to:

(a) the ability of the clients to afford the costs associated with the investment loans, regardless of the performance of the investments purchased and without relying on anticipated income or gains from the investments;

(b) the ability of the clients to withstand investment losses without jeopardizing their financial security if the Leverage Investment Strategy did not perform as represented; and

(c) the clients' age, investment objectives and personal financial circumstances.

42. The particulars of the 18 clients that implemented the Leverage Investment Strategy based upon the Respondent's recommendations are described below.

43. In almost all cases, the Respondent personally recommended the final loan in the series of investment loans obtained by the 18 clients. As a result, the Respondent was responsible for ensuring that the clients' total debt at the time of the final leverage investment recommendation was not excessive.

Client GF

44. Client GF is a former dairy farmer. He is 61 years old and has a high school education.

45. Client GF and his father jointly owned and operated a dairy farm with a milk quota and owned a herd of cattle. In 1992, client GF and his father became clients of VL, a former Approved Person at Money Concepts Barrie. Prior to seeking investment advice from VL, client

GF and his father had jointly saved approximately $300,000 which was invested in guaranteed investment certificates. In 1999, client GF's father died and client GF became the sole owner of the farm, milk quota, cattle, and their joint savings.

46. In January 2000, client GF obtained a loan in the amount of $77,796 for the purchase of mutual funds, based upon VL's recommendation to him.[7] In 2003, VL retired and the Respondent began to service client GF's accounts.

47. Between 2003 and 2004, client GF obtained, based upon the Respondent's recommendations, three investment loans totaling $172,500 which he used to purchase mutual funds for his account. During the same period, client GF obtained two loans totaling $150,000 which he used to purchase segregated funds.

48. In 2005, client GF sold the dairy quota and ceased to earn net income from the farm.[8]

49. Between 2005 (after client GF sold the dairy quota and ceased earning income from the farm) and October 2007, client GF obtained, based upon the Respondent's recommendations, four additional investment loans totaling $669,000 which he used to purchase mutual funds for his account.

50. By the time client GF obtained the tenth (and final) investment loan in October 2007, he was 55 years old, had ceased earning net income from his farm, and had borrowed more than $1 million, which represented almost 40% of his net worth. At that time, client GF was required to pay approximately $5,240 per month to cover the costs associated with the investment loans, which amount represented approximately 50% of his gross monthly income[9].

[7] This loan was recommended by VL. MFDA Staff does not allege that the Respondent engaged in misconduct with respect to this loan.

[8] Any gross income that client GF earned from the farm's operations was required to maintain, and pay the costs associated with, the farm. As a result, client GF earned no or very little net income after he sold the dairy quota.

[9] With respect to all clients identified in this Notice of Hearing, the calculation of the monthly loan costs as a percentage of the clients' gross income does not reflect other monthly expense obligations, such as mortgage

51. Given client GF's age, financial circumstances, and limited future earning potential, client GF did not have the ability to withstand or recover from investment losses arising from the implementation of the Leverage Investment Strategy.

52. Following the downturn in the financial markets in 2008, the proceeds generated by the mutual funds purchased by client GF decreased and were no longer sufficient to pay the monthly costs associated with the investment loans. Client GF was unable to afford to pay the costs associated with the investment loans on his own.

53. When client GF advised the Respondent that he was unable to afford the monthly costs associated with the investment loans, the Respondent arranged for client GF to convert his Registered Retirement Savings Plan ("RRSP") to a Registered Retirement Income Fund ("RRIF"), and use the income from the RRIF to service the investment loans.

54. At the same time that the proceeds generated by the investments decreased, the investments purchased by client GF began to decline in value.

55. Client GF sustained a significant loss relating to the implementation of the Leverage Investment Strategy, the full particulars of which will be provided prior to the commencement of the hearing on the merits.

Client TW

56. Client TW is self-employed. She is 48 years old. Prior to her dealings with the Respondent, client TW had not borrowed monies to invest.

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payments, utilities, car loans, etc., which the clients may have had at the time they obtained the loans. These additional monthly expense obligations would further impair the ability of the clients to afford the costs associated with the investment loans.

57. Client TW first met the Respondent in 2006. At that time, the Respondent arranged for client TW to complete a financial planning exercise which demonstrated that client TW's existing monthly expenses exceeded her monthly net income by approximately $2,000.

58. Between August and September 2006, client TW obtained, based upon the Respondent's recommendations, three investment loans totaling $275,000 to implement the Leverage Investment Strategy. By the time client TW obtained the final investment loan, her debt load from the investment loans represented more than 60% of her net worth, and she owed approximately $1,713 each month on account of the costs associated with the investment loans which represented approximately 14% of her gross monthly income.

59. Following the downturn in the financial markets in 2008, the proceeds generated by the investments purchased by client TW decreased and were insufficient to pay the monthly costs associated with the investment loans. After the proceeds from the investments declined, client TW was unable to afford to pay the costs associated of the investment loans on her own.

60. When client TW advised the Respondent that she was unable to pay the monthly costs associated with the investment loans, the Respondent arranged for client TW to convert her RRSP to a RRIF, and use the income from the RRIF to service the investment loans.

61. At the same time that the proceeds generated by the investments declined, the investments purchased by client TW also began to decline in value.

62. Client TW sustained a significant loss relating to the implementation of the Leverage Investment Strategy, the full particulars of which will be provided prior to the commencement of the hearing on the merits.

Clients PM and LM

63. Client PM and LM are ages 51 and 48, respectively.

64. Clients PM and LM first met the Respondent in 2007. At that time, the Respondent arranged for clients PM and LM to complete a financial planning exercise which demonstrated that their monthly expenses exceeded their monthly net income.

65. Between March and May 2007, clients PM and LM obtained, based upon the Respondent's recommendations, five loans totaling $530,000 for the purchase of mutual funds. During the same period, clients PM and LM obtained a loan in the amount of $50,000 for the purchase of segregated funds.

66. By the time clients PM and LM obtained the sixth (and final) investment loan in May 2007, they had borrowed $580,000 which represented more than 170% of their net worth. At that time, clients PM and LM owed approximately $3,000 each month in respect of the costs associated with the investment loans which represented more than 50% of their gross monthly income.

67. Following the downturn in the financial markets in 2008, the proceeds generated by the loans decreased and were insufficient to pay the costs associated with investment loans. As a result, clients PM and LM were forced to incur out-of-pocket expenses in order to service the investment loans, which amounts they could not reasonably afford to pay given their financial circumstances.

68. When clients PM and LM advised the Respondent that they were unable to afford the monthly costs associated with the investment loans, the Respondent arranged for the clients to convert their RRSP to a RRIF, and use the income from the RRIF to service the investment loans.

69. At the same time that the proceeds generated by the investments declined, the investments purchased by clients PM and LM also began to decline in value.

70. Clients PM and LM sustained a significant loss relating to the implementation of the Leverage Investment Strategy, the full particulars of which will be provided prior to the commencement of the hearing on the merits.

Client SW and SW

71. Clients SW and SW are ages 52 and 51, respectively. Prior to their dealings with the Respondent, clients SW and SW had not borrowed monies to invest.

72. Between September 2003 and February 2006, clients SW and SW obtained, based on the Respondent's recommendations, six loans totaling $300,000 for the purchase of mutual funds. By the time clients SW and SW obtained the final investment loan, their debt load from the investment loans represented more than 80% of their net worth, and they owed approximately $1,187 each month in respect of the costs associated with the investment loans which represented approximately 14% of their gross monthly income.

73. Following the downturn in the financial markets in 2008, the proceeds generated by the investments were insufficient to pay the costs associated with investment loans. As a result, clients SW and SW were forced to incur out-of-pocket expenses in order to maintain the investment loans, which amounts they could not reasonably afford given their financial circumstances.

74. When clients SW and SW advised the Respondent that they were unable to afford the monthly costs associated with the investment loans, the Respondent arranged for the clients to convert their RRSP to a RRIF, and use the income from the RRIF to service the investment loans.

75. Clients SW and SW sustained a significant loss relating to the implementation of the Leverage Investment Strategy, the full particulars of which will be provided prior to the commencement of the hearing on the merits.

Clients DM and JM

76. Clients DM and JM are ages 71 and 67, respectively. Clients DM and JM are both retired. Prior to their dealings with the Respondent, clients DM and JM had not borrowed monies to invest.

77. Between September 2000 and December 2006, clients DM and JM obtained, based on the Respondent's recommendations, thirteen loans totaling $693,207 for the purchase of mutual funds. During the same period, clients DM and JM also obtained three loans totaling $150,000 for the purchase of segregated funds.

78. By the time clients DM and JM obtained the sixteenth (and final) investment loan, they were ages 65 and 61, had borrowed more than $840,000 which represented almost 250% of their net worth. At that time, clients DM and JM owed approximately $5,096 each month in respect of the costs associated with the loans which represented approximately 68% of their gross monthly income.

79. Following the downturn in the financial markets in 2008, the proceeds generated by the investments were insufficient to pay the costs associated with investment loans. As a result, clients DM and JM were forced to incur out-of-pocket expenses in order to maintain the investment loans. The loan payments placed a significant financial burden on clients DM and JM, which they would not have agreed to had they been made aware of and understood the risks associated with the Leverage Investment Strategy.

80. At the same time that the proceeds generated by the investments declined, the investments purchased by clients DM and JM also began to decline in value.

81. Clients DM and JM sustained a significant loss relating to the implementation of the Leverage Investment Strategy, the full particulars of which will be provided prior to the commencement of the hearing on the merits.

Clients LE and KE

82. Clients LE and KE are ages 66 and 54, respectively. Prior to their dealings with the Respondent, clients LE and KE had not borrowed monies to invest.

83. Between May 2005 and June 2006, clients LE and KE applied for twelve loans totaling $990,000 for the purchase of mutual funds. During the same period, clients LE and KE also obtained a $50,000 loan for the purchase of segregated funds.

84. By the time clients LE and KE obtained the fourteenth (and final) investment loan, they have borrowed $1,040,000 which represented more than 200% of their net worth. At that time, clients owed $5,306 each month in respect of the costs associated with the loans, which represented approximately 37% of their monthly gross income.

85. Following the downturn in the financial markets in 2008, the proceeds generated by the investments were insufficient to pay the costs associated with investment loans. As a result, clients LE and KE were forced to incur out-of-pocket expenses in order to maintain the investment loans, which amounts they could not reasonably afford given their financial circumstances.

86. When clients LE and KE advised the Respondent that they were unable to afford the monthly costs associated with the investment loans, the Respondent arranged for the clients to convert their RRSP to a RRIF, and use the income from the RRIF to service the investment loans.

87. At the same time that the proceeds generated by the investments declined, the investments purchased by clients LE and KE also began to decline in value.

88. Clients LE and KE sustained a significant loss relating to the implementation of the Leverage Investment Strategy, the full particulars of which will be provided prior to the commencement of the hearing on the merits.

Clients WV and HV

89. Clients WV and HV are ages 81 and 77, respectively. Client WV retired in 1995 and client HV retired in 1990. Prior to their dealings with the Respondent, clients WV and HV had not borrowed monies to invest.

90. Between December 2001 and May 2007, clients WV and HV obtained, based upon the Respondent's recommendation, four loans totaling $225,000 for the purchase of mutual funds. During the same period, clients WV and HV also obtained two loans totaling $100,000 for the purchase of segregated funds.

91. By the time clients WV and HV had obtained the sixth (and final) investment loan, they were ages 75 and 71 respectively and had borrowed $325,000 to invest which represented almost 60% of their net worth. At that time, clients WV and HV owed approximately $1,751 each month in respect of the costs associated with the loans which represented approximately 35% of their gross monthly income.

92. Following the downturn in the financial markets in 2008, the proceeds generated by the investments were insufficient to pay the costs associated with investment loans. As a result, clients WV and HV were forced to incur out-of-pocket expenses in order to maintain the investment loans, which amounts they could not reasonably afford to pay given their financial circumstances.

93. At the same time that the proceeds generated by the investments declined, the investments purchased by clients WV and HV also began to decline in value.

94. Clients WV and HV sustained a significant loss relating to the implementation of the Leverage Investment Strategy, the full particulars of which will be provided prior to the commencement of the hearing on the merits.

Client MR

95. Client MR is 44 years old.

96. Between January and June 2005, client MR obtained, based upon the Respondent's recommendations, four loans totaling $200,000 for the purchase of mutual funds which represented more than 70% of her net worth. At that time, client MR owed approximately $854 per month in respect of the costs associated with the investment loans which represented approximately 24% of her gross monthly income.

97. Following the downturn in the financial markets in 2008, the proceeds generated by the investments were insufficient to pay the costs associated with investment loans. As a result, client MR was forced to incur out-of-pocket expenses in order to maintain the investment loans, which amounts she could not reasonably afford to pay given her financial circumstances.

98. At the same time that the proceeds generated by the investments declined, the investments purchased by client MR also began to decline in value.

99. Client MR sustained a significant loss relating to the implementation of the Leverage Investment Strategy, the full particulars of which will be provided prior to the commencement of the hearing on the merits.

Client JW

100. Client JW is 82 years old. She is retired.

101. Between October 2003 and November 2006, client JW obtained, based upon the Respondent's recommendation, four loans totaling $288,800 for the purchase of mutual funds. During the same period, client JW also obtained a loan in the amount of $50,000 for the purchase of segregated funds.

102. By the time client JW obtained the fifth (and final) investment loan, she was 75 years old, had borrowed $338,800 for investment purposes which represented approximately 40% of her net worth. At that time, client JW owed approximately $1,750 each month in respect of the costs associated with the investment loans which represented approximately 21% of her gross monthly income.

103. Following the downturn in the financial markets in 2008, the proceeds generated by the investments were insufficient to pay the costs associated with investment loans. As a result, client JW was forced to incur out-of-pocket expenses in order to maintain the investment loans, which amounts she could not reasonably afford to pay given her financial circumstances. Client JW was forced to sell a cottage property that she owned and move into a more affordable condominium in order to satisfy her financial obligations.

104. At the same time that the proceeds generated by the investments declined, the investments purchased by client JW also began to decline in value.

105. Client JW sustained a significant loss relating to the implementation of the Leverage Investment Strategy, the full particulars of which will be provided prior to the commencement of the hearing on the merits.

Clients JE and DE

106. Clients JE and DE are both 74 years old. Clients JE and DE are both retired. Prior to their dealings with the Respondent, clients JE and DE had not borrowed monies to invest.

107. Between September 2003 and May 2007, clients JE and DE obtained, based upon the Respondent's recommendation, four loans totaling $250,000 for the purchase of mutual funds. During the same period, clients JE and DE obtained two loans totaling $100,000 for the purchase of segregated funds.

108. By the time clients JE and DE obtained the sixth (and final) investment loan, they were both 68 years old, had borrowed $350,000 for the purpose of investing which represented more than 50% of their net worth. At that time, clients JE and DE owed approximately $1,783 each month in respect of the costs associated with the investment loans which represented more than 50% of their gross monthly income.

109. Following the downturn in the financial markets in 2008, the proceeds generated by the investments were insufficient to pay the costs associated with investment loans. As a result, clients JE and DE were forced to incur out-of-pocket expenses in order to maintain the investment loans, which amounts they could not reasonably afford to pay given their financial circumstances.

110. At the same time that the proceeds generated by the investments declined, the investments purchased by clients JE and DE also began to decline in value.

111. Clients JE and DE sustained a significant loss relating to the implementation of the Leverage Investment Strategy, the full particulars of which will be provided prior to the commencement of the hearing on the merits.

Clients SS and CS

112. Clients SS and CS are ages 48 and 43, respectively. Prior to their dealings with the Respondent, clients SS and CS had not borrowed monies to invest.

113. Between August 2003 and November 2006, clients SS and CS obtained, based upon the Respondent's recommendation, six loans totaling $270,000 for the purchase of mutual funds. During the same period, clients SS and CS obtained two loans totaling $100,000 for the purchase of segregated funds.

114. The Respondent was aware that on at least three occasions, clients SS and CS applied for investment loans but were declined by the lender on the basis that they already had too much debt as compared to their net worth.

115. By the time clients SS and CS obtained the eight (and final) investment loan, they had borrowed $370,000 which represented approximately 40% of their net worth. At that time, clients SS and CS owed at least $1,579 per month in respect of the costs associated with the loans which represented more than 20% of their gross monthly income.

116. Following the downturn in the financial markets in 2008, the proceeds generated by the investments were insufficient to pay the costs associated with investment loans. As a result, clients SS and CS were forced to incur out-of-pocket expenses in order to maintain the investment loans, which amounts they could not reasonably afford to pay given their financial circumstances.

117. Clients SS and CS converted their RRSP into a RRIF in order to make the monthly payments on the investment loans.

118. At the same time that the proceeds generated by the investments declined, the investments purchased by clients SS and CS also began to decline in value.

119. Clients SS and CS sustained a significant loss relating to the implementation of the Leverage Investment Strategy, the full particulars of which will be provided prior to the commencement of the hearing on the merits.

120. In summary, by engaging in the conduct described above, the Respondent made leveraged investment recommendations to clients without ensuring that the leveraged investment recommendations were suitable for the clients and in keeping with their investment objectives, including but not limited to the clients' ability to afford the costs associated with the investment loans and withstand investment losses, contrary to MFDA Rules 2.2.1 and 2.1.1.