



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: Edward S. Brown

NOTICE OF HEARING

NOTICE is hereby given that a first appearance will take place by teleconference before a hearing panel (the “Hearing Panel”) of the Atlantic Regional Council of the Mutual Fund Dealers Association of Canada (the “MFDA”) on July 10, 2014 at 11:00 a.m. (Newfoundland) concerning a disciplinary proceeding commenced by the MFDA against Edward S. Brown (the “Respondent”). Members of the public who would like to listen to the teleconference should contact the Senior Hearings Coordinator at 416-945-5146 or mwynnyckyj@mfda.ca to obtain particulars. The Hearing on the Merits will take place in Gander, Newfoundland at a time and venue to be announced.

DATED this 12th day of May, 2014.

“Rohit Kumar”

Rohit Kumar
Director of Regional Councils

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NOTICE is further given that the MFDA alleges the following violations of the By-laws, Rules or Policies of the MFDA:

Allegation #1: Between about November 2003 and April 2007, the Respondent misrepresented, failed to fully and adequately explain, or omitted to explain the risks, benefits, material assumptions, features and costs of a leveraged investment strategy that he recommended and implemented in the accounts of 9 clients, thereby failing to ensure that the leveraged investment strategy was suitable for the clients and in keeping with the clients' investment objectives, contrary to MFDA Rules 2.2.1 and 2.1.1.

Allegation #2: Between about November 2003 and April 2007, the Respondent failed to ensure that the leveraged investment strategy that he recommended and implemented in the accounts of 9 clients was suitable for the clients and in keeping with their investment objectives, having regard to the clients' relevant Know-Your-Client information and financial circumstances, including but not limited to the clients' ability to withstand investment losses and afford the costs associated with the investment loans and, contrary to MFDA Rules 2.2.1 and 2.1.1.

PARTICULARS

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. From December 1999 to July 2, 2008, the Respondent was registered in Newfoundland as a mutual fund salesperson with Berkshire Investment Group Inc. ("Berkshire"). Berkshire became a Member of the MFDA on March 8, 2002.
2. On July 2, 2008, Berkshire amalgamated with Manulife Securities International Limited, a Member of the MFDA. Following the amalgamation, Berkshire and Manulife Securities

International Limited continued to operate as Manulife Securities Investment Services Inc. (“Manulife”).¹

3. From July 2, 2008 to March 4, 2011, the Respondent was registered in Newfoundland as a mutual fund salesperson with Manulife Securities.

4. At all material times, the Respondent conducted business in Gander, Newfoundland.

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

The Respondent Recommends a Leveraged Investment Strategy

6. At all material times, the Respondent was the mutual fund salesperson responsible for servicing the accounts of the 9 Manulife clients listed below:

Clients JK and MK
Clients CB and TB
Client LW and BW
Client CJ and EJ
Client GC

7. Between about November 2003 and April 2007, the Respondent recommended and facilitated the implementation of a leveraged investment strategy whereby the clients borrowed monies and used the proceeds of the investment loans to purchase return of capital (“ROC”) mutual funds for their accounts at Manulife.

8. The leveraged investment strategy recommended by the Respondent was based on the premise that the investments purchased by the clients with their investment loans would generate sufficient returns to pay the clients’ borrowing costs, as well as provide them with excess discretionary income, such that the clients would not have to incur any out-of-pocket expenses to sustain the strategy.

¹ In this Notice of Hearing, any reference to Manulife includes Berkshire and Manulife Securities International Limited.

9. At all material times, the clients deferred to the Respondent’s recommendations concerning the leveraged investment strategy.

10. Relying on the Respondent’s recommendation, the clients borrowed in excess of the amount they could reasonably afford to finance and invested the borrowed monies in return of capital mutual funds (“ROC mutual funds”) offered by IA Clarington Investments and Stone & Co. In total, the clients obtained investment loans in the amount of \$700,000, as set out in the chart below:

Clients	Date of Loan	Lender	Loan Amount
Clients JK and MK	December 22, 2004 February 1, 2005 March 3, 2005	BMO Manulife AGF	\$80,000 \$50,000 <u>\$50,000²</u> \$180,000
Clients CB and TB	August 23, 2005	AGF	\$50,000
Client LW and BW	November 14, 2003 April 16, 2007 April 24, 2007	BMO AGF AGF	\$100,000 \$60,000 <u>\$60,000</u> \$220,000
Clients CJ and EJ	November 30, 2005 April 12, 2006	AGF B2B	\$50,000 <u>\$50,000</u> \$100,000
Client GC	August 31, 2005 September 20, 2005	AGF BMO	\$50,000 <u>\$100,000</u> \$150,000
Total Loans			\$700,000

Allegation #1: Failure to Explain Leveraged Investment Strategy

11. At the time the clients implemented the leveraged investment strategy in their accounts, the clients were unsophisticated investors with limited investment knowledge. None of them had previously borrowed monies to invest.

² The AGF loan was for \$100,000. \$50,000 was used to repay the Manulife loan. \$50,000 was new monies borrowed.

12. The Respondent did not present the leveraged investment strategy to the clients in a fair and balanced manner. During his discussions with clients, the Respondent focused on the positive aspects of the leveraged investment strategy and did not disclose or discuss all of the attendant risks and potentially negative outcomes. The Respondent either did not disclose and discuss the likelihood of any risks materializing, or if he did discuss such risks and the likelihood of the risks materializing, he did so in a manner that downplayed the likelihood of the risks arising and the potential consequences for the clients if the risks did materialize.

13. The Respondent failed or omitted to present the leveraged investment strategy to the clients using performance projections based on conservative rates of return or declining market conditions, 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 leveraged investment strategy and in particular, the consequences if the leveraged investment strategy did not generate distributions sufficient to cover the clients' costs of servicing their investment loans.

14. In the course of recommending the leveraged investment strategy to the clients, the Respondent made one or more of the following representations to them:

- (a) the leveraged investment strategy would not require the clients to incur any out-of-pocket expenses to cover the costs of the investment loans;
- (b) the ROC mutual funds could be relied upon to generate proceeds each month which would pay the costs associated with the investment loans, and provide additional monies that the clients could use to pay personal expenses, or deposit into a "side account" (as the Respondent referred to it) and reinvest the monies in the ROC mutual funds;
- (c) the value of the investments purchased with the borrowed monies would not decline and/or would grow at a rate of between 8 to 12% per year; and
- (d) after 7 to 12 years, the clients could sell the underlying mutual funds purchased with the investment loans, repay the investment loans with the proceeds from the sale, and keep the monies accumulated in the "side account".

15. The Respondent misrepresented, failed to fully and adequately explain, or omitted to explain to the clients that:

- (a) the leveraged investment strategy had material risks associated with it;
- (b) the ROC mutual funds could reduce, suspend or cancel altogether the payment of proceeds to investors, in which event the clients may not be able to rely upon the ROC mutual funds to pay the costs associated with the investment loans and provide additional monies;
- (c) if the ROC mutual funds reduced, suspended or canceled the payment of proceeds to investors, then clients may be forced to incur out-of-pocket expenses or rely on other sources of income, savings or credit to sustain the leveraged investment strategy, or terminate the leverage investment strategy and possibly incur financial losses;
- (d) if the clients terminated the leveraged investment strategy at a time when the value of the ROC mutual funds was less than the amount of the outstanding investment loans, the clients would be required to rely on other sources of income, savings or credit, if any, to cover their investment loss and pay the shortfall;
- (e) if the ROC mutual funds purchased with the borrowed monies declined in value, then the clients would incur greater investment losses than if the clients had purchased the same investments using their own monies; and
- (f) an increase in the cost of servicing the clients' investment loans due to a rise in interest rates may affect the projections concerning the sufficiency of the proceeds paid to investors by the ROC mutual funds to cover the costs associated with the investment loans and provide the clients with a supplementary source of income each month.

16. The ROC mutual funds were structured to pay monthly proceeds to investors which could include a return of the capital originally invested by the investors. In the event that the value of the underlying investments declined due to deteriorating market conditions, poor investment

performance or other factors such that the amount of the monthly proceeds paid to investors exceeded the increase in the value of underlying investments, there was a real and substantial risk that the ROC mutual funds would be required to reduce, suspend or cancel altogether the monthly proceeds paid to investors.

17. Initially, the ROC mutual funds generated proceeds which were sufficient to pay the costs associated the investment loans and provide supplementary income to the clients each month. Commencing in 2008, the proceeds paid to the clients by the ROC mutual funds declined. The reduced proceeds paid by the ROC mutual funds were insufficient to pay the clients' costs of servicing their investment loans and provide additional monies for deposit into a "side account".

18. As stated above, the proceeds paid by the ROC mutual funds to investors could include a return of the capital originally invested by the investor. If the returns generated by the underlying investments held by the ROC mutual fund were not sufficient to cover the proceeds paid to investors, then the shortfall would, over time, reduce the value of the ROC mutual funds purchased by the clients.

19. At about the same time as the ROC mutual funds reduced the payment of proceeds to investors in 2008, the ROC mutual funds also began to decline in value.

20. At the time the Respondent recommended the leveraged investment strategy to the clients, the Respondent knew or ought to have known that the clients could not afford to pay the costs of servicing the investment loans or to withstand investment losses in the event the leveraged investment strategy did not perform as the Respondent represented it would.

21. All of the clients had limited investment knowledge, limited investing experience, and had never previously borrowed monies to invest. The Respondent knew, or ought to have known had he conducted reasonable diligence to learn the essential facts relative to the clients, that the clients were unable to understand and appreciate the risks, benefits, material assumptions, features, and costs of the leveraged investment strategy without adequate explanation by him.

22. As a result of the Respondent’s misrepresentations and omissions, the clients believed that:

- (a) the leveraged investments they purchased would at least maintain their value, and may increase in value, while also generating a continuous monthly cash flow;
- (b) the leveraged investment strategy was low risk and their investments were secure; and
- (c) they would not have to incur any out-of-pocket expenses in order to implement and maintain the leveraged investment strategy in their accounts.

23. By engaging in the conduct described above, the Respondent misrepresented, failed to fully and adequately explain, or omitted to explain the risks, benefits, material assumptions, features and costs of the leveraged investment strategy that he recommended to the clients, thereby failing to ensure that the leveraged investment recommendation was 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 Leveraging Recommendations

24. At the time the Respondent recommended and assisted clients to obtain investment loans in order to implement the leveraged investment strategy, the Respondent knew or ought to have known the clients’ Know-Your-Client information as set out below³:

Clients	Ages	Occupations	Annual Household Income	Household Net Worth	Loan to Net Worth Ratio	Total Debt Service Ratio
Clients JK and MK	54 54	Guide/Tourism Home care	\$45,000	\$223,100	81%	36%
Clients CB and TB	41 32	Construction (owner) Bookkeeper	\$70,000	\$52,561	95%	66%
Clients LW and BW	46 42	Superintendent Office Manager	\$98,400	\$416,700	53%	35%

³ The Know-Your-Client information contained in the chart is captured at the time the Respondent recommended the investment loan, or final investment loan where the Respondent recommended multiple investment loans.

Clients	Ages	Occupations	Annual Household Income	Household Net Worth	Loan to Net Worth Ratio	Total Debt Service Ratio
Clients CJ and EJ	52 50	Plant Worker Seamstress	\$58,700	\$115,400	87%	16%
Client CG	59	Retired	\$65,000	\$280,300	54%	22%

25. Most of the clients' household net worth consisted of fixed assets, such as homes and registered investments, which could not easily be converted to cash to pay the costs associated with the investment loans or cover any investment losses arising from the leverage investment strategy.

26. At all material times, the Respondent knew or ought to have known that the leveraged investment strategy was unsuitable for the clients having regard to the clients' relevant Know-Your-Client information and financial circumstances, in that, among other things:

- (a) the clients could not withstand investment losses arising from the strategy; and/or
- (b) the clients could not afford to service their investment loans using their own personal income and without relying upon the distributions generated by the ROC mutual funds.

Ability to Withstand Investment Losses

27. The Respondent failed to consider, adequately or at all, whether the clients could withstand investment losses without jeopardizing their financial security if the leveraged investment strategy did not perform as the Respondent represented it would.

28. As a result of implementing the leveraged investment strategy, the clients incurred significant investment losses, the full particulars of which will be provided prior to the hearing on the merits.

29. The investment losses have jeopardized the financial security of the clients.

Ability to Afford the Costs Associated with the Investment Loans

30. The Respondent failed to consider, adequately or at all, whether the clients could afford, and were willing to pay out-of-pocket, the costs associated with the leveraged investment strategy in the event the leveraged investment strategy did not perform as represented by the Respondent and in particular, if the ROC mutual funds did not pay proceeds to investors as represented by the Respondent.

31. By engaging in the conduct described above, the Respondent failed to ensure that the leveraged investment strategy he recommended and implemented in the accounts of the clients was suitable for the clients and in keeping with their investment objectives, contrary to MFDA Rules 2.2.1 and 2.1.1.

NOTICE is further given that the Respondent shall be entitled to appear and be heard and be represented by counsel or agent at the hearing and to make submissions, present evidence and call, examine and cross-examine witnesses.

NOTICE is further given that MFDA By-laws provide that if, in the opinion of the Hearing Panel, the Respondent:

- has failed to carry out any agreement with the MFDA;
- has failed to comply with or carry out the provisions of any federal or provincial statute relating to the business of the Member or of any regulation or policy made pursuant thereto;
- has failed to comply with the provisions of any By-law, Rule or Policy of the MFDA;
- has engaged in any business conduct or practice which such Regional Council in its discretion considers unbecoming or not in the public interest; or
- is otherwise not qualified whether by integrity, solvency, training or experience,

the Hearing Panel has the power to impose any one or more of the following penalties:

- (a) a reprimand;
- (b) a fine not exceeding the greater of:
 - (i) \$5,000,000.00 per offence; and
 - (ii) an amount equal to three times the profit obtained or loss avoided by such person as a result of committing the violation;
- (c) suspension of the authority of the person to conduct securities related business for such specified period and upon such terms as the Hearing Panel may determine;
- (d) revocation of the authority of such person to conduct securities related business;
- (e) prohibition of the authority of the person to conduct securities related business in any capacity for any period of time;
- (f) such conditions of authority to conduct securities related business as may be considered appropriate by the Hearing Panel;

NOTICE is further given that the Hearing Panel may, in its discretion, require that the Respondent pay the whole or any portion of the costs of the proceedings before the Hearing Panel and any investigation relating thereto.

NOTICE is further given that the Respondent must **serve a Reply** on Enforcement Counsel and **file a Reply** with the Corporate Secretary within twenty (20) days from the date of service of this Notice of Hearing.

A **Reply** shall be **served** upon Enforcement Counsel at:

Mutual Fund Dealers Association of Canada
121 King Street West, Suite 1000
Toronto, Ontario
M5H 3T9
Attention: Charles Toth, Senior Enforcement Counsel
Fax: 416-361-9073
Email: ctoth@mfd.ca

A **Reply** shall be **filed** by:

- (a) providing 4 copies of the **Reply** to the Corporate Secretary by personal delivery, mail or courier to:
The Mutual Fund Dealers Association of Canada
121 King Street West, Suite 1000
Toronto, Ontario
M5H 3T9
Attention: Office of the Corporate Secretary; or
- (b) transmitting 1 copy of the **Reply** to the Corporate Secretary by fax to fax number 416-361-9781, provided that the Reply does not exceed 16 pages, inclusive of the covering page, unless the Corporate Secretary permits otherwise; or
- (c) transmitting 1 electronic copy of the **Reply** to the Corporate Secretary by e-mail at CorporateSecretary@mfda.ca.

A **Reply** may either:

- (i) specifically deny (with a summary of the facts alleged and intended to be relied upon by the Respondent, and the conclusions drawn by the Respondent based on the alleged facts) any or all of the facts alleged or the conclusions drawn by the MFDA in the Notice of Hearing; or
- (ii) admit the facts alleged and conclusions drawn by the MFDA in the Notice of Hearing and plead circumstances in mitigation of any penalty to be assessed.

NOTICE is further given that the Hearing Panel may accept as having been proven any facts alleged or conclusions drawn by the MFDA in the Notice of Hearing that are not specifically denied in the **Reply**.

NOTICE is further given that if the Respondent fails:

- (a) to **serve** and **file** a **Reply**; or
- (b) attend at the hearing specified in the Notice of Hearing, notwithstanding that a **Reply** may have been served,

the Hearing Panel may proceed with the hearing of the matter on the date and the time and place set out in the Notice of Hearing (or on any subsequent date, at any time and place), without any further notice to and in the absence of the Respondent, and the Hearing Panel may accept the facts alleged or the conclusions drawn by the MFDA in the Notice of Hearing as having been proven and may impose any of the penalties described in the By-laws.

END.

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