



**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: Enzo DeVuono**

Heard: July 11-15, 18, September 5-6, October 23-24, 2012 in Vancouver, British Columbia  
Decision and Reasons (Misconduct): November 22, 2012

**DECISION AND REASONS  
(Misconduct)**

Hearing Panel of the Pacific Regional Council:

The Hon. Thomas R. Braidwood, Q.C.  
Susan Monk  
Holly Millar

Chair  
Industry Representative  
Industry Representative

Appearances:

Shelly Feld )  
Francis Roy )  
)  
  
Enzo DeVuono )  
)

For the Mutual Fund Dealers Association  
of Canada  
  
On his own behalf

1. The allegation against the Respondent, Enzo DeVuono, is that:

**Allegation #1:** Between March 2006 and March 5, 2009, the Respondent recommended and sold mutual funds to clients BW and LW by way of a leveraged investment strategy without performing the necessary due diligence to learn the essential facts relative to the clients and without ensuring that the investments and the leveraged investment strategy were suitable and appropriate for clients BW and LW and in keeping with their investment objectives, contrary to MFDA Rules 2.2.1 and 2.1.1.

**Allegation #2:** Between March 2006 and March 5, 2009, the Respondent failed to fully and adequately explain the features and inherent risks of a leveraged investment strategy and its underlying investments to clients BW and LW, including:

- (a) the risk that the underlying investments might decline in value and the clients would be unable to pay back their investment loans or cover investment losses;
- (b) the risk that the underlying investments might reduce or suspend the distributions paid to investors and required by clients BW and LW to sustain the leveraged investment strategy;
- (c) the risks associated with maintaining the required debt to asset ratio of the margin loans recommended and facilitated by the Respondent on behalf of clients BW and LW to implement the leveraged investment strategy;

thereby failing to ensure that the investments and the leveraged investment strategy were suitable and appropriate for clients BW and LW and in keeping with their investment objectives, contrary to MFDA Rules 2.2.1 and 2.1.1.”

2. The allegation is that the Respondent recommended and implemented a strategy to BW and LW, who were elderly unsophisticated clients who lacked any significant sources of income, and obtained margin loans in an amount that substantially exceeded their net worth and invested the proceeds in “return of capital” equity mutual funds, the operation and features of which the clients did not understand.

3. At a motion held by teleconference on June 8, 2012, counsel for the MFDA withdrew Allegation #3 set out in the Notice of Hearing.

## **THE PARTIES**

**BW**

4. BW was 77 years of age and her husband, LW, was 57 years of age at the time of the investment. BW had no formal education beyond Grade 7, and had no previous investment experience or education and, we find, was essentially financially illiterate. She had never borrowed money or held any investments prior to dealing with the Respondent, and had been retired for more than 10 years. Her occupation had been the driver of a bus. Her gross income for the 2005 calendar year was approximately \$19,000.00 earned from Canada Pension Plan and Old Age Security payments. She had also in the past had engaged in housekeeping services for a lodge and was an employee for a brief period of time in a store. She had always struggled to make ends meet and as it was said: “never had any money”. She and LW were married in 1997.

## **LW**

5. LW was mentally deficient, for at the time of his birth there was a restriction of the blood flow to his brain, which caused him to have a serious mental handicap. Since September 4, 1998, his wife BW had held a power of attorney appointing her as lawful attorney for him for he could not manage money or understand financial matters. His employment was limited to the completion of menial jobs for minimum pay. In 2005, his income was somewhere between \$400.00 and \$1,900.00. He, of course, had no investment experience or education. Both he and BW were struggling financially to maintain their home and their vehicles.

6. The only significant asset owned by BW and LW was their home on Bowen Island, which was appraised at the approximate value of \$500,000.00, and on which they raised chickens.

## **Enzo DeVuono**

7. The Respondent has been registered as a Mutual Funds Salesperson in Ontario since May 25, 1995, and as a Mutual Funds Salesperson/Dealing Representative in British Columbia from March 20, 2006 to December 23, 2011. He obtained his registration in British Columbia in order to implement the arrangement here under consideration. When he joined Equity Associates Inc. (“Equity”), the Respondent signed an Agreement of Approved Person dated February 14, 2006 acknowledging that he was bound by and obliged to observe and comply with the By-laws, Rules and Policies of the MFDA and to submit to the jurisdiction of the MFDA.

8. BW and LW signed New Account Application Forms dated March 15, 2006 and became clients of Equity. The Respondent was the Approved Person responsible for servicing these accounts.

9. A review of the Respondent's client accounts revealed that approximately 3/4 of his clients were involved in leverage investment arrangements.

### **Craig Scott**

10. Mr. Scott is the son of BW and is married with children. He has what was described in the evidence as a good job, but his employment did not include any business experience from the financial end of business endeavours. He was involved in a mining company and was proficient in being able to analyze and describe what was "on the ground" when new prospects in the mining world were reviewed. He had no formal education beyond Grade 10. He had never completed a business or investment course. He had very limited investment experience. He invested once in a penny stock.

### **THE LAW**

#### **Mutual Fund Dealers Association of Canada – Rules**

**“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.

(Note: This is from the more recent Rules, but it was enforced at the time of the events here under consideration.)

- 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;
  - (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 the execution thereof.
- 2.2.2. **New Account Application Form.** A New Account Application Form must be completed for each new account of a client. If the New Account Application Form does not include know-your-client information, this must be documented on a separate Know-Your-Client form. Such form or forms shall be duly completed to confirm with the requirements of Rule 2.2.1 and shall be signed by a client and dated. Account numbers must not be assigned unless they are accompanied by the proper name and address for the client and such name and address must be supported by the New Account Application Form.
- 2.2.3 **New Account Approval.** Each member shall designate a trading partner, director or officer, or, in the case of a branch office, a branch manager reporting directly to the designated partner, director or officer, who shall be responsible for approval of the opening of new accounts and the supervision of account activity. The designated person shall prior to or promptly after the completion of any initial transaction specifically approve the opening of such account in writing and a record of such approval shall be maintained in accordance with Rule 5.”

## **Standard of Proof**

11. Since 2008, it has been settled law in Canada that “there is only one civil standard of proof at common law and that is proof on the balance of probabilities. In all civil cases, the trial judge must scrutinize relevant evidence with care to determine whether it is more likely than not that an alleged event occurred.” Evidence must always be sufficiently clear, convincing and cogent to satisfy the balance of probabilities test but there is no objective standard to measure sufficiency.

*F.H. v. McDougall, 2008 SCC 53 at paras 40, 46 and 49*

12. The Supreme Court of Canada has rejected the notion that the seriousness of the allegations or consequences changes the standard of proof. In all cases, evidence must be

scrutinized with care by the trial judge and it is inappropriate to say that there are legally recognized different levels of scrutiny of the evidence depending upon the seriousness of the case.

*F.H. v. McDougall, supra at paras 40 and 45*

13. The above standard of proof applies to proceedings instituted under the Mutual Fund Dealers Association of Canada Rules and By-laws as here.

### **THE NARRATIVE**

14. Mr. Scott, the son of BW, felt sorry for his mother in that she was always financially strapped and that the addition of another \$1,000.00 per month to her income would be of an enormous benefit.

15. He, at an earlier time, had visited the Respondent for tax advice and for filing his tax return. Then in the year 2005, he wanted to obtain advice on the appropriate method to purchase a new car in order to possibly gain some tax relief. Should it be purchased outright, should it be leased, and the like. Accordingly, he arranged to discuss the matter with the Respondent. As a result of their discussion, the Respondent recommended the appropriateness of a leveraged investment strategy.

16. To convince Mr. Scott of the benefits of a leveraged concept, the Respondent produced a document headed "Savana Financial Services Inc." This document explained and set forth an example of what would happen if \$48,093.00 was invested in a leveraged concept. This was the amount that Mr. Scott had in order to purchase the vehicle. Without going through the document in its entirety, I will mention that an example was used of a "fund price today based on globe fund pricing \$7.987 prime lending rate 4.25% interest rate". And it further read, "you must pay back a two for one loan on the above at a prime rate plus 0.50% for 20 years over the life of the credit". The cost of the item, namely the car, would result in monthly payments of \$957.95. Thereafter certain of these numbers were used in order to indicate various scenarios. If he simply used his original funds of \$48,093.00, then from out of his pocket must come another \$134.00 to make up the monthly car payment.

17. Then the document explains that if the original amount to invest were leveraged, then the money on hand is now up to \$96,186.00. Then out of his pocket, he only needs \$106.45 in order to pay the interest on the funds borrowed. It is most significant that in this document explaining this arrangement, the word “dividend” is used which is totally incorrect. It is a return of capital, and perhaps occasionally in the future the fund would be fortunate enough to pay a combination of monies earned. Secondly, there is not a word on any of the documents about any of the multiple risks.

18. Without going into too much detail, another document was produced of a generic variety which was prepared by the Respondent in order to convince clients as to the benefits of a leveraging arrangement. In this document, it was illustrated that the more funds one borrowed, the more an investment would yield. There was no notation of any type of a risk assessment or the fact that historically it was a return of capital.

19. As a result of Mr. Scott’s experience with this leveraged investment arrangement, he then discussed with the Respondent the needs of his mother and the desirability of obtaining an investment strategy that would yield for her \$1,000.00 a month.

20. The evidence is in dispute as to who suggested obtaining the loan on the house, but in any event certainly after the loan was obtained, the Respondent had full knowledge of the fact that the monies that were presented to him from BW and LW were from a loan on her home.

21. BW and LW were referred to a mortgage broker who assisted them to arrange a loan on the family home in the sum of \$300,000.00. It is obvious that they would not have the funds to make the payment on the loan, and it is revealed that the application form for the obtaining of the loan showed an income of some \$68,000.00 instead of in the neighbourhood of \$20,000.00 which was the reality.

22. There is no evidence that the Respondent or indeed BW or LW knew of this exaggeration.

23. When BW and LW received the loan funds through the assistance of her son, Mr. Scott, \$50,000.00 of it was used to pay back property taxes and for other upgrades that were needed on

the farm. Thereafter, the sum of \$250,000.00 was deposited with the Respondent for the investment plan.

24. Before going into the circumstances leading up to the investment, we will now describe the investment itself.

### **Investment**

25. Between March 2006 and March 2009, the Respondent advised BW and LW to implement a leveraging strategy. The circumstances are:

- (a) obtaining a mortgage as above-described on their previously unencumbered home that was valued at approximately \$500,000.00 in the amount of \$300,000.00;
- (b) using \$250,000.00 of the mortgage proceeds as collateral for additional investment loans in order to triple the amount of money available for investment, specifically by:
  - i. dividing the \$250,000.00 in mortgage proceeds into two sums of \$125,000.00 each;
  - ii. posting the two sums of \$125,000.00 as collateral to obtain two additional “2 for 1” margin loans amounting to:
    - A. \$250,000.00 from AGF Trust Company (“AGF”); and
    - B. another \$250,000.00 from B2B Trust Company (“B2B”);
- (c) applying the total amount of \$750,000.00 in proceeds from loans obtained by his new clients, BW and LW, into mutual funds.

26. At or about the time BW and LW secured the mortgage, they were asked by the Respondent to complete a number of Equity dealer forms, mutual fund company forms, and lender forms and the like, including, among others:

- i. an Equity new account application form (“NAAF”);
- ii. a trade order form;
- iii. pledge letters;
- iv. investment loan applications for B2B and AGF;

- v. a Clarington Funds Investment Application form;
- vi. an Equity leverage disclosure document; and
- vii. an Equity letter of direction.

27. These Equity account forms were sent by the Respondent to BW, either by email or by fax to a business centre on Bowen Island. If he sent documents to her by fax, the Respondent informed BW when they had been sent by phone or email so that BW could go and pick them up at the Bowen Island business centre. The Respondent further instructed to BW sign the equity account forms and then send them back to him.

28. BW did not complete these forms on her own. The Respondent simply asked her to sign the documents and return them to him. The Respondent assured her that he would look after the completion of the equity account forms and that she did not have to worry about the details. BW did as she was told by the Respondent. Where applicable, she filled out LW's name, their birthdates and addresses. She also signed each equity account form sent to her by the Respondent. These documents were mostly left blank to be filled in by the Respondent. On the NAAF and leverage disclosure document where the documents required that the signatory indicate the date on which the documents were signed, BW wrote her birth date and LW's birth date, not the dates on which she signed the documents. Then BW sent the documents to the Respondent as indicated substantially incomplete. The Respondent then added important information to the forms after he received them back such as Know-Your-Client information, details concerning loan amounts, fund names and fund codes identifying which investments were being purchased with the proceeds of the loans and the amounts of each purchase. He also corrected information on the forms that had not been filled out accurately including the dates when the documents had been signed.

29. With reference to Know-Your-Client information on the documentation, namely the NAAFs, the following inaccurate information was recorded:

<b>Investment Objectives</b>	Income, Tax Savings and Estate Planning.
<b>Estimated Income</b>	\$26,000 – 50,000

<b>Estimated Net Worth</b>	\$200,000+
<b>Investment Knowledge</b>	Good
<b>Time Horizon</b>	10+ years
<b>Risk Tolerance</b>	Medium

30. The Respondent admitted during the proceedings that he made the necessary check marks indicated on the Know-Your-Client section on the NAAFs without consulting either BW or LW.

31. There are also instances disclosed in these documents where the Respondent indicated that he was guaranteeing the signatures of BW and LW when of course this was not the fact.

### **Credibility**

32. The British Columbia Court of Appeal decision in *Faryna v. Chorny*, [1952] 2 DLR 354 at 357 is frequently cited for the proposition that:

“The credibility of interested witnesses, particularly in cases of conflict of evidence, cannot be gauged solely by the test of whether the personal demeanour of the particular witness carried conviction of the truth. The test must reasonably subject his story to an examination of its consistency with the probabilities that surround the current existing conditions. In short, the real test of the truth of the story of a witness in such a case must be its harmony with the preponderance of the probabilities, which a practical and informed person would readily recognize as reasonable in that place and in those conditions.”

33. We unhesitatingly accept the evidence of BW and Mr. Scott, and whenever that evidence conflicts with the evidence of the Respondent, we prefer the evidence of BW and Mr. Scott. We reach this conclusion having regard to the standard of proof that is necessary in proceedings of this type and also on the basis of weighing the evidence as a whole. However, six matters stand out:

- i. as described above, in the NAAF forms under the “Know-Your-Client” section, the Respondent deliberately misstated the situation and this must have been done to deceive his superiors;
- ii. that on at least two occasions, he put a guarantee of signature stamp on documents

confirming that he witnessed the signature of BW and LW when this was untrue and again this was an attempt to mislead;

- iii. in order to obtain the stated objective of providing a \$1,000.00 per month benefit to the mother, it would only have taken \$267,286.74 invested in the same manner that the Respondent arranged here to provide sufficient funds to allow the mother to enjoy the said \$1,000.00 per month;
- iv. at no time was the obvious explained or suggested, namely, simply a line of credit for \$300,000.00 and drawing down a \$1,000.00 per month plus interest which would have lasted BW and LW's each past the age of 100;
- v. when the Respondent prepared and submitted loan applications on behalf of these clients for a 2 for 1 investment loan from each of B2B and AGF, the Respondent purposely made two separate loan applications on behalf of BW and LW in order to circumvent credit checks that otherwise would have been carried out by the loan companies in order to make sure that his plan succeeded; and
- vi. the Respondent listed the funds from the original loan as capital.

34. From the above, it must be obvious that BW did not understand what the requested form meant. In particular:

- (a) she did not know that one of her objectives was "income" and did not know what the objective "estate planning" meant;
- (b) she was unfamiliar with the term "time horizon" and had no idea why the box "10+" years was checked;
- (c) she could not account for why the income range was \$26,000-\$50,000 was checked off when her household income was much less than \$25,000.00 per year; and
- (d) she could not account for why her investment knowledge would be identified as "Good".

35. We have reached the conclusion on the above evidence that these blatant incorrect statements in the forms was a deliberate attempt to mislead anyone who read the documents, including any supervisory body or the Respondent's "partner" and must have been done to allow him to proceed improperly with a leveraged strategy.

36. We find that when these documents were entered into in March 2006, the Respondent knew that the client's Know-Your-Client information that he had reported on the NAAFs was misrepresented. Specifically, the Respondent knew that his clients, BW and LW, among other

things:

- (a) had no prior investment experience;
- (b) had limited to no investment knowledge;
- (c) had total family income of approximately \$20,000.00 per year consisting largely of BW's Canada Pension Plan and Old Age Security;
- (d) had no disposable or additional sources of income;
- (e) had a low risk tolerance; and
- (f) did not have, or it was unreasonable for them to have, a "10+" years investment time horizon.

37. After the information was assembled, the Respondent had received \$250,000.00 from the mortgage proceeds from which he invested \$125,000.00 in the Canadian Dividend Fund and \$125,000.00 in the Tactical Income Fund. Then using these funds as a base, leveraged each of them twice for a total of \$375,000.00 in each fund for an overall total of \$750,000.00.

38. On one of the loan applications, the gross annual income was indicated as "combined family income of between \$30,000 and \$49,999". This was on the B2B application.

39. In conclusion, after the investment loans were approved, the Respondent purchased additional investments for BW and LW of \$250,000.00 in the Canadian Dividend Fund and \$250,000.00 in the Global Income Fund, thereby implementing a leverage investment strategy in the sum of \$750,000.00, all of which was debt as against an annual income of approximately \$20,000.00.

40. The commission earned by the Respondent from the leverage investment strategy was \$38,300.00 during the initial purchase of these funds. The Respondent received \$38,300.00 and subsequently the Respondent earned trailer fees of:

- (a) 0.5% per year on the total assets that remained invested in the Deferred Sales Charge version of the funds; and
- (b) 1% per year on the total assets that were re-invested in Front End Load versions of the Fund (as a result of the opening of what has been referred to as a "slush

fund”).

41. This occurred in each year following the initial purchases. The Respondent retained 100% of all commissions earned from his book of business and paid a fixed monthly fee to Equity for back office services and regulatory fees.

### **The Nature of the Investment**

42. Much of evidence was tendered before us as to the nature of this leverage investment strategy. It is an exceptionally sophisticated arrangement. We are of the opinion that the Respondent did not understand the concept of the difference between return of capital and investment return on the funds. On the documents that were disclosed that the Respondent indicated that he used to explain the concept to Mr. Scott, the son of BW, his illustrations used the word ‘dividend’. Whereas in fact, the funds that were chosen for the prior number of years did not have a dividend to distribute. We were referred to a document entitled “Interim Management Report of Fund Performance” for the 1A Clarington Canadian Dividend Fund. The document shows that for the years 2003, 2004 and 2005, the \$0.08 return on the fund was totally composed of a return of capital. The concept of a return of capital was never explained either to Mr. Scott or indeed to BW and LW.

43. The Canadian Income Fund had a stipulated return of \$0.08 on their shares, whereas the Tactical Income Fund had a stipulated return of \$0.06 per share. It was in the sole discretion of either fund to lower that distribution. Certain charts were filed and explained as to the result of various scenarios concerning the return of capital on such funds. For example, if one paid \$10.00 for one of the funds as here, by the 25th month if there was a capital only distribution, the shares would now be worth \$8.00. If there was a real return on the investment of 4.95%, but still an \$0.08 distribution, by the 25th month, the fund would be worth \$9.00 each, and so on.

44. We find as a fact that not only did the Respondent not understand the concept of this investment as it related to the deterioration of the investment, but also no attempt of course was made to explain it either to Mr. Scott, or BW and LW, such that if such shares were purchased at \$10.00 distributed as capital without any real earnings on the 50th month, it would be worth \$6.00 or a 40% deterioration just based on the concept of return of capital.

45. When the leverage investment was first put together, there were funds that enabled the clients to receive the \$1,000.00 per month that they required, and also funds available in order to make payments on the loan from the return mostly of capital of indeed these investments. Also there was a certain amount of monies left over. Those monies were placed into an account sometimes referred to as a “slush fund” and invested in the same Clarington Mutual Fund. There is somewhat of a conflict of the evidence as to the use and purpose of the fund, but no doubt it was meant to be a “rainy day investment fund”. At one point, \$15,000.00 of the shares were sold in order to prevent a margin call as the market began to deteriorate and of course, on that transfer eventually there could well be a commission and the evidence reveals that the shares could have been pledged rather than sold and reinvested.

46. We are also of the opinion that the question of a margin call was never explained to Mr. Scott or the Respondent’s clients. Certain margin calls were made, and the evidence discloses this occurred in about February 2008. At that time, the Respondent did not discuss the risk management issues with BW and LW or with Mr. Scott, and did not recommend any changes to the strategy or the portfolio and, in fact, no changes were made.

47. In the fall of 2008, the decline was such that the monthly distributions began to decrease and, of course, the clients were unable to continue to service the investment loans. There was a discussion between the Respondent and Mr. Scott as to methods by which to cover the loss and to have the strategy continue. In particular, a form of guarantee was presented to Mr. Scott to sign and when he needed independent legal advice, the solicitor immediately realized the total inappropriateness of the arrangement and the matters were brought to a head.

48. As a result of the collapse and the selling of the funds in order to partially pay down the loans, the result was that BW and LW were left with no investment portfolio, and outstanding loans in excess of \$285,000.00. This included the \$250,000.00 mortgage they originally took out with the bank.

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) Accordingly I consider a strategy of buying ROC funds and using leverage with high loan/value ratios to be an inherently flawed strategy.”

### **The Duties Imposed on the Respondent**

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.”

*Lamoureux (Re)*, [2001] A.S.C.D. No. 613 (A.S.C.) [*“Lamoureux”*] at p. 81

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’s suitability obligation. 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

## **The Position of the Respondent, the Role of Mr. Scott, and Agency**

58. There is no question on the evidence that when the Respondent, by telephone, attempted to speak to his clients, BW immediately referred him to Mr. Scott, and the position of BW was that she trusts her son and that her son would do everything on her behalf.

59. Mr. Scott also in his role was very concerned, as noted above, about his mother's inability to get by on her meagre pension and the fact that she needed \$1,000.00 per month more. He was very pleased with his own investment strategy as described above that was put into place by the Respondent at the time of the purchase of his vehicle.

60. It was then pursuant to a discussion, the details of which are vague by reason of the passage of time, between Mr. Scott and the Respondent that implemented the leverage arrangement for BW and LW. However, we are satisfied on the facts that the extent of the loan, namely the sum of \$750,000.00, was not discussed with either BW and LW, or with Mr. Scott, although no doubt Mr. Scott became aware of it later, but certainly not BW and LW.

61. Based on this evidence, the Respondent raises the question of ostensible authority and there is no question that if this had been a normal commercial transaction, the instructions given to the Respondent and to her son, and the conduct of the son on behalf of his mother, would in no question amount to an ostensible authority.

62. We are of the opinion that the concept of agency has no place in the interpretation of the duties imposed under the MFDA Rules:

- (a) the duties imposed under Rule 2.2.1 are duties owed to a client and cannot be amended to substitute an agent with a client;
- (b) the agent would step into the shoes of the mutual fund advisor in explaining matters to his or her principal without the necessary regulatory status or training of the salesman;
- (c) the scope of authority of an agent would often be difficult to define; and
- (d) the motives of an agent would often be unclear.

63. In the facts of this case, there can be no validity in the concept of ostensible authority for

to the knowledge of the Respondent, his clients had a total lack of sophistication and indeed one of whom had a mental incapacity.

64. Also on the evidence, again a concept of agency would be illusionary for the Respondent here could not rely on the authority of Mr. Scott for Mr. Scott did not himself have the necessary understanding to be involved in such a sophisticated arrangement and to so advise BW and LW of the leveraged concept.

65. In any event, ostensible authority to choose an investment has no place when the investment is inappropriate.

66. There are many risks in the case that were not explained either at all or indeed adequately to Mr. Scott, and of course the clients were unable to understand the risks. Some of these risks are as follows:

- (a) there were no significant assets other than the home that was mortgaged to facilitate the strategy or cover any shortfalls or any margin calls;
- (b) the clients' home and only asset was placed at risk in the strategy;
- (c) there were no liquid assets that could be used to satisfy a margin call, payoff the loans in the event of a market downturn, or provide any back-up source of financial security;
- (d) these were elderly people. They had no future employment prospects that could enable them to sustain even short term losses; and
- (e) we have of course made the finding that the clients did not know the extent of the loan. The clients thought the loan was only the bank loan of the \$250,000.00, not the other \$500,000.00.

67. In the securities regulatory context, an advisor is not permitted to accept instructions with respect to a client account from a third party on the basis of a third party's "ostensible authority" to provide Know-Your-Client information or trade instructions. An advisor is only permitted to accept instructions from a third party, if the third party has trading authority or a power of attorney to act on behalf of the client.

*Milewski (Re)*, [1999] I.D.A.C.D. No. 17 (I.D.A.) [*"Milewski"*]

68. In the *Milewski* case, the following appears at page 9:

“The issue is simply one of the due diligence required by a registered representative when opening a new account. In the District Council’s view, it is not sufficient to take another person’s word, even a husband’s. Due diligence requires that the information relating to a new client’s investment experience and objectives must be obtained directly from the client. The registered representative’s obligations are owed to her and it is her to whom he must look for instructions.”

69. The Respondent also relies on Section 2.2.1(d) of the MFDA Rules claiming that he properly advised his client’s son, Mr. Scott:

“(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 or Approved Person has so advised the client before the execution thereof.”

70. In *Lamoureux (Re)*, the court in discussing what is described as a three-stage process, in addition to what I have cited above, also emphasized the following:

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

71. The Respondent also relies upon a document signed by his clients which acknowledges that they understood certain risks.

72. There is among the exhibits a document entitled “Equity Associates Inc.”, and under that

“Leverage Disclosure (borrowing money to invest)”. There are two such documents. One with reference to “Initial Leverage Amount \$500,000.00” and the other “Initial Leverage Amount \$250,000.00”. Upon a careful reading, there are the following statements:

“That a leverage purchase involves a greater risk than a purchase using cash reserves only.”

“The extent a leverage person is involved in capitals undue risk is determined to be made by an individual case basis.”

“The lender may require that the amount outstanding on the loan not rise above the agreed percentage of the market value of the shares. If this would occur, the borrower must pay down the loan or sell the shares so as to return the loan to the agreed percentage relationship.”

73. On the evidence, it is clear that the clients would have no concept what any of the matters identified in the documents meant. The documents were obviously mailed to be signed and were signed and returned back to the Respondent. There is no indication that any of it was explained to the clients, nor indeed to Mr. Scott.

74. Also with reference to dealing with the role of Mr. Scott in this matter, it is important to consider the following again from the Alberta Securities Commission:

“The obligation on a registrant to ensure that each investment recommended to a client is suitable is a particularly important protection for those clients whose investment experience and sophistication may be insufficient to enable them to fully recognize or assess the risks inherent in an investment. As noted below, disclosure to the client of the negative material factors of an investment, however important, is not necessarily relevant to a suitability determination and cannot replace a registrant’s obligation to assess suitability. Acknowledgment on the part of an investor of awareness of the material negative factors or risk does not convert an unsuitable investment into a suitable one.

Our view is consistent with the OSC’s decision in *Marchment & MacKay*, supra. There, the OSC considered whether the respondents, who had sent a variety of documents to their clients, could rely on this documentation to satisfy their obligation to ensure that securities sold to their customers were suitable and that they had adequately disclosed to the clients the risks associated with investing in the securities recommended. The OSC, in deciding that the obligation to determine suitability rests with the

registrant and cannot be transferred to the client.

We reject this attempt to rely on these procedures as an effort to transfer to the customers the burden of determining whether the high risk investments being recommended to them by Marchment salespersons were suitable for purchase by them. The obligation to determine suitability clearly rests with the registrant.”

*Lamoureux, supra. p. 20.*

75. The position of the Respondent in his argument and indeed when he testified was that he acknowledges that the investment was not suitable for these clients, but said that he did so because of the instructions to do so by Mr. Scott, the son.

76. However, at no time did he advise either Mr. Scott or BW and LW that the investment was not suitable. In fact, on the Respondent’s own evidence, he said this was one of the arrangements that he put forward and recommended, and certainly he did everything in his power to have his superiors understand that the income and assets of his clients were sufficient to be involved in such an arrangement.

### **Agency**

77. Mr. Scott himself did not have the necessary sophistication to be in a position of advising his mother as to whether or not this leveraging investment was appropriate. His background is:

- (a) no formal education beyond Grade 10;
- (b) never completed business or investment courses;
- (c) limited investment experience. He had a \$0.01 stock that he lost money on;
- (d) been introduced to the idea of borrowing to invest in ROC funds for the first time by the Respondent just a few months prior to the leveraging investment strategy being implemented for BW and LW and, of course, that account involved \$50,000.00;
- (e) never previously borrowed funds to invest prior to setting up his own leverage investment strategy with the Respondent;
- (f) implemented a much more conservative leverage investment strategy in his own

account than the one BW and LW embarked on in 2006;

- (g) he depended on the Respondent to describe the mechanics of a leverage investment strategy to him, including the obtaining of investment loans and the mechanics of the return of capital funds;
- (h) had no experience in dealing with investment loan companies and would not have known that by limiting the loan request from each investment company to \$250,000.00, credit checks by the lenders could be avoided;
- (i) had no experience in a margin call prior to the leverage investment strategy being setup for his mother; and
- (j) his express interest strategy was one that would generate a \$1,000.00 per month for his mother and not more than that amount.

78. The Respondent also suggested that this was an unsolicited trade. This proposition, of course, is in no way supported by the evidence.

79. In *Phillips (Re)* [2011] IIROC No. 34, the following is stated:

“20. In the IIROC Interview the Respondent was asked “was there ever a recommendation where [SF] said – where you recommend something, he said no, don’t buy it?” The Respondent replied “I don’t think so, no.”

21. DW testified that all the securities purchased by her were the Respondent’s “idea”.

22. As set out below, neither SF nor DW had the sophistication or knowledge to purchase securities based on anything other than the Respondent’s guidance.

23. The Panel is therefore satisfied that all securities by SF or DW were purchased on the Respondent’s initiative.

...

54. The Panel has found that the Respondent was aware of SF’s and DW’s personal circumstances and was aware that both were unsophisticated investors who trusted her and relied wholly upon her skill and judgment. The Respondent must also have been aware of the high risk nature of the securities purchased. The Panel therefore finds that the Respondent knew at the time she made the purchases for SF and DW referred to above that the securities were entirely unsuitable, and contrary to the best interests of

these clients.”

80. There is no question on the evidence for us and we find as a fact that the advice came from the Respondent and it was he who conceived, arranged and implemented the investment strategy.

## **CONCLUSION**

81. In conclusion, we are of the opinion that the Respondent:

- (a) failed to ensure that the investment products and leveraged investment strategy that he recommended to clients BW and LW were suitable and in keeping with the investment objectives of the clients, contrary to Rules 2.2.1 and 2.1.1; and
- (b) failed to fully and adequately explain the features and inherent risks of a leveraged investment strategy and the underlying investments that he recommended to clients BW and LW, contrary to MFDA Rules 2.2.1 and 2.1.1.

82. As a result of the strategy that the Respondent recommended to BW and LW, these elderly unsophisticated clients who lacked any significant sources of income obtained margin loans in amounts that substantially exceeded their net worth and invested the proceeds in “return of capital” equity mutual funds, the operation and features of which, the clients could not possibly understand.

83. The Respondent’s recommendations had devastating consequences to the clients as the investment portfolio that the Respondent recommended declined in value and the amounts of distributions payable by the “return of capital” mutual funds were significantly reduced, resulting in margin calls that eliminated the clients’ entire investment portfolio and left them substantially indebted to lenders without any means of repaying their outstanding loans.

84. By recommending this investment strategy, the Respondent breached his suitability obligations to the clients and the standard of conduct that all Approved Persons are required to uphold.

85. The parties will now need to arrange a hearing before us on the question of penalty.

**DATED** this 22<sup>nd</sup> day of November, 2012.

“Thomas Braidwood”

The Hon. Thomas R. Braidwood, Q.C.,  
Chair

“Susan Monk”

Susan Monk,  
Industry Representative

“Holly Millar”

Holly Millar,  
Industry Representative