Court File No. CV-18-00608086-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

B E T W E E N :

ONTARIO SECURITIES COMMISSION

Applicant

- and -

MONEY GATE MORTGAGE INVESTMENT CORPORATION

Respondent

APPLICATION UNDER
Sections 126 and 129 of the *Securities Act*, R.S.O. 1990, c. S.5, as amended

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BOOK OF AUTHORITIES
OF THE ONTARIO SECURITIES COMMISSION
(Receivership Application and Continuation of Freeze Direction)

November 5, 2018

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1. *Ontario (Securities Commission) v Factorcorp Inc.*, [2007] OJ No 4496, 2007 CarswellOnt, paras 47-48 [*Factorcorp*] (SCJ [Comm List])

2. *Ontario Securities Commission v Sextant Strategic Opportunitites Hedge Fund LP et al.*, [2009] OJ No 3063, 2009 CarswellOnt 4241, para 54 (SCJ [Comm List]) [*Sextant*]

3. *Securities and Exchange Commission v. Wencke*, (1980) 622 F. 2d 1363, Court of Appeals, 9th Circuit

4. *Quaddrexx (Re)*, 2017 ONSEC 3

5. *Pezim v British Columbia (Superintendent of Brokers)*, (1994) 2 SCR 557

6. *Ontario Securities Commission v Sbaraglia* (23 December 2010), Toronto, Ont, Court File No CV-10-883-00CL (unreported) (S.C.)

7. *Ontario Securities Commission v. Future Solar Developments Inc.*, 2015 ONSC 2334

8. *Ontario Securities Commission v. Sextant Capital Management Inc.*, 2010 ONCA 228 (March 3, 2010)

9. *Ontario Securities Commission v. Haiyan (Helen) Gao Jordan*, 2016 CarswellOnt 14615 (S.C.)

Case Name:

Ontario (Securities Commission) v. Factorcorp Inc.

RE: Ontario Securities Commission (Applicant), and Factorcorp Inc. and Factorcorp Financial Inc. (Respondents)

[2007] O.J. No. 4496

161 A.C.W.S. (3d) 841

Court File No. 07-CL-7124

Ontario Superior Court of Justice

G.B. Morawetz J.

Heard: October 17, 2007.
Judgment: October 26, 2007.

(51 paras.)

Insolvency law -- Receivers, managers and monitors -- Grant of receivership -- Grounds -- Motion by Commission for appointment of receiver and manager of respondent Factorcorp -- Factorcorp pooled funds raised through issuance of debentures and loaned them to 12 sub-lenders who, in turn, loaned them to small businesses -- Factorcorp unable to satisfy all debenture redemption requests for reasons of liquidity and suspended redemptions -- Motion allowed -- Considering most loans not secured and that Factorcorp unable to continue to service interest to debenture holders and pay other operating costs, interest of creditors of Factorcorp best served if receiver appointed.

Securities regulation -- Regulatory commissions -- Powers or jurisdiction -- Appointment of receiver -- Motion by Commission for appointment of receiver and manager of respondent Factorcorp -- Factorcorp pooled funds raised through issuance of debentures and loaned them to 12 sub-lenders who, in turn, loaned them to small businesses -- Factorcorp unable to satisfy all debenture redemption requests for reasons of liquidity and suspended redemptions -- Motion allowed -- Considering most loans not secured and that Factorcorp unable to continue to service interest to debenture holders and pay other operating costs, interest of creditors of Factorcorp best served if receiver appointed.

Motion by Commission for appointment of receiver and manager of respondent Factorcorp -- Factorcorp registered as Limited Market Dealer to provide funding for factoring, leasing and similar short term secured asset-backed financing services to commercial clients -- Factorcorp pooled funds raised through issuance of debentures and loaned them to 12 sub-lenders who, in turn, loaned them to small businesses -- 80 per cent of investors to whom Factorcorp debentures were sold, did not qualify for the Accredited Investor exemption under Securities Act -- Redemption requested on behalf of clients not qualifying for exemption comprised about 50 per cent of total principal amount advanced to Factorcorp -- Factorcorp unable to satisfy all such requests for reasons of liquidity and suspended redemptions -- Monitor retained by Commission concluded that Factorcorp's monthly operating costs exceed its cash interest payments received and that Factorcorp unable to continue to service interest to debenture holders and pay other operating costs -- HELD: Motion allowed -- Only $13 million out of $50 million of loans made by Factorcorp were secured -- Operating costs greater than the amount of interest received -- No realistic refinancing plan -- Interest of creditors of Factorcorp best served if receiver appointed -- Investments made by Factorcorp in breach of representations made in Offering Memorandum and Factorcorp had not been able to remedy the problem.

Counsel:

Melissa J. MacKewn and Cullen Price, for the Ontario Securities Commission.

Arthur Hamilton, for Factorcorp Inc. and Factorcorp Financial Inc.

Rachelle Moncur, for KPMG Inc.

ENDORSEMENT

1 G.B. MORAWETZ J.:-- On October 17, 2007 the motion of the Ontario Securities Commission ("OSC") pursuant to section 129 of the *Ontario Securities Act* (the "Act") to appoint KPMG Inc. as Receiver and Manager of Factorcorp Inc. and Factorcorp Financial Inc. (collectively "Factorcorp") was granted, with written reasons to follow. These are those reasons.

2 Factorcorp Inc. is an Ontario corporation registered under securities law as a Limited Market Dealer ("LMD"). Factorcorp Financial Inc. is an Ontario corporation that is not a reporting issuer and is not registered with the OSC. Mr. Mark Twerdun is the controlling shareholder and sole director and officer of both Factorcorp Inc. and Factorcorp Financial Inc.

3 During the last three to four years Factorcorp, through the sale of debentures, raised approximately $50 million from approximately 700 Ontario investors. The debentures have

maturity dates of 1, 2 or 3 years and interest rates of 6, 7 or 8% per annum. The terms of the debentures are such that an automatic reinvestment occurs unless a redemption request is received 120 days prior to the end of the term of the debenture.

4 Factorcorp pooled the funds raised through the issuance of debentures and loaned them to approximately 12 sub-lenders (the "Customers") who, in turn, loaned them to various small to mid-sized businesses (the "End Borrowers").

5 Factorcorp was formed for the purpose of providing funding for factoring, leasing and similar short term secured asset-backed financing services to commercial clients. The offering memoranda alleges that the loans between Factorcorp and its Customers are secured.

6 In distributing its debentures, Factorcorp relied on the Accredited Investor ("AI") exemption to the prospectus requirement contained in section 53 of the Act.

7 The bulk of Factorcorp's debentures were sold by a single dealer, Farm Mutual Financial Services Inc. ("Farm Mutual"). Beginning in November 2006, Farm Mutual conducted an internal review of the files of investors to whom Factorcorp debentures were sold.

8 The affidavit of Mr. Moniz, a representative of the OSC, refers to communications that he had with a Farm Mutual compliance consultant who estimated that approximately 80% of the investors to whom Factorcorp debentures were sold, did not qualify for the AI exemption.

9 Farm Mutual has submitted repayment requests on behalf of clients who may not qualify as AIs under Ontario securities law. These requests comprise approximately 50% of the total principal amount advanced to Factorcorp. Mr. Twerdun has acknowledged that Factorcorp cannot satisfy all such requests for reasons of liquidity and in May 2007, redemptions were suspended. Mr. Twerdun has also acknowledged that he is considering various refinancing and/or restructuring alternatives in order to be in a position to satisfy redemption requests.

10 On July 6, 2007, pursuant to section 127(5) of the Act, the OSC made a temporary order which required: a) that the status quo be maintained through the imposition of a cease trade order and a preclusion of redemptions in relation to the debentures; and b) that a monitor be engaged by Factorcorp on terms established by the OSC.

11 On July 27, 2007, the OSC made a further order that Mr. Twerdun and Factorcorp retain a monitor selected by OSC staff by August 1, 2007 on terms to be established by the OSC. The monitor's mandate was to review the business, operations and affairs of Factorcorp and any company controlled directly or indirectly by Mr. Twerdun or Factorcorp involved with the issuance of securities and related proceeds. KPMG Inc. was subsequently retained as monitor (the "Monitor").

12 On August 3, 2007, the within application was issued and was adjourned on terms.

13 Since that time Factorcorp has provided information to the Monitor relating to asset valuation, security interest analysis, expenses and its ongoing refinancing arrangements.

14 The Monitor required this information to assess (i) the reasonableness of Factorcorp Financial Inc.'s budget including whether Factorcorp Financial Inc. can pay, out of receipts from Customers, essential expenses and interest payments due under the debentures; (ii) the value and recoverability of Factorcorp Financial Inc.'s loans (and investments) made to Customers and by Customers to End Borrowers; and, (iii) the likelihood of the Companies achieving some satisfactory form of refinancing in the near term.

15 The most recent Monitor's report is dated October 15, 2007 (the "Seventh Report"). The Monitor comments on the efforts of Factorcorp and Mr. Twerdun to obtain overall refinancing for Factorcorp. The Seventh Report also comments on the various investments made by Customers.

16 With respect to refinancing efforts, Mr. Twerdun advised the Monitor that he continues to talk with four potential parties who he says are considering providing refinancing for Factorcorp. However, Mr. Twerdun does not have permission from such potential investors to reveal their identity. The Monitor has not received any information that enables it to assess the likelihood of any new financing transactions closing, or their timing.

17 With respect to the investments of Factorcorp, the Monitor provided details in its Fifth Report, on the debt and security documents contained in the copies of Factorcorp's Customer files as provided to the Monitor. The Fifth Report contained a summary of the investments with Customers. A number of deficiencies were noted. The total amount of Factorcorp investments which are secured is approximately $13 million. Factorcorp holds approximately $19.7 million in preferred shares and has made loans totaling approximately $18.1 million for which the files do not contain satisfactory evidence of valid security.

18 The Seventh Report which updates the Fifth Report does not alter the previous report with respect to the amount of the investments in preferred shares or the loans for which there is inadequate security documentation. A summary of Factorcorp's investments is included in the Seventh Report at Appendix B.

19 The Monitor commented extensively on Factorcorp's investment in $19.7 million of preferred shares of one Customer. The unaudited financial statements of this Customer for the fiscal year ended September 30, 2006 indicate that the Customer had assets of $19.4 million and liabilities of $22.6 million, which leads to an additional concern, namely that this Customer is not in a financial position whereby it could redeem the shares. The Monitor comments that Factorcorp has provided a signed term sheet dated October 9, 2007 in respect to the conversion of preferred shares to conventional secured debt, but the Monitor notes that the customer may not be in the legal position to convert the preferred shares to secured debt.

20 The Monitor also commented on the cash flow forecast of Factorcorp. Based on the limited information available, the Monitor concluded that it appears that Factorcorp's operating costs on a monthly basis exceed its cash interest payments received. The Monitor observed that not all customers are current and that without cash inflows over and above the amount of interest payments currently being received from customers, Factorcorp will not be able to continue to service the interest to debenture holders and pay other operating costs.

21 The position of Factorcorp was put forth in the affidavit of Mr. Twerdun sworn October 16, 2007. Not surprisingly, the affidavit attempts to paint a different story from that provided in the affidavit of Mr. Moniz and in the Monitor's reports. Mr. Twerdun stated that Factorcorp only accepted subscriptions for debentures from persons who represented to Factorcorp that they were AIs. Mr. Twerdun stated that the issue of investments being made by non-AIs only came to his attention as a result of an inquiry made by the Mutual Fund Dealers' Association into the operations of Farm Mutual and that this issue came as a surprise to Factorcorp. The problem was compounded when Farm Mutual required many of its clients to request payment of their debentures. Mr. Twerdun states that it was as a result of Farm Mutual's actions and breach of its duties that Factorcorp received repayment requests in the amount of approximately 50% of its portfolio and given the illiquidity of Factorcorp's portfolio, Factorcorp could not repay such a significant portion of its portfolio resulting in its suspension of payments to all debenture holders in May 2007.

22 Mr. Twerdun states that neither Factorcorp nor Factorcorp Financial is insolvent. This statement is made on the basis that the debenture holders who have issued repayment requests through Farm Mutual are not AIs and as such Factorcorp believes it has a right of set off as a result of their misrepresentations.

23 With respect to Factorcorp's investment in the preferred shares of its Customer, Mr. Twerdun states that Factorcorp Financial has negotiated to convert the preference shares into two one year loans aggregating $20 million, but it is noted that the term sheet is dated October 9, 2007 and is non-binding.

24 Mr. Twerdun also explained that he has had discussions with other borrowers and that these borrowers have agreed in certain cases to accelerate repayment of their obligations and in still other situations he anticipates receiving term sheets which will lead to repayment of outstanding loans within a relatively brief period of time. Documentation to support Mr. Twerdun's statements is lacking.

25 Based on discussions that Mr. Twerdun has had with borrowers, he stated that approximately 75% of all loans made by Factorcorp Financial will be repaid within one year.

26 Mr. Twerdun is concerned that if a receiver is appointed, the customers and potential financiers at Factorcorp will likely renege on repayment schedules or agreements in the belief that the receiver will be willing to accept a lower return of principle provided that the loan is repaid over a short period.

27 With respect to refinancing efforts, Mr. Twerdun states that a certain refinancing transaction could not be pursued as the potential financier withdrew as it was not interested in providing financing to a company whose business was under review by a monitor. He is also of the view that the presence of the monitor is detrimentally affecting four current refinancing proposals.

28 Mr. Twerdun concludes that, if a receiver is not appointed, negotiations will result in the successful refinancing of Factorcorp Financial by January 31, 2008. However, if a receiver is appointed, he is of the view that the potential financiers will no doubt terminate discussions about refinancing. Mr. Twerdun also states that Factorcorp Financial has not defaulted on any interest payments and has not received any communications from debenture holders expressing dissatisfaction with the current arrangements. Counsel submits that the debenture holders are not currently prejudiced by the status quo.

Should a Receiver by Appointed

29 A receiver may be appointed under section 129(2) of the Act. However, no order shall be made unless the Court is satisfied that the appointment of a receiver is in the best interests of the creditors, or it is appropriate for the due administration of Ontario securities law.

30 The OSC submits that both parts of the test have been satisfied. Counsel submits that there is a broad discretion provided to the court and that the enforcement decisions of the OSC should be taken into consideration.

31 Redemptions have been suspended. Interest continues to be paid but the cash flow forecast casts doubt on the ability of Factorcorp to maintain interest payments. The security in support of the loans made by Factorcorp to its Customers is, in many situations, deficient or non-existent. A significant investment is not even evidenced by a debt obligation. It is a holding of preferred shares.

32 Counsel to the OSC submits that the solution is for a sale of the portfolio and the question then becomes who is the best party to effect a sale of the portfolio. The OSC submits that it needs to be conducted by a receiver.

33 Counsel concentrates on three areas. Firstly, whether the loans are secured. Secondly, what are the refinancing possibilities. Thirdly, what is the state of the cash flow forecast.

34 As previously noted, and notwithstanding that Factorcorp's investment were to be secured, only $13 million out of $50 million of loans made by Factorcorp are secured. The preference share investment represents $19.7 million and $18 million is made up of loans for which there is no evidence of valid and enforceable security.

35 With respect to refinancing proposals, counsel to the OSC submits that there is no tangible refinancing plan. I agree. Any credible investor will need confirmation of the validity and enforceability of security. Any credible investor will identify the shortcomings of the portfolio when it conducts due diligence.

36 The cash flow forecast also indicates that the operating costs are going to be greater than the amount of interest received. Cash flow remains positive to date on account of a return of capital of approximately $1.2 million, but the source of such funding cannot be identified.

37 The Monitor is not aware of any information which would indicate that for September and October, receipts will substantially exceed the Factorcorps' estimates including amounts related to the return of capital, as a result of Factorcorps' refinancing efforts, repayments from Customers or from any other source. Based on current information, the Monitor concluded that Factorcorp would not be able to satisfy its current redemption obligations.

38 Finally, counsel submits that there is no compelling evidence to indicate that Mr. Twerdun could do a better job to protect the interests of creditors than a receiver.

39 Counsel to Factorcorp submits that the debenture holders would be best protected if the receiver is not appointed. He stressed that, to date, full interest has been paid and there are no portfolio performance defaults. Further, Mr. Twerdun is actively seeking refinancing and is also working with both Customers and End Borrowers in an effort to improve the portfolio. Counsel submits that debenture holders would be better off if a receivership is avoided and that a refinancing or workout would be substantially complete by the end of 2007 or early in 2008.

40 Mr. Hamilton also submitted that an unwinding of the portfolio would be a disaster for the debenture holders and that the best opportunity for the debenture holders is through a workout and that the workout can be best implemented by Mr. Twerdun through his relationships with both Customers and End Borrowers. A receiver, counsel submits, does not have such relationships and the focus of a receiver is different from than that of management in that the receiver would not embark on a full scale workout. In addition, he raises the question of whether the receiver would pursue Farm Mutual. Litigation has now been instituted by Factorcorp as against Farm Mutual. At the very least, counsel submits that the commissions received by Farm Mutual of $2.2 million should be pursued by Factorcorp as well as the action based on Farm Mutual's role in permitting non-AIs to purchase the debentures.

41 Notwithstanding the submissions of counsel to Factorcorp, I am of the view that the interest of the creditors of Factorcorp would be best served if a receiver was appointed. One cannot ignore certain fundamental points.

42 Firstly, Factorcorp's Offering Memorandum provides that the investments were to have been made on a secured basis. Clearly, this did not happen. The reports of the Monitor indicate that only $13 million out of the approximately $50 million of the investments are secured. An investment of $19.7 million is not even made by way of loan but is in preferred shares in a company whose financial state is questionable. The remainder of the investments of approximately $18 million are either unsecured loans or have deficient security. Mr. Twerdun was the directing mind of

Factorcorp and he must take responsibility for making investment decisions. The decision to invest in preferred shares and in neglecting to obtain security for a number of other investments, cannot be said to be decisions that were made in the best interests of the creditors of Factorcorp. Regardless of whether the investors were AI or non-AI, it does not alter the fact that the investment decisions made by Factorcorp and Mr. Twerdun breached the terms of the offering memoranda, to the detriment of the creditors. In all likelihood, the only question remaining is to determine the extent of the loss facing the investors.

43 Secondly, the refinancing efforts undertaken by Factorcorp have not demonstrated tangible results. There are no commitments. The proposals referenced by Mr. Twerdun are preliminary in nature. The recent timing of the proposals appears to suggest that these investors have not done any serious due diligence. One party, who had been identified as a potential refinancier as early as November 2006, has not put forth any binding proposal. No party has stepped forward to refinance Factorcorp. There are four mystery parties and one chartered bank, the identity of which remains unknown. Factorcorp has, in my view, had ample time to put forward a solution. None has been forthcoming.

44 Thirdly, redemptions were suspended in May 2007 and the cash flow forecasts are not encouraging. In my view, Factorcorp's creditors are at risk.

45 Simply put, these investments made by Factorcorp are in breach of the representations made in the Offering Memorandum and Factorcorp has not, in my view, been able to remedy the problem. Factorcorp and its principal have only offered promises for a better tomorrow. However, Mr. Twerdun's and Factorcorp's plan on how to fix the problem, must be greeted with a large degree of skepticism. In my view, there is nothing on the record, that would persuade me that the creditors would be best served with the status quo.

46 The Monitor was engaged in early August. The Monitor noted in its reports that information that it requested from Mr. Twerdun was often delayed due to apparent concerns about confidentiality. When information was provided it was lacking in detail. The refinancing proposals are, in my view, not proposals. They are expressions of interest, in many cases dated but a few days before the Seventh Report. The Monitor has had no time to consider the *bona fides* of any such proposals. In this regard Factorcorp and Mr. Twerdun have to take full responsibility for the current situation. There is nothing before the Court to support their position that a refinancing is imminent, or, indeed, feasible and there is nothing to support Mr. Twerdun's contention that the debenture holders would be best protected if the receiver is not appointed.

47 In my view, the time has come to appoint a receiver. The receiver is, in my view, in a much better position to protect the interest of the creditors, than is Mr. Twerdun or Factorcorp.

48 The receiver is also in a position to protect the interests of all stakeholders, including Factorcorp. In this regard, part of the Receiver's mandate will be to evaluate and report on the merits of Factorcorp's position vis-à-vis Farm Mutual.

49 Having been satisfied under the first branch of the test under section 129(2)(a), it is not necessary to consider the second aspect of the test, namely whether it is appropriate for the due administration of Ontario securities law. However, having reviewed the temporary orders granted under section 127 of the Act, and having considered the issues raised in the Fifth and the Seventh Report, I am also of the view that it would be appropriate for the due administration of Ontario securities law to appoint a receiver.

50 An order shall issue, in the form submitted, appointing KPMG as receiver and manager of Factorcorp.

51 The parties previously indicated the need to maintain confidentiality over certain portions of the documents. Redacted versions of the Seventh Report and the Responding Motion Record are in the Court File. The unredacted materials will be sealed until November 5, 2007, pending further order.

G.B. MORAWETZ J.

cp/e/qlaxs/qlmxt

Case Name:
Ontario (Securities Commission) v. Sextant Strategic Opportunities Hedge Fund L.P.

RE: IN THE MATTER OF the Securities Act, R.S.O. 1990, c. S.5 as amended
Ontario Securities Commission, (Applicant), and Sextant Strategic Opportunities Hedge Fund L.P., Sextant Capital Management Inc. and Sextant Capital GP Inc., (Respondents)

[2009] O.J. No. 3063

179 A.C.W.S. (3d) 345

Court File No. CV-09-8053-CL

Ontario Superior Court of Justice
Commercial List

G.B. Morawetz J.

Heard: April 30, 2009.
Judgment: July 17, 2009.

(68 paras.)

Securities regulation -- Offences and enforcement -- Declaration -- Appointment of receiver, receiver and manager, trustee, liquidator -- Application by securities commission for appointment of receiver over assets and undertakings of respondent hedge fund and corporations allowed, and motion by respondent companies to strike out paragraphs of affidavit dismissed -- Motion by respondent companies without merit -- Interests of investors not served by maintaining status quo -- Appointment of receiver justified as being in best interests of investors and appropriate for due administration of securities law -- Appointment of receiver necessary as respondent companies received payments from fund, their conduct indicated they could not be trusted with investors' interests, and receiver required access to books and records -- Securities Act, s. 129.

Application by securities commission for appointment of receiver over assets and undertakings of respondent hedge fund and corporations and motion by respondent companies to strike out paragraphs of affidavit. The hedge fund was a mutual fund in Ontario operated by the two respondent companies. Nearly 250 Canadian had invested just under $30 million in the fund since 2006. The securities commission became aware of issues with respect to the fund and its management including potential fraud, potential misappropriation of investor money, misrepresentation, self-dealing by the fund managers and numerous and significant recordkeeping inaccuracies and record manipulation. The respondent companies brought a separate motion to strike out paragraphs of the affidavit filed by the securities commission in support of its application on the basis that they contained either opinions, conclusions or legal arguments and that during the course of cross-examination on the affidavit, the affiant refused to answer questions with the result that the respondent companies were unable to test the paragraphs of the affidavit consequently were unable to make full answer and defence.

HELD: Application allowed and motion dismissed. The motion brought by the respondent companies had no merit and to the extent they complained of the refusals of the affiant, they should have challenged his refusals rather than bring a motion to strike. The evidence of the securities commission raised serious concerns. The interests of the investors were not served by maintaining the status quo and the appointment of a receiver was justified as being in the best interests of the investors and appropriate for the due administration of Ontario securities law. In order to protect the investors, the appointment of a receiver was necessary for each of the respondent companies because they received payments from the fund which should be reviewed, their conduct indicated that they could not be trusted with the continuing responsibility for investors' interests and the receivers required access to the books and records of the fund which the companies were responsible for.

Statutes, Regulations and Rules Cited:

Ontario Securities Act, R.S.O. 1990, c. S.5, s. 111, s. 116, s. 129

Counsel:

Susan Kushneryk, for Ontario Securities Commission.

Robert Brush and Anna K. Markiewicz, for the respondents Sextant Capital Management Inc. and Sextant Capital GP Inc.

David Bish, for PricewaterhouseCoopers Inc.

ENDORSEMENT

G.B. MORAWETZ J.:--

Introduction

1 The Ontario Securities Commission (the "OSC" or the "Commission") moves for the appointment of a receiver and/or receiver and manager (collectively "receiver") over the assets and undertaking of Sextant Strategic Opportunities Hedge Fund L.P. ("Sextant Canadian Fund"), Sextant Capital Management Inc. ("SCMI") and Sextant Capital GP Inc. ("Sextant GP") (collectively, the "Sextant Canadian Entities") pursuant to s. 129 of the *Ontario Securities Act* (the "Act").

2 The OSC takes the position that the Sextant Canadian Fund is a mutual fund in Ontario, managed by SCMI and Sextant GP. The OSC submits that nearly 250 Canadians have together invested just under $30 million in the Sextant Canadian Fund since 2006.

3 The OSC submits that it has become aware of issues giving rise to what it considers to be significant concerns with respect to the Sextant Canadian Fund and its management, SCMI and Sextant GP. The OSC submits that these problems include potential fraud, potential misappropriation of investor money, misrepresentations, self-dealing by the fund managers, and numerous and significant recordkeeping inaccuracies and apparent record manipulation.

4 The OSC further submits that any one of the foregoing list of concerns would be sufficient to cause risk to investors' interests in the Sextant Canadian Fund and, taken together, these issues and the course of conduct which created them, have placed investors' interests at significant risk. The OSC submits that the only way to safeguard those interests and to adequately address the numerous deficiencies and irregularities associated the Sextant Canadian Fund and its management is to introduce an independent, third party to undertake a verifiable review and analysis of the fund and its management. They submit that the investors are entitled to a process that is reliable and that they can trust.

5 Accordingly, the OSC seeks the appointment of a receiver pursuant to s. 129 of the Act, for the interests of the investors and for the due administration of Ontario securities law.

6 The OSC submits that the respondents chose not file any responding material in this application, such that the evidence proffered by the OSC in the affidavit of Mr. Raymond Daubney sworn March 5, 2009 is uncontroverted.

7 No party appeared on behalf of the Sextant Canadian Fund.

8 SCMI and Sextant GP oppose the appointment of a receiver on the basis that:

(i) there are serious flaws in the evidentiary record underlying this application;

(ii) it is unnecessary to appoint a receiver for SCMI and Sextant GP for the due administration of Ontario securities law or to protect the interests of creditors and security holders; and

(iii) the appointment of a single receiver for all three of the respondents will create an irreconcilable conflict of interest for that receiver.

9 SCMI and Sextant GP take the position that limiting the receiver's appointment to the Sextant Canadian Fund, but on terms requiring SCMI and Sextant GP to cooperate with the receiver, will avoid this conflict of interest while, at the same time, ensure that the interests of stakeholders will be protected and Ontario securities law will be duly administered.

Motion of SCMI and Sextant GP

10 SCMI and Sextant GP brought a separate motion to address what they consider to be serious flaws in the evidentiary record underlying the application. They sought an order striking out certain paragraphs of the affidavit of Mr. Daubney, in particular, paragraphs 78, 82, 88, 90, 121, 161, 175, 188 and 189 on the basis that all of these paragraphs contain either opinions or conclusions or legal argument. The moving parties also take the position that on April 9, 2009 they attempted to cross-examine Mr. Daubney on his affidavit but during the course of the examination, Mr. Daubney refused to answer or took under advisement questions respecting the basis for his opinions and legal conclusions and the factual underpinnings of those opinions and conclusions. They further suggest that, as a result of Mr. Daubney's refusal to answer, they were unable to test what they consider to be the improper and highly prejudicial paragraphs of the affidavit of Mr. Daubney in defence of the application and, as a result, they were unable to make full answer and defence.

11 In my view, the motion brought by SCMI and Sextant GP has no merit. To the extent that the moving parties complain about the refusal of Mr. Daubney to answer certain questions or to take certain questions under advisement, they should have challenged his response as opposed to bringing a motion to strike. Any complaints with respect to the conduct of the cross-examination were, in this respect, within the control of SCMI and Sextant. The moving parties made the decision not to challenge the refusals or taking questions under advisement.

12 Counsel to SCMI and Sextant GP also challenge Mr. Daubney's evidence with respect to his statements on valuation on the basis that he is not a qualified expert valuator. Mr. Daubney is not an expert and his concluding opinion on valuation has not been considered. However, certain of his comments on the issue of value are factual in nature and go to the reasonableness of the factors that are considered in a valuation. These statements have been considered. The concerns of SCMI and Sextant GP go to weight.

13 Certain of Mr. Daubney's statements are in the form of legal argument, and have been either disregarded or discounted to the point where they have been given, little or no weight.

Facts and Concerns

14 A summary of the factual background to this application has been set out in the factum of the OSC and the factum of SCMI and Sextant Capital.

15 At paragraph 72 of the OSC factum, counsel submits that there are a number of reasons why the appointment of a receiver is in the best interests of the Sextant Canadian Fund security holders and for the due administration of Ontario securities law. These reasons include:

(a) SCMI and Sextant GP have caused the Sextant Canadian Fund to pay each of them significant fees, including fees in excess of $3.5 million in 2008 alone, as a result of manipulation of the value of the fund - which purportedly increased by approximately 172% from the end of 2007 to the end of 2008 notwithstanding that the underlying assets are principally shares of companies that are not operating:

(b) there is a capital shortfall in the Sextant Canadian Fund based on outstanding redemption requests and the value of the Sextant RBC Accounts and the Sextant Canadian Fund New Edge account;

(c) the value of the assets held by the Sextant Canadian Fund is uncertain, such that the accurate net asset value per unit held by investors held in the Sextant Canadian Fund is not known;

(d) record keeping inaccuracies have to be investigated to determine the accurate shareholdings held in the Sextant Canadian Fund and to confirm the accuracy and propriety of the flow of money out of the fund;

(e) there is a history of mismanagement of the investments in the Sextant Canadian Fund;

(f) there has been significant regulatory non-compliance;

(g) investors' interests are not served by the status quo whereby SCMI and Sextant GP continue to manage the Sextant Canadian Fund;

(h) there is no evidence that SCMI or Sextant GP are in any better position than a receiver to protect investors' interests;

(i) there is no evidence of a tangible alternative to appointing a third party to step in and manage the Sextant Canadian Entities; and

(j) in light of the recordkeeping inconsistencies, questionable value of the assets of the Sextant Canadian Fund, evidence of forgery and other fraudulent activity, investors are entitled to an independent and verifiable claims process.

16 The above list of reasons has been drawn from paragraph 188 of the affidavit of Mr. Daubney, which was one of the paragraphs challenged by SCMI and Sextant GP. It is, in my view, appropriate, to review the basis for some of these statements.

17 Earlier in his affidavit, Mr. Daubney states that the Sextant Canadian Fund is structured as a limited partnership pursuant to a Limited Partnership Agreement between Sextant GP and the investors in the Sextant Canadian Fund dated February 17, 2006. There is also an Amended and Restated Limited Partnership Agreement dated July 28, 2008 which introduced a new class of units in the Fund but otherwise retained identical governance provisions. The initial and subsequent agreements together are referred to as the "LP Agreement".

18 The LP Agreement includes, among others, the following provisions:

(i) the Sextant Canadian Fund will make investments in accordance with the disclosure in its offering document;

(ii) the Sextant Canadian Fund may not invest more than 20% of its portfolio, based on the net asset value at the most recent calculation date, in any single class of securities of an issuer as calculated at cost;

(iii) the Sextant Canadian Fund will not purchase securities from, or sell securities to SCMI or any of its affiliates or any firm in which any principle of SCMI may have a direct or indirect material interest; and

(iv) the Sextant Canadian Fund will pay a 2% advisory fee to SCMI and a 20% performance fee or "management allocation" to Sextant GP.

19 The affidavit of Mr. Daubney at paragraph 21 also references a confidential offering memorandum which describes investment restrictions applicable to the Fund, including that Sextant Canadian Fund may not invest more than 20% of its portfolio in any single class of securities of an issuer and that it will not purchase securities from, or sell securities to SCMI or any of its affiliates or any firm which a principal of SCMI may have a direct or indirect material interest.

20 At paragraph 22, Mr. Daubney addresses the relationship between Mr. Otto Spork and the Sextant Canadian Entities. Mr. Daubney states that Mr. Spork is the directing mind behind these three entities and various related entities, including those invested in by the Sextant Canadian Fund. Mr. Daubney states that Mr. Spork created an elaborate structure with three main components:

(a) the investment component which solicits investors and includes three investment funds, one in Canada (i.e. the Sextant Canadian Fund) and two in the Cayman Islands;

(b) the management component including SCMI and Sextant GP in Toronto and Sextant Capital Management, an Islandi ehf ("Sextant Iceland"), which manages the investment funds in exchange for fees paid by the funds from investors' money; and

(c) the glacier company component, consisting of two private Luxembourg companies and their Icelandic subsidiaries which were the primary investments for the three investment funds.

21 Mr. Daubney goes on to state that through this structure, Mr. Spork was able to take investors' monies in at least two ways. First, he could take investors' money through management fees, in the management component and, second, through direct investment in his own Luxembourg companies.

Further, Mr. Spork has significant ownership and management roles in the various entities relevant to this matter, including SCMI, Sextant GP, Sextant Iceland, the Sextant Strategic Hybrid 2 Hedge Resource Fund Offshore Ltd. ("Sextant Hybrid Fund"), the Sextant Strategic Global Water Fund Offshore Ltd. ("Sextant Water Fund"), Iceland Glacier Products S.A. ("IGP") and Iceland Global Water 2 S.A. ("IGW").

22 Mr. Daubney goes on to state that in addition to the Sextant Canadian Fund, the Sextant investment structure includes the Sextant Hybrid Fund and the Sextant Water Fund (together, the "Sextant Offshore Funds") two investments funds incorporated under the laws of the Cayman Islands. Further, although the Sextant Offshore Funds are incorporated in the Cayman Islands, their custodial accounts are held at New Edge in Canada and IAS is the net asset calculation agent for the Funds.

23 Mr. Daubney further states that the net asset value of the Sextant Offshore Funds in December 2008, as stated on the IAS Portfolio Valuation Statement for those funds, was just over U.S. $100 million. Those statements also indicate that their respective investment holdings essentially mirrored the investments held by the Sextant Canadian Fund for the same month, in that the portfolios of all three funds were just over 90% invested IGP and just over 2.5% invested in IGW, as calculated by IAS.

24 Mr. Daubney also states that the Sextant Offshore Funds were not isolated but rather were an integral part of the structure created by Mr. Spork.

25 With respect to Sextant funds management, SCMI was incorporated in Ontario in August 2005. It is registered under the Act as an investment counsel, portfolio manager and limited market dealer and is the principle distributor of the Sextant Canadian Fund.

26 Sextant GP was incorporated in Ontario in December 2005.

27 Mr. Daubney is of the view that the only purpose for SCMI and Sextant GP apparent in the records available to staff of the OSC, is to manage the Sextant Canadian Fund.

28 Mr. Daubney further states that the management of the Sextant Canadian Fund and the Sextant Offshore Funds, in addition to SCMI and Sextant GP, includes Sextant Iceland.

29 Mr. Daubney goes on to describe the third component of the investment structure created by Mr. Spork which is comprised of two limited Luxembourg companies, IGP and IGW, and their Icelandic subsidiaries. Mr. Daubney states that Mr. Spork has ownership interests and management roles in each of IGP and IGW. IGP and IGW are limited Luxembourg companies. IGP has a wholly-owned subsidiary called Iceland Glacier Products ehf ("IGP Iceland") and IGW has a wholly-owned subsidiary called Iceland Global Water EHF ("IGW Iceland").

30 Mr. Daubney further states that IGP Iceland is intended to operate, in the future, as a bottled water business that extracts and bottles glacier water, as set out in its business plan. Mr. Daubney states that OSC staff have not been able to confirm the details of any glacier rights held by IGP, although there is some indication that IGP does have some rights to at least one glacier in Iceland. A plant is being constructed in the town in connection with the lease but the plant is not yet operating.

31 The relationship of the Sextant Canadian Entities to Mr. Spork to IGP and IGW raises concerns in the areas outlined in the LP Agreement referenced at [18] above. It also raises concerns in respect of the mandated prohibition against self dealing by mutual funds (Section 111); and the standard of care of investment funds (Section 116).

32 Section 2 of the factum is entitled *Misconduct: Manipulation of Value, Mismanagement of Investments and Manipulation of Records*. In my view, the submissions in this section raise very serious issues.

33 At paragraph 78 of his affidavit, Mr. Daubney states that there is no evidence supporting the purported value of IGP and, to the contrary, it appears that the value of those shares has been fraudulently manipulated by or to the knowledge of SCMI and Sextant GP, for purposes including allowing SCMI and Sextant GP to collect significant management and performance fees that they did not earn. This paragraph was also the subject of challenge by counsel to SCMI and Sextant GP. Again, it is appropriate to review the basis for these statements.

34 At paragraph 79, Mr. Daubney states that the value of the Sextant Canadian Fund is tied almost exclusively to the value of its shares in IGP and with over 90% of the market value of the Sextant Canadian Fund held in shares of IGP, the fund's holdings are materially over concentrated in IGP.

35 Mr. Daubney also states that IGP shares held by the Sextant Canadian Fund are over concentrated even on the basis of the initial cost of the shares. He states that even at the cost or book value recorded on the IAS portfolio valuation statement, at $6,131,347 out of a total portfolio book value of $10,516,509.06, the Sextant Canadian Fund holds 58.3% of its assets in shares of IGP. The IAS portfolio valuation statement for July 2007 lists the book value for those shares of $1,758,405 out of a total portfolio book value of $3,002,841.65, or 59% of the total portfolio book value. Mr. Daubney states that, even on a cost-base calculation, the IGP shares represent more than half the value of the Fund. This evidence is objective in nature and it can properly be considered.

36 Mr. Daubney goes on to question the stated value of IGP as not being reliable or supportable. He states that the IGP shares purportedly increased in value from their initial cost of EUR 0.163 in July 2007 to a market value of EUR 2.450 in January 2009. He states that this a 1400% increase from the purchase price to the stated market value a year and one-half later, notwithstanding that this is a non-operating business and there have been no material developments that would explain the surging value of these shares. The calculations were challenged by Mr. Brush on Mr. Daubney's cross-examination, and using different variables, the percentage of the fund's total portfolio that was invested in a single security in July 2007 was 31.5%, which I note is still more than 50% greater than the permitted maximum of 20%. Mr. Daubney also stated that the purported increase in value over time resulted in millions of dollars in management fees being paid from investors' money. He also states that there is no evidence that neither of the mandated valuation procedures was followed by Sextant GP in respect of the value of IGP for the purpose of the Sextant Canadian Fund. Rather, he states that the value of IGP shares was set from time to time by the Board of Directors of Sextant Iceland, which consists of Mr. Spork and two other individuals.

37 Mr. Daubney went on to state that in determining the value of IGP, the directors of Sextant Iceland relied on purported independent valuations of IGP Iceland at December 31, 2007, as prepared by companies called Hempstead and Spardata (together, the "Purported Valuations"). Mr. Daubney is of the view that the Purported Valuations do not constitute independent or reliable valuations and cannot be reasonably relied upon to support the value assigned by Sextant Iceland Board of Directors.

38 Mr. Daubney further refers to a letter dated September 29, 2008 from Canacord Capital Corporation ("Canacord") to Mr. Spork (the "Canacord Letter"). The Canacord Letter indicates that it is a financing proposal, not a valuation.

39 Mr. Daubney states that among the materials that Mr. Spork provided to Canacord in connection with the Canacord Letter were purported letters of intent for the purchase of water (the "LOIs"). He states that at least three of those LOIs are fraudulent insofar that three of the LOIs purport to be agreements with, respectively, the Los Angeles Department of Water and Power, the San Diego County Water Authority and Division 4, Orange County Water District. Mr. Daubney states that the purported counter parties to each of these LOIs has confirmed that they did not, in fact, execute these agreements; moreover, none of them had any previous dealings with Sextant, IGP or their related entities, or had so much as heard of Sextant, IGP or Mr. Spork. The statements of Mr. Daubney are corroborated by the affidavits of Mr. Philip Anthony of the Orange County Water District, Mr. Wally Knox of the Board of the Los Angeles Department of Water and Power and Mr. Barry Martin of the San Diego Water Authority.

40 Mr. Daubney went on to state that there was no basis for the claimed market value in excess of $160 million in December 2008. Similarly, he stated that without operations, there was no basis for the claimed returns on their shares from July 2007 to November 2008.

41 Mr. Daubney also made the point that OSC staff had written to counsel for the Sextant Canadian Fund, SCMI and Sextant GP and counsel for Mr. Spork and Sextant Iceland, inviting them to provide some explanation or basis for the extraordinary value and purported rate of return for IGP. No substantive response has been received.

42 A number of the statements made by Mr. Daubney raise issues that comment on the value of the IGP, but they are not, in my view, valuations. Obvious examples would be the three LOIs with Los Angeles, San Diego and Orange County. The remarkable sworn responses from these municipal officials casts considerable doubt on the *bona fides* and operations of Mr. Spork and by extension, the Sextant Canadian Entities.

43 Mr. Daubney also comments about recordkeeping inaccuracies or manipulation. He states that records for the Sextant Canadian Fund and related entities contain a number of material inaccuracies and there is evidence that those records have been manipulated. As a result, he states that the records relating to the fund are unreliable. Further, as the general partner and investment advisor, Sextant GP and SCMI are responsible for the records of the Sextant Canadian Fund.

44 According to Mr. Daubney, the material of recordkeeping inaccuracies include the following:

(a) the number of IGP shares held by the Sextant Canadian Fund does not reconcile between the IGP share register book and the IAS records for the Fund;

(b) based on the IGP share register book, the IAS portfolio valuation statements have overstated the Sextant Canadian Fund's ownership of IGP shares and, therefore, the Fund's value by an amount between EUR 3,080,463.40 and EUR 6,755,463.40;

(c) the cost of IGP shares as reported on the IAS portfolio valuation statements or the Sextant Canadian Fund is inconsistent, in that the IAS portfolio valuation statements and portfolio valuation detailed statements show variances over time among the number of shares held, the average cost of those shares and the total cost of those shares, without the valuations correlating consistently;

(d) the value of the initial investment in IGP shares by the Sextant Canadian Fund and the Sextant Offshore Funds is recorded on the IAS portfolio valuation statements does not match the value of the shareholders' investment in IGP as recorded in the annual accounts for IGP as at December 31, 2007;

(e) there appears to have been a transfer of US $1.2 million to Riambel, a holding company owned by Mr. Spork, out of funds paid by the Sextant Canadian Fund and the Sextant Offshore Funds for IGP shares and there is no apparent basis or justification for this transfer; and

(f) there are no share certificates and there is no share register for IGW, such that those shares held in the Sextant Canadian Fund and the Sextant Offshore Funds are not evidenced anywhere.

45 At paragraphs 46-53 of the factum, the section is entitled, *Investments not in Accordance with Offering Memoranda or LP Agreement.* The submissions in this section raise very serious issues with respect to the role of the investment advisor, SCMI and the basis on which the advisory and performance fees were calculated.

46 At paragraph 54 of the factum, the submission is made that the manipulation of value, manipulation of records and mismanagement of investments by SCMI and Sextant GP, as managers of the Sextant Canadian Fund, have cost investors millions in invalid fees, caused the net asset value of the Sextant Canadian Fund to be unreliable, created a capital shortfall in the fund and otherwise compromised the value of the fund and that the actions of SCMI and Sextant GP have thereby materially compromised and diminished the value of investors' investments in the Sextant Canadian Fund.

47 The above submission is based on statements in the affidavit of Mr. Daubney at paragraphs 156-174.

48 It is noted that in excess of $3.5 million was charged to the Sextant Canadian Fund in 2008 in respect of the advisory and performance fees, combined. The statement is made that these fees are based almost entirely on the purported value of the fund's IGP shares.

49 Serious questions are raised as to whether the shares hold anything more than a nominal value, and certainly not the purported value in the tens of millions of dollars as listed on the IAS portfolio valuation statements. In my view, the statement of Mr. Daubney again raises very serious questions about the operation of the fund.

50 It is not surprising that the submission is made that the recordkeeping inaccuracies and manipulations, as described in Mr. Daubney's affidavit, have caused the net asset value of the Sextant Canadian Fund, therefore the value of the individual investor's investments, to be uncertain.

51 Counsel to SCMI and Sextant GP at paragraphs 30-85 of their factum raise what they consider to be serious flaws in the evidentiary foundation for the application. I cannot give effect to this submission. In my view, there is ample objective evidence to establish that serious issues have been raised and that there are serious areas of concern with respect to all three respondents. These areas of concern relate not only to the protection of the position of the investors but also with respect to the due administration of securities law in Ontario. In my view, the basis for the application of the OSC has, beyond any doubt, been established.

Law

52 Section 129 of the Act permits the Commission to apply to court for an order appointing a receiver. Such an order shall be made if the court is satisfied that such an appointment is:

(i) in the best interests of the company's creditors or the security holders or of subscribers to the company; or
(ii) it is appropriate for the due administration of Ontario securities law.

53 I am in agreement with the submissions set out at paragraphs 89-98 of the factum submitted by counsel to the OSC which address the criteria to be considered on a s. 129 application.

54 The criteria for determining what is in the best interests of creditors, security holders or subscribers for the purpose of the appointment of a receiver under the Act is broader than a solvency trust. The criteria should taken into consideration all the circumstances and whether, in the context of those circumstances, it is in the best interest of creditors that a receiver be appointed. The criteria should also take into account the interests of all stakeholders. See *British Columbia (Securities Commission) v. Di Cimbriani* (1996), 138 D.L.R. (4th) 263 (B.C.C.A.) and *Ontario (Securities Commission) v. Factorcorp Inc.*, [2007] O.J. No. 4496 (S.C.J.).

55 Further, where there is a history of mismanagement, no evidence of a tangible alternative resolution, evidence that investors' interests will not be served by maintaining *status quo* and evidence that the company is not in a better position than a receiver to protect investors' interests, it is appropriate to appoint a receiver. See *Factorcorp, supra*, and *Ontario Securities Commission v. C & M Financial Investments Ltd.* (1979), 23 O.R. (2d) 378 (H.C.J.).

56 In addition, where there is evidence of regulatory breaches and evidence that the value and integrity of assets purchased with investor funds has been compromised, it is in investors' best interests, that a receiver be appointed so that such investors are provided with an independent and verifiable review and analysis. Investors deserve treatment they can rely upon. See *Factorcorp, supra*, and *Ontario (Securities Commission) v. ASL Direct* (November 14, 2008),Toronto (CV-08-7793-00CL (S.C.J.).

Conclusion

57 The evidence of Mr. Daubney and others raises many serious and troubling concerns. I am satisfied that the investors' interest will not be served by maintaining the *status quo*. There are also a number of troubling concerns that have been raised relating to regulatory non-compliance that justify the appointment of a receiver on the basis of it being appropriate for the due administration of Ontario securities law.

58 I accept the submission at paragraph 72 of the factum which is referenced at [15]. The situation, in my view, justifies the appointment of a receiver for SCMI, Sextant GP and the Sextant Canadian Fund as being in the best interests of the Sextant Canadian Fund security holders (its investors) and it is also appropriate for the due administration of Ontario securities law.

59 I have been satisfied that the requirements for the appointment of a receiver under both parts of s. 129 have been met.

60 In my view, in order to protect investors, the appointment of a receiver is necessary for each of the Sextant Canadian Entities. A receiver is necessary for SCMI and Sextant GP because, among other things:

(i) these are the entities to which fees were paid from the Sextant Canadian Fund and these payments should be reviewed;

(ii) SCMI and Sextant GP are responsible for certain conduct as outlined in the affidavit of Mr. Daubney and, in my view, cannot be entrusted with the continuing responsibility for investors' interests; and

(iii) as the managers of the Sextant Canadian Fund, SCMI and Sextant GP are responsible for the books and records of the fund to which the receiver will require access.

61 Further, a receiver is necessary for the Sextant Canadian Fund to ensure that investors' assets in the fund are managed, and potentially distributed, in an orderly fashion.

62 The records are such that investors' funds are not completely accounted for and identified shortcomings in the operations of SCMI and Sextant GP require an independent review. In these circumstances, investors are entitled to an independent and verifiable reporting process and to treatment on which they can rely more generally.

63 It seems to me that anything less than the appointment of a receiver would not permit the overview or control of the financial affairs of the company.

64 I note that counsel to SCMI and Sextant GP submitted that the Sextant Canadian Fund is not a mutual fund and therefore not in breach of s. 111 of the Act. No submission was made by the Sextant Canadian Fund.

65 To the extent that this is an issue, the OSC, in my view, has provided a full response to this position at paragraphs 107 and 108 of its factum.

66 Counsel to SCMI and Sextant GP also raised the issue that the appointment of a single receiver for all three of the respondents will create an irreconcilable conflict of interest for that receiver. In my view, it is premature to consider this issue. The interests of the investors can be best served, it seems to me, if there is one receiver who coordinates the mandated activities of the receiver. To the extent that the receiver identifies issues of conflict, these can be addressed at a future time.

Disposition

67 In the result, the application is granted. PricewaterhouseCoopers Inc. ("PwC") is appointed as Receiver and Manager over the property, assets and undertakings of each of SCMI, Sextant GP and the Sextant Canadian Fund. The consent of PwC has been filed.

68 An order shall issue in the form of the draft order presented.

G.B. MORAWETZ J.

cp/e/qllxr/qlmxb/qlaxw/qlcal

622 F.2d 1363
United States Court of Appeals,
Ninth Circuit.

SECURITIES AND EXCHANGE COMMISSION, Plaintiff,
v.
Walter WENCKE et al.
SUPERIOR MOTELS, INC., Petitioner-Appellant,
v.
R. N. GOULD and Securities and Exchange Commission, Receiver and Real Party in Interest and Appellee.

No. 78-1395.
|
June 9, 1980.

Synopsis

Appeal was taken from an order of the United States District Court for the Southern District of California, G. Thompson, J., which denied leave of court to enforce a prior state court judgment against a defendant in a securities fraud action. The Court of Appeals, Kennedy, Circuit Judge, held that: (1) district court had authority, after appointing a receiver in securities fraud action, to issue a stay, which was effective against nonparties and which was issued without any prior notice to them, prohibiting all persons from commencing any suit against the receivership entities except by leave of court, and (2) district court did not abuse its discretion in denying leave of court to enforce prior state court judgment and to complete another prior state court proceeding against receivership entity; however, district court would be required to determine whether a bond was necessary to protect creditor's interest.

Affirmed in part; remanded.

Attorneys and Law Firms

***1365** Alex A. Harper, Craig W. Walker, Michael G. Zybala, San Diego, Cal., for Securities and Exchange Commission.

Faber L. Johnston, Johnston, Miller & Giannini, San Jose, Cal., for Wencke, et al.

Appeal from the United States District Court for the Southern District of California.

Before WRIGHT, KENNEDY and TANG, Circuit Judges.

Opinion

KENNEDY, Circuit Judge:

A district court may appoint a receiver in a securities fraud action brought by the Securities and Exchange Commission (SEC). The somewhat novel question presented by this appeal is whether a district court may also issue a stay, effective against nonparties and without prior notice to them, prohibiting "all investors, creditors, and other persons" from "(c)ommencing, prosecuting, continuing or enforcing any suit" against the receivership entities, except by leave of the court. Resolution of this case requires consideration of what securities law policies are furthered when a corporation not linked with the defendant in the SEC action is prevented from enforcing a prior state court judgment (and completing another prior state court proceeding) against a receivership entity.

A. The Motel Complex

Appellant Superior Motels (Superior) built and owned a motel complex including a restaurant and cocktail lounge. In 1967, Superior entered into a sale and lease-back agreement with Lamplighter Properties whereby it leased the complex for a term of twenty years. On April 26, 1969, Superior assigned its lessee's interest to a corporation eventually known as Sun Fruit, Ltd.[1] On or about October 1, 1972, Sun Fruit sublet the motel complex to its wholly-owned subsidiary, Rinn Motor Hotels. Shortly thereafter, Rinn Motor Hotels sublet the motel property (but not the restaurant) to Rinn-Sunnyvale Motor Hotel, a partnership of which Rinn Motor Hotels held an 80% leasehold interest and was a copartner. The motel was known by various names, but is here referred to as the Executive Inn.

B. The Nevada Receivership and Superior's State Court Action

Early in 1972, defendants Walter Wencke and Richard Mets acquired control of Sun Fruit through fraudulent means. See SEC v. Wencke, 577 F.2d 619 (9th Cir.), cert. denied, 439 U.S. 964, 99 S.Ct. 451, 58 L.Ed.2d 422, (1978) (hereinafter cited as Wencke I). For the next two years, ***1366** Wencke caused Sun Fruit to transfer most of its assets to corporations owned or controlled by Wencke in exchange for nominal cash and notes. In July, 1975, on behalf of one of Sun Fruit's creditors, Wencke petitioned a Nevada state court to place Sun Fruit into receivership and appoint himself as receiver. Wencke was appointed on August 7, 1975. This action was an attempt by Wencke to conceal his looting of Sun Fruit. Wencke I, supra, 577 F.2d at 622.

On November 25, 1975, Superior filed an action in California state court to regain possession of the leasehold interest in the Executive Inn. Sun Fruit, by the sublease described above, had assumed Superior's lease. The sublease contained a provision that the appointment of a receiver for the lessee would constitute a breach of the agreement, and Superior relied upon this clause to regain the motel lease and the right to operate it. [2] Named as defendants, among others, were Sun Fruit, Rinn Motor Hotels, Inc., and Rinn-Sunnyvale Motor Hotels. Allegedly because of defective service of process, Sun Fruit did not appear to contest the action, and on October 1, 1976, a Judgment in Unlawful Detainer by Default was entered against Sun Fruit by the state court. The court held that Superior was entitled to possession from Sun Fruit and "all persons holding possession of the premises under or through it or them." Rinn Motor Hotels and Rinn-Sunnyvale Motor Hotels claimed possessory rights apart from the Sun Fruit lease, and Superior proceeded against them in a separate action. On March 1, 1977, a state court in a memorandum decision ruled in Superior's favor, finding that the defendants had an interest in the property only by virtue of Sun Fruit's leasehold interest. Before the state court entered a final judgment, however, and also before Superior took possession of the premises, the federal district court entered a stay prohibiting further proceedings in the state court. We turn now to the federal proceedings.

C. SEC Proceedings, Receivership, and the Blanket Stay

On July 22, 1976, the SEC brought an action for injunctive and other equitable relief against Wencke, his wife, and several business entities controlled by Wencke and his associates, including Sun Fruit, Rinn Motor Hotels, Inc., and its subsidiary, Rinn-Sunnyvale Motor Hotel. On November 19, 1976, the district court orally granted the SEC's motion for a preliminary injunction and receivership. The temporary receiver appointed by the court was authorized to take custody of and conserve whatever assets might remain for the defrauded public investors until he could fully investigate the complex corporate relationships created by Wencke and audit the various corporate and trust entities to determine the extent of the receivership estate. On December 20, 1976, the district court granted injunctive and ancillary relief, effective as of November 19, based on its finding that the SEC had "made a prima facie case that Wencke has engaged in fraud and mismanagement with respect to defendant Sun Fruit (and other entities eventually placed in the receivership)," and that there was "a likelihood of irreparable harm to . . . shareholders of Sun Fruit unless the requested receivers are appointed." Because at least some of Sun Fruit's assets were subject to the Nevada receivership, the district court, out of concern for comity, declined to place these assets under the control of the federal receiver.

Following these preliminary orders, discovery began in the federal action. In order to attack the district court's jurisdiction, Wencke refused to be sworn at a deposition the SEC had scheduled. On the magistrate's recommendation, the district court ***1367** struck the answers of all defendants and entered default judgments against them. To enable the receiver to take complete control over Wencke's entities, the district court also issued a permanent injunction which, among other things, enjoined further proceedings in the Nevada receivership and brought Sun Fruit within the federal receivership. Wencke I, supra, 577 F.2d at 621-22.

The district court entered Findings of Fact and Conclusions of Law and its Final Judgment of Permanent Injunction and Ancillary Relief on March 3, 1977, several months after the California state court determined that Sun Fruit and any sublessees of Sun Fruit had forfeited their leasehold interests in favor of Superior, and two days after the state court determined that Rinn Motor Hotels, Inc. and Rinn-Sunnyvale Motor Hotels had no other independent right to the disputed property. By virtue of the federal court order, the defendants [3] turned control over the entities placed in the receivership to the receiver, R. N. Gould. Gould was authorized to assume possession and control over all assets of the many entities in the receivership, to operate the entities on an ongoing basis, to hire lawyers and accountants to audit and investigate the financial condition and transactions of the entities, to resist all actions and claims brought against any of the entities, and to prosecute all claims which the entities might have.

The aspect of the court's decision which produced this appeal was a stay directed not only to all defendants, but also to nonparties. Except by leave of the court, all persons were stayed from continuing with any proceedings against the entities in receivership. [4]

On May 25, 1977, the Nevada court terminated the Nevada receivership for Sun Fruit "in the interest of comity." There have been no further proceedings in the California court. On May 16, 1977, Superior filed a petition ex parte with the district court for modification or relief from the court's order, to allow it to enforce the state court judgment. The court denied the motion but permitted Superior to make a formal motion for the same relief. Superior filed such motion, and on December 14, 1977, the district court refused to modify its injunction or grant an exception for Superior. Superior appeals from this denial.

D. Wencke I

In Wencke I, we concluded that the district court "had jurisdiction to enjoin the ***1368** Nevada state court." Id. at 623. Wencke argued, as does Superior in this appeal, that the Anti-Injunction Act, 28 U.S.C. s 2283, prevented the court from issuing an injunction. That section provides: "A court of the United States may not grant an injunction to stay proceedings in a State court except as expressly authorized by Act of Congress, or where necessary in aid of its jurisdiction, or to protect or effectuate its judgments." Relying on Leiter Minerals, Inc. v. United States, 352 U.S. 220, 77 S.Ct. 287, 1 L.Ed.2d 267 (1957), and NLRB v. Nash-Finch Co., 404 U.S. 138, 92 S.Ct. 373, 30 L.Ed.2d 328 (1971), we held that section 2283 does not apply to injunctions issued at the request of the United States or administrative agencies enforcing applicable federal law. See also Puget Sound Gillnetters Ass'n v. United States District Court, 573 F.2d 1123, 1133 (9th Cir. 1978), rev'd on other grounds sub nom. Washington v. Washington State Commercial Fishing Vessel Ass'n, 443 U.S. 658, 99 S.Ct. 3055, 61 L.Ed.2d 823 (1979). Superior argues that this limitation on section 2283 applies only if the issues involved in the state and federal actions are the same. It is true that in Leiter Minerals and Nash-Finch, supra, the contested issues were the same. The situation addressed in Wencke I, however, involved a state receivership resulting from what was, in essence, an insolvency proceeding, while the federal court was concerned with issues of securities fraud. We nevertheless held that section 2283 did not prevent the United States from securing an injunction against the former proceeding. The case before us presents a like situation since Superior's action to enforce its lease was to protect its rights as a creditor and the federal proceeding was in large part designed to protect the innocent shareholders and promote investor confidence. Therefore, section 2283 is not a bar to the injunction, even assuming the clause "necessary in aid of its jurisdiction, or to protect or effectuate its judgments," would not permit the injunction by its own terms.

We held also in Wencke I that where a state proceeding was simply another device to cover Wencke's fraud and the federal receiver was necessary to prevent further violations of federal securities laws and protect public investors, the appointment of a federal receiver was not barred by the state receivership. [5] If Superior's action were determined to be another instance of fraudulent conduct by Wencke or business entities under his control, we think there would be little question as to the federal court's power to enjoin enforcement of the judgment. Like the Nevada receivership, such a judgment would be simply another item of fraudulent conduct which the court could protect against. There has been no finding, however, that Superior is in any way linked to Wencke or that the state court action is part of any fraudulent scheme.

E. The Authority of the District Court to Stay All Proceedings

"(W)henever it appears to the Commission that any person is engaged or is about to engage in acts or practices" which violate the securities laws, the SEC may secure injunctive relief in a federal court. See 15 U.S.C. s 77t(b) (Securities Act of 1933); 15 U.S.C. ss 78u(d) & (e) (Securities Exchange Act of 1934). A normal injunctive order entered pursuant to Fed.R.Civ.P. 65 is

> binding only upon the parties to the action, their officers, agents, servants, employees, and attorneys, and upon those persons in active concert or participation with them who receive actual notice of

> the order by personal service or otherwise.

Rule 65(d). Superior was not a party to the federal court proceedings, however, and there has been no finding that it falls within any of the categories of persons named in rule 65(d). In addition, there has been no finding that Superior has violated or is likely to violate the securities laws, or that its ***1369** state court action is part of the fraud of any party in the federal action. Therefore, the authority of the district court to stay Superior from proceeding in another court must rest on some other grounds.

The federal courts have inherent equitable authority to issue a variety of "ancillary relief" measures in actions brought by the SEC to enforce the federal securities laws. [6] This circuit has repeatedly approved imposition of a receivership in appropriate circumstances. [7] The power of a district court to impose a receivership or grant other forms of ancillary relief does not in the first instance depend on a statutory grant of power from the securities laws. Rather, the authority derives from the inherent power of a court of equity to fashion effective relief. [8]

There is no dispute in this case as to the district court's general authority to impose a receivership over the various entities affected by Wencke's fraud; indeed, such authority was upheld in Wencke I. Moreover, the court may issue blanket stays against litigation in other courts by parties to the securities fraud action and others named in rule 65(d). See, e. g., SEC v. United Financial Group, 576 F.2d 217, 221 n.8 (9th Cir. 1978) (hereinafter cited as United Financial Group II). The dispute regarding the district court's authority centers around its power to stay or enjoin nonparties from taking action against the entities in receivership, except by leave of the court. Superior contends that in none of the securities fraud cases relied on by the SEC did the district court attempt to fashion equitable relief binding on persons not enumerated in rule 65(d). [9]

The power of the district court to issue a stay, effective against all persons, of all proceedings against the receivership entities rests as much on its control over the property placed in receivership as on its jurisdiction over the parties to the securities fraud action. The district court took control over the properties in question when it imposed the receivership and appointed Gould as receiver to manage those properties. The blanket stay was found by the district court necessary to achieve the purposes of the receivership. We conclude the district court had the power to enter the order.

Our conclusion finds support in several lines of decisions. This circuit, albeit in the context of discussing orders entered against parties, has approved imposition of blanket stays in SEC enforcement actions upon an appropriate showing, see ***1370** SEC v. Lincoln Thrift Ass'n, 557 F.2d 1274, 1277 n.1 (9th Cir. 1977); United Financial Group II, supra, 576 F.2d at 221 n.8. Moreover, in Wencke I this court held, "The district court had jurisdiction to enjoin the Nevada state court." 577 F.2d at 623. Although the court did not discuss the question at length, this conclusion might be understood as a determination that stays directed to nonparties may be entered where necessary to protect the federal receivership. [10]

At least three other courts in securities fraud cases have entered stays nearly identical to that entered by the district court. See SEC v. An-Car Oil Co., 604 F.2d 114, 117 (1st Cir. 1979) (TRO enjoining "all creditors from commencing, prosecuting, continuing, or enforcing suit against (the entities put into receivership)"); Lankenau v. Coggeshall & Hicks, 350 F.2d 61, 62 (2d Cir. 1965) (staying "all persons . . . from commencing or continuing any suits against the defendant herein or his property other than suits to enforce liens . . ."); Jordan v. Independent Energy Corp., 446 F.Supp. 516, 520 (N.D.Tex.1978) (staying "all persons, firms or corporations from 'commencing, prosecuting, continuing or enforcing any suit or proceeding, or from executing or issuing or causing the execution or issuance of any court attachment . . . or other proceedings for the purpose of impounding or . . . interfering with any property owned by or in the possession of defendant . . .' "). Moreover, in United Financial Group II, in addition to the footnote referred to above, the court affirmed the broad power of the court to protect a receivership imposed in an SEC enforcement action: "When the receivership court takes jurisdiction of the debtor's estate, it has power to issue orders barring actions which would interfere with its administration of that estate. See Diners Club, Inc. v. Bumb, 421 F.2d 396 (9th Cir. 1970), and cases cited." 576 F.2d at 220. The case relied on by the court, Diners Club, Inc., was a bankruptcy case which reaffirmed in broad terms the "inherent powers of a court of equity to protect its control of a res in its custody." 421 F.2d at 398. The court in Diners Club, Inc., approved a restraining order against further proceedings in another court by a nonparty against the entity in receivership. Cf. also SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1105-06 (2d Cir. 1972).

Even apart from bankruptcy proceedings, which we discuss below, stays or injunctions effective against nonparties have been approved in a variety of other contexts. In United States v. Hall, 472 F.2d 261 (5th Cir. 1972), the district court had entered an injunction designed to reduce disruption in schools subject to the court's desegregation order. The injunction prohibited "all persons" from taking certain actions and provided for criminal contempt sanctions against "anyone having notice of this order." Id. at 263. The court of appeals affirmed the contempt conviction of a nonparty with notice despite the lack of a statute conferring express authority to issue such a stay. [11]

The type of stay entered by the district court in the case before us is a routine ***1371** feature of bankruptcy proceedings. Indeed, the Bankruptcy Act specifically provides for stays of proceedings by nonparties upon the filing of a bankruptcy petition. See 11 U.S.C. ss 362, 541. The power of a federal court to enter such stays, however, does not depend on specific congressional authorization such as that contained in the Bankruptcy Act. See Diners Club, Inc. v. Bumb, supra, 421 F.2d at 398. The Supreme Court has repeatedly emphasized the broad equitable powers of the federal courts to shape equitable remedies to the necessities of particular cases, especially where a federal agency seeks enforcement in the public interest. [12] Where, as here, the stay provides that parties may seek leave of the district court to proceed against the receivership entities, we hold that a district court in an SEC enforcement action may, upon an appropriate showing of necessity, stay proceedings against a court-imposed receivership, and that such a stay can be made effective against persons not parties to the SEC action who have notice of the stay. Implicit in our holding is the conclusion that rule 65(d) does not limit the power of a federal court to enter such orders.

Even conceding the power of the district court to enter a general stay, Superior contends that the court could not issue the stay here, since the California state court had already acquired "in rem" or "quasi-in rem" jurisdiction over the motel properties. There is authority to the effect that where a state court has taken control over property, in certain circumstances a federal court may not subsequently attempt to take control over the same property. See, e. g., Colorado River Water Conservation District v. United States, 424 U.S. 800, 96 S.Ct. 1236, 47 L.Ed.2d 483 (1976); Kline v. Burke Const. Co., 260 U.S. 226, 43 S.Ct. 79, 67 L.Ed. 226 (1922); Tweel v. Frankel, 444 F.Supp. 1071 (S.D.W.Va.1978); Stewart Securities Corp. v. Guaranty Trust Co., 394 F.Supp. 1069 (W.D.Okl.1975). See generally C. Wright, A. Miller & E. Cooper, Federal Practice & Procedure s 3631 (1976). [13] We assume arguendo that the California action between Superior and Sun Fruit could be characterized as quasi-in rem, since the action determined title to the leasehold interest as between the parties. See Smith v. Humble Oil and Ref. Co., 425 F.2d 1287 (5th Cir.), cert. denied, 400 U.S. 902, 91 S.Ct. 138, 27 L.Ed.2d 138 (1970). [14] We nevertheless conclude that the federal court was not prevented from staying further proceedings in the California case.

In Wencke I, this court approved the appointment of the federal receiver and upheld the district court's stay of the receivership in Nevada. This conclusion seems sufficient to defeat any broad argument that the federal court did not have the power to assert control over entities already under the control of a state court.

In addition, a federal court may assert control over property and enjoin persons ***1372** from further proceedings in a state court where the subject matter of the two suits is different or the jurisdiction is not concurrent, at least where, as here, the state court has not taken actual possession of the property. An early statement of this rule appears in Harkin v. Brundage, 276 U.S. 36, 43, 48 S.Ct. 268, 271, 72 L.Ed. 457 (1928):

> (W)here the jurisdiction is not the same or concurrent, and the subject-matter in litigation in the one is not within the cognizance of the other, or there is no constructive possession of the property in dispute by the filing of a bill, it is the date of the actual possession of the receiver that determines the priority of jurisdiction.

See also Princess Lida of Thurn and Taxis v. Thompson, 305 U.S. 456, 59 S.Ct. 275, 83 L.Ed. 285 (1939); Penn Gen. Cas. Co. v. Pennsylvania ex rel. Schnader, 294 U.S. 189, 196, 55 S.Ct. 386, 79 L.Ed. 850 (1935); Empire Trust Co. v. Brooks, 232 F. 641 (5th Cir.), cert. denied, 243 U.S. 655, 37 S.Ct. 480, 61 L.Ed. 948 (1916), appeal dismissed, 245 U.S. 634, 38 S.Ct. 133, 62 L.Ed. 522 (1917); United States v. Allen, 328 F.2d 377 (5th Cir. 1964). "Courts have been anxious to prevent direct interference without forcing one tribunal to be overly cautious about the possibility that a prior suit in another forum may involve the property." C. Wright, A. Miller & E. Cooper, supra s 3631 at 11. It is especially appropriate in an action like this one that the federal courts have the power, if necessary, to take control over an entity and impose a receivership free from interference in other court proceedings. The bases of the suits by Superior and the SEC differ; there are few judicial economies favoring permitting the state court action to proceed, see Colorado River Water Conservation District, supra, 424 U.S. at 818-20, 96 S.Ct. at 1246-48. There is a strong federal interest in insuring effective relief in SEC actions brought to enforce the securities laws. Finally, the stay does not deprive the state court judgment of effect; it merely postpones that effect. See David v. Hooker, Ltd., 560 F.2d 412, 418 (9th Cir. 1977). For all of the above reasons, therefore, we hold that the district court had jurisdiction to enter the orders it did.

F. The Necessity for the Stay

Our conclusion that the court had power to enter the stay does not resolve the case. We must also address whether the district court misused its discretion in entering the stay or in not granting Superior leave to proceed. See Lincoln Thrift, supra, 557 F.2d at 1277; SEC v. United Financial Group, Inc., 474 F.2d 354 (9th Cir. 1973); Los Angeles Trust Deed & Mortgage Exchange, supra, 285 F.2d at 180-82.

The ultimate goals of SEC intervention were protection of innocent shareholders and enhancement of investor confidence in the securities markets. Appointment of the receiver in this case furthered several subsidiary policies of the securities laws. The assets of the corporate entities were marshalled and preserved against further misappropriation and dissipation; the financial affairs of the entities needed to be clarified for the benefit of innocent shareholders; the receiver and his staff could conduct independent investigation of claims the entities might have against former management or other parties, prosecution of which would benefit investors and deter future violations; and defenses against possibly fraudulent or collusive actions brought against the entities could be discovered and asserted. As we held in Wencke I, these are legitimate justifications for the district court's imposition of a receivership. See also SEC v. United Financial Group, Inc., 474 F.2d 354, 358 (9th Cir. 1973).

With regard to issuance of the blanket stay, the SEC and the receiver claim there was a danger that some litigation commenced or prosecuted against the receivership entities might be collusive or fraudulent, thus further dissipating the assets of the receivership entities to the detriment of innocent shareholders. The preliminary report of the receiver Gould stated in part:

> ***1373** I find that Walter Wencke is defendant in various court actions involving corporations within the overall corporate galaxy, and we are discovering additional litigation on a daily basis . . . (H)e continues to remain in control of many corporations now identified by our investigations. The corporations in the receivership estate have dealt, and must continue to deal with those corporations under Wencke's control, placing the Temporary Receiver in a difficult and impractical position.

The receiver and the district court also felt it essential for the receiver to be given time to explore all the complex transactions and aspects of the receivership estate so that innocent shareholders suffered no further harm.

A receiver appointed by a court in the wake of a securities fraud scheme may encounter difficulties sorting out the financial status of the defrauded entity or entities. There may be a genuine danger that some litigation against receivership entities amounts to little more than a continuation of the original fraudulent scheme. Similarly, the securities fraud may have left the finances of the receivership entities so obscure or complex that the receiver is hampered in conducting litigation. Moreover, the expense involved in defending the many lawsuits which often are filed against an entity in the wake of a securities fraud scheme may be overwhelming unless some are temporarily deferred. A stay of proceeding against receivership entities except by leave of the court may be an appropriate response to the above concerns, and the district court did not abuse its discretion in this case by entering the blanket stay.

There remains the question whether denial of leave to proceed in Superior's particular case was justified. In denying Superior's ex parte motion for relief from the stay, the district court found:

> The Receiver must be given an opportunity to progress in his assigned tasks before this Court contemplates lifting any stays. To remove the stay as requested could seriously damage the Receivership estate by, among other reasons, disrupting the orderly administration by the Receiver of this Case.

The court adopted a similar rationale in denying Superior's written motion:

> To remove the stay would make it extremely burdensome or impossible for the Receiver to perform his mandated duties, to the detriment of legitimate creditors and shareholders.

Determining whether an exception should be made in a particular case to a previously entered blanket stay involves a comparison of the interests of the receiver (and the parties the receiver seeks to protect) and of the moving party. We have discussed above the reasons why stays may be necessary to permit the receiver to carry out his tasks of sorting out the affairs of the entities in the receivership estate. The interests of the moving party are also relevant. The district court should consider whether refusing to lift the stay genuinely preserves the status quo or whether the moving party will suffer substantial injury if it is not permitted to proceed. The merit of the moving party's claim is also a relevant consideration. Where the claim is unlikely to succeed (and the receiver therefore likely to prevail), there may be less reason to require the receiver to defend the action now rather than defer its resolution. On the other hand, where the likelihood that the receiver will prevail is small, when the receiver's position is considered realistically and not in the abstract, there is less reason to permit the receiver to avoid resolving the claim; a blanket stay should not be used to prejudice the rights which innocent and legitimate creditors may have against the receivership entities, see Los Angeles Trust Deed & Mortgage Exchange, supra, 285 F.2d at 182.

The time at which the motion for relief from the stay is made also bears on the exercise of the district court's discretion. Where the motion for relief from the stay is ***1374** made soon after the receiver has assumed control over the estate, the receiver's need to organize and understand the entities under his control may weigh more heavily than the merits of the party's claim.[15] As the receivership progresses, however, it may become less plausible for the receiver to contend that he needs more time to explore the affairs of the entities. The merits of the moving party's claim may then loom larger in the balance.

Apparently because of Sun Fruit's lack of resources, investigation of its financial status proceeded more slowly than that of other businesses in the receivership. With regard to litigating Superior's claim, however, no new material information appears to have been developed at least since the receiver's report of July 29, 1977, and the receiver's Memorandum of Points and Authorities filed on July 19, 1977, in response to Superior's motion for leave to proceed in state court. In the report, the receiver discussed the many lawsuits filed by and against receivership entities. With regard to Superior's action, the receiver said in part:

> In (the) Receiver's opinion this suit and the preliminary judgment are based on a highly technical interpretation of a contractual relationship. The facts are that all parties to the contract have received what they bargained for and none of the parties have been damaged. . . . Counsel advises that we have a good position relative to a new trial or appeal. At this point in time the stay is invaluable to the Receivership estate, affording it the opportunity to deal with this problem when time and resources permit.

In the memorandum of points and authorities, the receiver advanced essentially the same arguments which it advanced in its brief to this court dated September 14, 1978, more than a year later. The receiver stated:

> On October 1, 1976, a default judgment was entered against Sun Fruit, Ltd., one of the defendants in the State Court action. At that time Mr. Walter Wencke was the receiver appointed by a Nevada State Court for Sun Fruit, Ltd. It appears he chose, rather than to defend upon the merits, to take the position that Sun Fruit was not served. Richard Mets, former President of Sun Fruit, had been served, but at the time he had either resigned or been terminated and, therefore, he had no connection with Sun Fruit, and could not accept service. Stated differently, the Superior Court was without jurisdiction.

In light of this history, we doubt the receiver can continue to justify denial of Superior's motion on the grounds that he needs more time to discover new facts relevant to Superior's state court action.

The receiver has filed a complaint in state court seeking to have the state court judgment of October 1, 1976, set aside. Superior contends the receiver has not pursued the claim and the action would be dismissed if he did, and to date there has been no adjudication that the state court lacked jurisdiction or that its determination is unenforceable. The same is true with regard to the later adjudication against the two subsidiaries of Sun Fruit regarding any nonleasehold property interests they might have. The costs of litigating the validity of the state court determination are unclear from this record. The value of the motel property to the receivership estate is substantial, although this factor does not provide unequivocal support for refusing to lift the stay, see p. 1375 infra.

The substantial discretion which a district court possesses in making this type of decision leads us to affirm the denial of Superior's motion. That denial, however, occurred on December 14, 1977, more than two years ago. In light of our holding below, the district court will in any event be required to determine whether a bond is necessary to protect Superior's interest. We also direct the court on remand to determine whether ***1375** the stay against Superior can still be justified.[16]

F. Indemnity Bond

A district court has the discretion to require, in appropriate circumstances, some form of special security for a claim against an entity in receivership. Donellan Jerome, Inc. v. Trylon Metals, Inc., 270 F.Supp. 996 (N.D.Ohio 1967). See also Redding & Co. v. Russwine Construction Corp., 417 F.2d 721, 727 (D.C.Cir.1969). There is no dispute in this case that the receiver has been remitting to the lessor the monthly rent on the properties, $10,000 per month. Superior contends, however, that the receiver has on the average been collecting approximately $20,000 per month over and above an amount sufficient to cover the rental payments. Should Superior ultimately be held entitled to the leasehold interest by virtue of the Nevada receivership and California court proceedings, Sun Fruit might be liable to Superior for substantial sums. Although Sun Fruit is not now insolvent or in bankruptcy proceedings, statements by both the receiver and Superior indicate that Sun Fruit has few assets, and many creditors and other parties want to bring suit against it. Accordingly, it is not apparent to us that the stay as applied to Superior simply maintains the status quo.

We therefore remand this case for further proceedings, at which time the district court should reexamine the necessity for a stay, and if the stay is continued in effect, determine whether a security bond should be required.

AFFIRMED in part and REMANDED for further proceedings.

All Citations

622 F.2d 1363, Fed. Sec. L. Rep. P 97,533

Footnotes

1 As of April 26, 1969, the corporation was known as Royal Executive Inns of America. It was later renamed the Rinn Corporation, and on March 31, 1974, it was renamed Sun Fruit, Ltd.

2 The lease provided in part:

7. Either (a) the appointment of a receiver to take possession of all or substantially all of the assets of lessee, or (b) a general assignment by lessee for the benefit of creditors, or (c) any action taken or suffered by lessee under any insolvency or bankruptcy act shall constitute a breach of this lease by Lessee.

3 The court's injunction was effective against all persons named in Fed.R.Civ.P. 65(d).

4 "(A)ll investors, creditors, and other persons, and all others acting on behalf of any such investor, creditor or other person, including sheriffs, marshals, other officers, deputies, servants, agents, employees, and attorneys," were stayed from:

(1) Commencing, prosecuting, continuing or enforcing any suit or proceeding against the entities in receivership, except that such actions may be filed to toll any statute of limitations;

(2) Using self-help or executing or issuing or causing the execution or issuance of any court attachment, subpoena, replevin, execution or other process for the purpose of impounding or taking possession of or interfering with or creating or enforcing a lien upon any property owned by or in the possession of the entities in receivership or the receiver, wheresoever situated;

(3) Attempting to modify, cancel, terminate, call, extinguish, revoke, or accelerate (the due date), of any lease, loan, mortgage, indebtedness, security agreement or other agreement with any of the entities in receivership or any entity controlled by them; and

(4) Doing any act or thing whatsoever to interfere with the taking control, possession, or management, by the receiver appointed herein, of the property and assets owned, controlled or in the possession of the entities in receivership, or to in any way interfere with or harass said receiver, or to interfere in any manner with the exclusive jurisdiction of this Court over the entities in receivership.

The district court entered an Order Clarifying the Final Judgment on April 5, 1977. The order stated that "Royal Executive Inn-Sunnyvale, Inc." and "its subsidiaries," as used in the March 3 orders, included Rinn-Sunnyvale Motor Hotel. We agree with the appellee Gould and the SEC that this order is not a significant fact in this case. We reject Superior's contention that the court added a new party to the action and subjected it to orders previously entered against other parties.

5 Wencke was convicted of mail fraud and making false statements to the SEC. We affirmed the conviction, United States v. Wencke, 604 F.2d 607 (9th Cir. 1979).

6 See generally Farrand, Ancillary Remedies in SEC Civil Enforcement Suits, 89 Harv.L.Rev. 1779 (1976).

7 See SEC v. United Financial Group, Inc., 576 F.2d 217 (9th Cir. 1978); Wencke I, supra; SEC v. Lincoln Thrift Ass'n, 557 F.2d 1274 (9th Cir. 1977); SEC v. United Financial Group, Inc., 474 F.2d 354 (9th Cir. 1973); Los Angeles Trust Deed & Mortgage Exchange v. SEC, 285 F.2d 162 (9th Cir. 1960), cert. denied, 366 U.S. 919, 81 S.Ct. 1095, 6 L.Ed.2d 241 (1961). See also SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1103-06 (2d Cir. 1972); SEC v. Charles Plohn & Co., 433 F.2d 376 (2d Cir. 1970); SEC v. Bowler, 427 F.2d 190 (4th Cir. 1970); SEC v. Bartlett, 422 F.2d 475, 477-79 (8th Cir. 1970); SEC v. Keller Corp., 323 F.2d 397, 403 (7th Cir. 1963); SEC v. Fifth Avenue, Coach Lines, Inc., 289 F.Supp. 3 (S.D.N.Y.1968), aff'd, 435 F.2d 510 (2d Cir. 1970); Lankenau v. Coggeshall & Hicks, 350 F.2d 61 (2d Cir. 1965).

8 See SEC v. United Financial Group, Inc., 474 F.2d 354, 358-59 (9th Cir. 1973); Los Angeles Trust Deed & Mortgage Exchange, supra, 285 F.2d at 181-82; SEC v. Charles Plohn & Co., supra; SEC v. Bowler, supra; SEC v. Bartlett, supra. See also Mills v. Electric Auto-Lite Co., 396 U.S. 375, 386, 90 S.Ct. 616, 622, 24 L.Ed.2d 593 (1970); J. I. Case Co. v. Borak, 377 U.S. 426, 433, 84 S.Ct. 1555, 1560, 12 L.Ed.2d 423 (1964).

9 It is unclear to us that the district court's stay of proceedings, as applied to the facts of this case, went any further than the normal rule preventing suits against a federal receiver except by leave of the court. See United Financial Group II, supra, 576 F.2d at 221 n.8; Lincoln Thrift, supra, 557 F.2d at 1277 n.1; 7 Moore's Federal Practice P 66.07(2) (1979); 28 U.S.C. s 959.

10 An alternative explanation is that the injunction referred to by the court was effective against Wencke, the receiver in the Nevada proceedings, and his associates.

11 In a passage relevant to this case, the court said:

The principle that courts have jurisdiction to punish for contempt in order to protect their ability to render judgment is also found in the use of in rem injunctions. Federal courts have issued injunctions binding on all persons, regardless of notice, who come into contact with property which is the subject of a judicial decree. A court entering a decree binding on a particular piece of property is necessarily faced with the danger that its judgment may be disrupted in the future by members of an undefinable class those who may come into contact with the property. The in rem injunction protects the court's judgment.

472 F.2d at 265-66 (citations omitted). See also United States v. Crookshanks, 441 F.Supp. 268, 270 (D.Or.1977) ("(A) court can enjoin non-parties whose actions threaten to interfere with compliance with prior orders of the court."). Cf. United States v. Dean Rubber Mfg. Co., 71 F.Supp. 96 (W.D.Mo.1946).

Our reliance on this case does not depend on the court's determination that the district court's order more closely resembled a TRO than a preliminary or permanent injunction. See 472 F.2d at 267-68.

12 See, e. g., Mills v. Electric Auto-Lite Co., 396 U.S. 375, 386, 90 S.Ct. 616, 622, 24 L.Ed.2d 593 (1970); J. I. Case Co. v. Borak, 377 U.S. 426, 433, 84 S.Ct. 1555, 1560, 12 L.Ed.2d 423 (1964); Hecht Co. v. Bowles, 321 U.S. 321, 329, 64 S.Ct. 587, 591, 88 L.Ed. 754 (1944); Porter v. Warner Holding Co., 328 U.S. 395, 398, 66 S.Ct. 1086, 1089, 90 L.Ed. 1332 (1946). See also SEC v. United Financial Group, Inc., 474 F.2d 354 (9th Cir. 1973); Los Angeles Trust Deed & Mortgage Exchange v. SEC, 285 F.2d 162 (9th Cir. 1960), cert. denied, 366 U.S. 919, 81 S.Ct. 1095, 6 L.Ed.2d 241 (1961); SEC v. Management Dynamics, Inc., 515 F.2d 801, 808 (2d Cir. 1975).

13 Cases relied on by Superior such as McGough v. First Arlington Nat'l. Bank, 519 F.2d 552 (7th Cir. 1975), are inapposite because the securities fraud action was brought by a private party, not the SEC, and because the federal court had not assumed control of property by imposing a receivership. The only alleged threat to the district court's jurisdiction in that case was operation of res judicata and collateral estoppel doctrines.

14 Although the details of the state court proceedings are not before us on this appeal, we have some question regarding how, on Superior's theory, the California court could acquire jurisdiction over the disputed property when it was already subject to a receivership in Nevada.

15 The merits of the moving party's claim may also be more difficult to evaluate at this time.

16 The record indicates that Boise Cascade, Inc., was permitted to enforce a lien against the receivership, while the State of California was denied permission to institute a fraud action against Sun Fruit, and that a suit was permitted against another of the receivership entities, see Wencke I, supra at 623.

End of Document

Case Name:

Quadrexx Hedge Capital Management Ltd. (Re)

IN THE MATTER OF the Securities Act, RSO 1990, c S.5, and IN THE MATTER OF Quadrexx Hedge Capital Management Ltd., Quadrexx Secured Assets Inc., Miklos Nagy and Tony Sanfelice

2017 LNONOSC 47

(2017) 40 OSCB 1308

Ontario Securities Commission

Panel: Christopher Portner, Commissioner

Heard: April 22-24, 27-30, May 1, 4, 6-8, 11-15, September 21, 24, 25, 28-30, October 1, 2, 5, 9, November 16, 18-20, December 7-10, 14, 16-18, 2015; January 18-20 and May 26 and 27, 2016.
Decision: February 6, 2017.

(393 paras.)

Appearances:

Derek Ferris, Michelle Vaillancourt: For Staff of the Commission.

Jay Naster: For Tony Sanfelice.

Miklos Nagy: Representing himself, Quadrexx Hedge Capital Management Ltd. and Quadrexx Secured Assets Inc.

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XI. FINDINGS AND CONCLUSIONS

REASONS AND DECISION
(Subsection 126.1(1)(b) of the Securities Act)

I. INTRODUCTION

A. Overview

1 This proceeding involves allegations of fraud against two individuals, Miklos Nagy ("Nagy") and Tony Sanfelice ("Sanfelice"), and two corporations of which they were, among other things, the directing minds, Quadrexx Hedge Capital Management Inc. ("QHCM") and Quadrexx Secured Assets Inc. ("QSA" and, collectively with Nagy, Sanfelice and QHCM, the "Respondents"). The allegations of fraud arise from three separate distributions of securities in reliance on exemptions from the prospectus requirements of the Securities Act, RSO 1990, c S.5 (the "Act"). The Respondents are also alleged to have breached other provisions of the Act as summarized in paragraph [9] below.

B. Quadrexx

2 Quadrexx Asset Management Inc. ("Quadrexx") was incorporated in Canada on March 12, 2003. With the coming into force of National Instrument 31-103 - Registration Requirements, Exemptions and Ongoing Registrant Obligations ("NI 31-103") in September 2009, Quadrexx's previous registration as a limited market dealer automatically became registration as an exempt market dealer ("EMD"). Quadrexx was also registered as an investment counsel and portfolio manager, which designations changed to portfolio manager in September 2009. In January 2011, Quadrexx also became registered as an investment fund manager.

3 During the period from July 2008 to and including January 2013 (the "Material Time") Quadrexx traded in its own securities and in the securities of QHCM, QSA and the limited partnerships of which QHCM was the general partner, in reliance on exemptions from the prospectus requirements of the Act. On June 18, 2013, Quadrexx filed an assignment in bankruptcy under section 49 of the Bankruptcy and Insolvency Act and is not a party to this proceeding.

C. The Respondents

4 Nagy is a Chartered Financial Analyst and held the following positions with Quadrexx, QHCM and QSA:

> Quadrexx: Nagy was a director and officer of Quadrexx from March 12, 2003 (the date of its incorporation) until January 2013. Nagy was the Ultimate Responsible Person ("URP") for Quadrexx from November 25, 2004 to September 28, 2009 and the designated compliance officer for Quadrexx from

May 16, 2005 to September 28, 2009. Nagy was a directing mind of Quadrexx during the Material Time and was also registered as the ultimate designated person ("UDP") of Quadrexx from December 18, 2009 to May 15, 2013.

QHCM: Nagy has been a director and the President of QHCM since May 22, 2007 (the date of its incorporation). Nagy was a directing mind of QHCM during the Material Time.

QSA: Nagy was a director and officer of QSA from June 15, 2011 (the date of its incorporation) to March 25, 2013. Nagy was a directing mind of QSA during the Material Time.

5 Sanfelice is a Certified Management Accountant and a Certified General Accountant and held the following positions with Quadrexx, QHCM and QSA:

(a) Quadrexx: Sanfelice was a director and officer of Quadrexx from March 12, 2003 (the date of its incorporation), but resigned one day later. He again became an officer of Quadrexx on December 6, 2004, with primary responsibility for Quadrexx's finances, and a director on October 10, 2007. Sanfelice resigned as a director of Quadrexx on April 1, 2013. He was a directing mind of Quadrexx during the Material Time and was registered as the Chief Compliance Officer of Quadrexx for each of its registration categories from December 3, 2007 to May 15, 2013.

(b) QHCM: Sanfelice was a director, the Secretary and a directing mind of QHCM from May 22, 2007 (the date of its incorporation) to November 24, 2009.

(c) QSA: Sanfelice was an officer of QSA from June 15, 2011 (the date of its incorporation) to March 25, 2013. Sanfelice was a directing mind of QSA during the Material Time.

6 QHCM was incorporated in Ontario on May 22, 2007 and acted as the general partner of a number of limited partnerships including Diversified Assets LP ("DALP").

7 QSA was incorporated in Canada on June 15, 2011 as a wholly-owned subsidiary of Quadrexx. QSA was established to provide investors with a return derived from an investment in a portfolio of U.S. residential mortgage-backed securities.

D. The Allegations

8 In its Statement of Allegations dated January 30, 2014, Staff alleges that Nagy, Sanfelice and QHCM (in the case of paragraph (a) below), Quadrexx (in the case of paragraphs (b) and (c) below) and QSA (in the case of paragraph (c) below) engaged or participated in an act, practice or course of conduct that they knew or reasonably ought to have known perpetrated a fraud contrary to subsection 126.1(1)(b) of the Act and contrary to the public interest, namely:

(a) The valuation of Canadian Hedge Watch Inc. in connection with the purchase of its shares by DALP;

(b) The use by Quadrexx of investor funds raised from the sale of its QAM II Shares to pay dividends to other investors; and

(c) The misappropriation of QSA investor funds.

The allegations, evidence and submissions with respect to each of the foregoing alleged frauds is discussed in detail below.

9 In addition, Staff alleges that:

(a) Quadrexx failed to notify the Ontario Securities Commission (the "Commission") as soon as possible when its excess working capital was less than zero and Quadrexx allowed its excess working capital to continue to be below zero, in breach of NI 31-103;

(b) At the time that Quadrexx was the portfolio manager for DALP, Quadrexx knowingly caused DALP to loan Quadrexx $170,000 in breach of subsection 118(2)(c) of the Act;

(c) Quadrexx failed to deal fairly, honestly and in good faith with its clients in breach of subsection 2.1(1) of OSC Rule 31-505 - Conditions of Registration ("Rule 31-505");

(d) As officers and/or directors of Quadrexx, QHCM and QSA, Sanfelice and Nagy authorized, permitted or acquiesced in the breaches of Ontario securities law that are alleged against Quadrexx, QHCM and QSA and, pursuant to section 129.2 of the Act, are deemed to have also not complied with Ontario securities law;

(e) Sanfelice breached his obligations as the Chief Compliance Officer (the "CCO") of Quadrexx pursuant to subsection 1.3(1) of Rule 31-505 during the period from July 2008 to September 27, 2009 and pursuant to section 5.2 of NI 31-103 during the period from September 28, 2009 to January 14, 2013, and also acted contrary to the public interest; and

(f) Nagy breached his obligations as UDP of Quadrexx pursuant to section 5.1 of NI 31-103 during the period from December 18, 2009 to January 14, 2013, and also acted contrary to the public interest.

E. Merits Hearing

10 The merits hearing in this proceeding (the "Hearing") included 40 days of testimony by witnesses commencing on April 22, 2015 and concluding on January 20, 2016. Following the delivery of lengthy written closing submissions by the parties, oral closing submissions were heard on May 26 and 27, 2016.

11 Sanfelice was represented by counsel. Nagy represented himself and the corporate Respondents.

F. Witnesses Called

12 Staff of the Commission called the following 16 witnesses:

(a) Employees of the Commission:

(i) Susan Pawelek, an accountant in the Commission's Compliance and Registrant Registration Branch ("Pawelek" and the "CRR Branch", respectively);

(ii) Yvonne Lo, a senior forensic accountant in the Commission's Enforcement Branch ("Lo" and the "Enforcement Branch", respectively);

(iii) Michael Ho, a senior forensic accountant in the Enforcement Branch ("Ho"); and

(iv) Chris Caruso, an accountant in the CRR Branch ("Caruso").

(b) Business valuators:

(i) Farouk Mohamed, a Certified Business Valuator who, at the relevant time was a Manager in the business valuation group of Deloitte & Touche LLP ("Mohamed" and "Deloitte", respectively);

(ii) Steven Polisuk, a Certified Business Valuator who, at the relevant time, was a Senior Manager in the business valuation group of Deloitte ("Polisuk"); and

(iii) Harry Figov, a Certified Business Valuator who, at the relevant time was the principal of HJF Financial Inc. ("Figov" and HJF", respectively).

(c) Former employees or agents of Quadrexx:

(i) Alan Doody, a former Controller of Quadrexx ("Doody"); and

(ii) Tamara Orlova, a former Accounting Manager and, subsequently, Controller of Quadrexx ("Orlova").

(d) Investors:

(i) DW, a self-employed Ontario resident who invested in QAM II Shares;

(ii) AC, a retired Alberta resident who invested in QAM II Shares;

(iii) LM, a retired Saskatchewan resident who invested in QAM II Shares;

(iv) JS, a self-employed Alberta resident who invested in QSA;

(v) RL, a field service representative and a resident of Alberta who invested in QSA; and

(vi) MS, a dealing representative of Quadrexx and a resident of Alberta who also invested in QSA.

13 A seventh investor witness, JM, a self-employed farmer and resident of Alberta who invested in QSA, declined to complete his testimony. With the agreement of the parties, the evidence which JM did provide will be disregarded in its entirety.

14 In addition to testifying themselves, Nagy and Sanfelice called the following four witnesses:

(a) Richard McLean, who provided due diligence services for Quadrexx and was a potential joint-venture partner with Quadrexx;

(b) Mark Skuce, Legal Counsel in the CRR Branch ("Skuce");

(c) Jeffrey Shaul, a Certified Financial Analyst and the founder of Robson Capital Management Inc., who was appointed as the new portfolio manager and investment fund manager for DALP after the Material Time, effective April 1, 2013; and

(d) David Gilkes, a former consultant to Quadrexx ("Gilkes").

II. PRELIMINARY ISSUES

A. Agreed Statement of Facts

15 Staff filed an Agreed Statement of Facts dated April 29, 2015, which was signed by or on behalf of each of the Respondents. The Respondents make factual admissions in the Agreed Statement of Facts relating to the securities of Quadrexx, QSA and the limited partnerships of which QHCM was the general partner.

16 Most of the agreed facts are non-controversial background details and dates. The Respondents also made certain factual admissions relating to the representations that were made to investors to which reference will be made elsewhere in these Reasons.

B. Law of Fraud

17 Fraud is prohibited under subsection 126.1(1)(b) of the Act, which provides that:

> 126.1 (1) A person or company shall not, directly or indirectly, engage or participate in any act, practice or course of conduct relating to securities,

derivatives or the underlying interest of a derivative that the person or company knows or reasonably ought to know,

...

(b) perpetrates a fraud on any person or company.

18 The Commission has considered the foregoing provision in a number of decisions and it is now settled that establishing a breach of subsection 126.1(1)(b) of the Act requires proof of the same elements of fraud as in a prosecution under the Criminal Code, RSC 1985, c C-46.

19 In the leading case of R v Théroux, [1993] 2 SCR 5 ("Théroux"), the Supreme Court of Canada confirmed that fraud consists of two main elements, namely, the prohibited act (actus reus) and the required state of mind (mens rea) and summarized both as follows:

> . . . the actus reus of the offence of fraud will be established by proof of:
>
> 1. the prohibited act, be it an act of deceit, a falsehood or some other fraudulent means; and
>
> 2. deprivation caused by the prohibited act, which may consist in actual loss or the placing of the victim's pecuniary interests at risk.
>
> Correspondingly, the mens rea of fraud is established by proof of:
>
> 1. subjective knowledge of the prohibited act; and
>
> 2. subjective knowledge that the prohibited act could have as a consequence the deprivation of another (which deprivation may consist in knowledge that the victim's pecuniary interests are put at risk).

20 Accordingly, the act of fraud is established by a dishonest act and deprivation. The dishonest act is established by proof of deceit, falsehood or some "other fraudulent means." Other fraudulent means encompasses all other means, other than deceit or falsehood, which can be properly characterized as dishonest and is "determined objectively, by reference to what a reasonable person would consider to be a dishonest act." The courts have included within the meaning of "other fraudulent means" the use of investors' funds in an unauthorized manner, the use of corporate funds for personal purposes, non-disclosure of important facts, exploiting the weakness of another, unauthorized diversion of funds and the unauthorized appropriation of funds or property.

21 Deprivation is established by proof of detriment, prejudice or risk of prejudice to the economic interests of the victim caused by the dishonest act. Actual economic risk may establish deprivation, but it is not required; prejudice or risk of prejudice to an economic interest is sufficient. The mere creation of a financial risk to another by dishonesty constitutes deprivation. Risk of prejudice consists of inducing an alleged victim through the accused's dishonesty, to take some form of economic action (such as the making of an investment or a loan), even if that action does not cause an actual economic loss.

22 The requisite intent for fraud requires proof of subjective knowledge of the prohibited act of dishonesty and subjective knowledge that the dishonest conduct could result in deprivation to another. The test is not whether a reasonable person would have foreseen the consequences of the dishonest act, but whether a respondent subjectively appreciated those consequences, at least as a possibility. To establish the mens rea of fraud, Staff must prove that the Respondents knowingly undertook the acts which constituted the falsehood, deceit or other fraudulent means and that the Respondents knew that deprivation could result from such conduct.

23 Where the required conduct and knowledge is established, there is fraud whether respondents actually intended or were reckless to the consequence of their conduct. It is no defence that a respondent may have hoped that deprivation would not take place or held a sincere belief that no deprivation would ultimately materialize. Many frauds are perpetrated by people who sincerely believe that their acts will not ultimately result in actual losses to others.

24 Staff need not prove precisely what was in the mind of a respondent at the time of the dishonest act. A subjective awareness of the consequences can be inferred from the dishonest act itself. The inference of subjective knowledge of the risk may be drawn from the facts as a respondent believed them to be. Respondents may introduce evidence negating that inference, such as evidence of circumstances leading them to believe that no one would act on the dishonest act.

25 To establish the requisite intent of a corporation, it is sufficient to show that its directing minds knew or reasonably ought to have known that the acts of the corporation perpetrated a fraud.

C. Standard of Proof

26 It is well settled that the standard of proof that must be met in an administrative proceeding such as this matter is the civil standard of the balance of probabilities.

27 In F.H. v McDougall, [2008] 3 SCR 41 ("McDougall"), the Supreme Court of Canada noted the different approaches taken by courts and administrative tribunals in evaluating evidence on this standard of proof, and noted that heightened standards were often applied when allegations against a defendant were particularly serious, including in cases of fraud. The Court went on to clarify that there is only one civil standard of proof for all allegations, the balance of probabilities.

28 The Court noted in McDougall that the "evidence must always be sufficiently clear, convincing and cogent to satisfy the balance of probabilities test." However, the requirement for clear, convincing and cogent evidence does not elevate the civil standard of proof above a balance of probabilities.

29 The balance of probabilities standard requires the trier of fact to decide "whether it is more likely than not that the event occurred".

D. Admission of Hearsay Evidence

30 Hearsay evidence is admissible in administrative hearings before the Commission pursuant to subsection 15(1) of the Statutory Powers Procedure Act, RSO 1990, c S.22. Hearing panels have broad discretion to admit as evidence at a hearing, whether or not the evidence is given or proven under oath or affirmation or admissible as evidence in a court, any oral testimony and any document or other thing relevant to the subject matter of the proceeding.

31 Hearing panels must determine the weight to be accorded to admissible hearsay evidence while taking into account the rules of procedural fairness. In making determinations on weight, care must be taken to avoid placing undue reliance on uncorroborated evidence and hearsay evidence that lacks sufficient indicia of reliability.

32 During the Hearing, I permitted the admission of certain hearsay evidence to which the Respondents objected on the basis that I would determine the weight to be accorded to such evidence when considering all of the evidence in this matter. Counsel for Sanfelice again raised the issue of hearsay evidence in his closing submissions, particularly as it related to comments attributed by Polisuk, at the relevant time a Certified Business Valuator employed by Deloitte, to Iseo Pasquali of Deloitte in relation to the valuation of Canadian Hedge Watch Inc. I have addressed this issue in paragraph [67] below.

E. Assessment of Credibility

33 Credibility is a crucial issue in this proceeding. Staff alleges that the evidence of Nagy and Sanfelice is not credible in certain instances and some of their testimony clearly conflicts in material respects with the testimony of investor witnesses or is inconsistent with documentary evidence.

34 In making assessments of credibility and reliability, the British Columbia Court of Appeal stated that:

> Justice does not descend automatically upon the best actor in the witness box. The most satisfactory judicial test of truth lies in its harmony with the preponderance of probabilities disclosed by the facts and circumstances in the

conditions of the particular case.

> (R v Pressley (1948), 94 CCC 29 (BCCA) at para 12; Springer v Aird & Berlis LLP (2009), 96 OR (3d) 325 (SCJ) ("Springer") at para 14; Re Suman (2012), 35 OSCB 2809 at paras 315-316)

35 The following comments by Farley J. were also cited by Newbould J. with approval in Springer:

> The evidence and the way it is given should be taken in context and in a balanced way. No one should expect perfection in testimony and it is often said that evidence which is too consistent may be a sign on it being artificially constructed. I also recognize that there can be inadvertent rationalization of memory to fit what is afterwards said that must have happened as opposed to actually remembering what did happen.
>
> (Olympic Wholesale Co. v 1084715 Ontario Ltd. (cob Lady Lin Foods), [1997] OJ No 5482 (Gen Div) at para 3)

36 In civil cases in which there is conflicting testimony and the trier of fact is deciding whether a fact occurred on a balance of probabilities, finding the evidence of one party credible may well be conclusive of the result because that evidence is inconsistent with that of the other party. In such cases, believing one party will mean explicitly or implicitly that the other party was not believed on the important issue in the case.

37 Disbelief of a witness's evidence on one issue may well taint the witness's evidence on other issues, but an unfavourable credibility finding against a witness does not, of itself, constitute evidence that can be used to prove a fact in issue.

38 In assessing the credibility of Nagy and Sanfelice, I have carefully considered whether their evidence is in harmony with the preponderance of probabilities disclosed by the facts of this matter and have concluded that it is not in all instances. As I note below, there are instances in which I have not accepted the testimony of Nagy and Sanfelice or found it evasive, not consistent with the weight of the evidence or not credible.

III. VALUATION OF CANADIAN HEDGE WATCH INC.

A. Staff's Allegations

39 QHCM established DALP, the limited partnership of which it was the general partner, on June 13, 2008 to raise funds for the purpose of investing in at least one, but no more than three, private equity businesses. The first such investment by DALP was the acquisition of all of the issued and outstanding shares of Canadian Hedge Watch Inc. ("CHW"), approximately 75% of which were owned by Nagy and Sanfelice.

40 In connection with the acquisition of CHW's shares, the Respondents engaged Deloitte to conduct an estimate of the fair market value of CHW as required by the terms of the two offering memoranda that QHCM issued on behalf of DALP to finance the acquisition of CHW. Staff alleges that the Respondents terminated the engagement when Deloitte communicated to Sanfelice that its estimate of value would be well below the $2.65 million purchase price for CHW's shares that was contemplated by the initial offering memorandum.

41 Staff further alleges that QHCM immediately retained a second firm, HJF, to conduct the estimate of CHW's fair market value but on the basis of forecasts that were revised, when compared to the forecasts provided to Deloitte, to reflect higher revenue and earnings before interest, taxes, depreciation and amortization ("EBITDA") for each of the forecasted years. HJF's valuation report estimated that the fair market value of CHW was between $2,099,397 and $2,971,978 with a mid-point of $2,535,688, which was employed as the price paid by DALP for the shares of CHW.

42 Finally, Staff alleges that none of the foregoing information was communicated to DALP investors and that the Respondents, directly or indirectly, participated in an act, practice or course of conduct that they knew or reasonably ought to have known perpetrated a fraud on DALP investors in breach of section 126.1(1)(b) of the Act and was contrary to the public interest.

B. Canadian Hedge Watch Inc.

43 CHW was incorporated in Ontario as a private company on January 23, 2002. Nagy, Sanfelice and three other persons were the initial shareholders of CHW. Sanfelice was also the President and Chief Executive Officer of CHW.

44 By 2008, CHW was primarily engaged in providing hedge fund data, information, reports and news to the Canadian marketplace. A bi-monthly newsletter and access to a website was provided to subscribers, which included hedge fund companies, banks, advisors and investors.

45 In 2008, Nagy and Sanfelice decided to divest their respective interests in CHW and focus on Quadrexx. At the time, Nagy owned 50.3% of CHW's common shares and Sanfelice owned 32% of CHW's common shares and 39% of its preferred shares. Nagy and Sanfelice also decided, in collaboration with their business associates, Mark Wainberg ("Wainberg") and Jeff Parent ("Parent"), to effect the divestiture by means of an offering of securities in reliance on exemptions from the prospectus and, in certain provinces, the dealer registration requirements pursuant to National Instrument 45-106 - Prospectus and Registration Exemptions ("NI 45-106"). They also retained Michael Sharp ("Sharp"), a partner of a major Toronto-based law firm, to represent them in this regard.

46 On April 27, 2008, while in the process of preparing a draft offering memorandum, Sharp advised Nagy and Wainberg by an e-mail message dated April 27, 2008 that they would need to include the audited financial statements of CHW, as they would be selling securities "not just to accredited investors, but to the significantly less sophisticated class of 'eligible investors' using Form 45-106F2", a reference by Sharp to National Instrument Form 45-106F2 - Offering Memorandum for Non-Qualifying Issuers ("Form 45-106F2"). Sanfelice testified at the Hearing that Quadrexx had received legal advice that it did not need to include a valuation of CHW but, after consulting with some of his accounting colleagues, he and Nagy decided to include a valuation as they were proposing to sell their interests in CHW. (Exhibit 251 at p 6)

47 In an e-mail message to Sharp on April 12, 2008, Nagy indicated that he wanted the offering memorandum to provide for interim closing at the end of each month, regardless of the money raised to date, so that commissions could be paid to agents as "[w]e are positive that at the very least we will attain the minimum." By an e-mail message dated April 14, 2008, Sharp advised Nagy that "[y]ou can of course pay commissions to agents out of your own pocket; what you can't do if there is a minimum offering is use the investor's funds for this purpose." (Exhibit 251 at pp 1-2)

48 On May 19, 2008, Nagy sent an e-mail message to Sharp expressing his concern that a third party business evaluation would take about three to four months to complete. Sharp advised Nagy that the limited partnership which would be established to sell securities (see paragraph [49] below) could enter into an agreement to acquire CHW at a price to be determined based on the third party valuation and that the marketing of the limited partnership could commence while the valuation was undertaken.

C. Formation of DALP

49 DALP was established as a limited partnership under the laws of Ontario on June 13, 2008 for the purpose of investing in at least one, but no more than three, private equity businesses. QHCM was the general partner of DALP and Sanfelice was the initial limited partner. Nagy was a director and the President of QHCM and Sanfelice was a director and the Secretary.

50 In its capacity as the general partner of DALP, QHCM retained Quadrexx to act as DALP's investment advisor.

51 During the period from July 22, 2008 to May 30, 2009, Quadrexx sold 1,130 limited partnership units of DALP ("DALP Securities") to 37 investors pursuant to two offering memoranda, namely, an Offering Memorandum dated June 16, 2008 (the "First DALP OM") and a further Offering Memorandum dated February 28, 2009 (the "Second DALP OM"). The total amount realized from the sale of DALP Securities was $5.65 million.

52 The First DALP OM stated that the acquisition of some or all of the issued and outstanding shares of CHW would be the initial equity investment made by DALP and, more particularly, that:

> [DALP] intends to purchase CHW shares from its existing shareholders for a total price not to exceed $2.65 million in total. Prior to June 30, 2009, the General Partner will engage a third party "business valuator" firm to valuate the fair market value of CHW. The price [DALP] pays for acquiring CHW (either fully or partially) may be adjusted downward should the valuation of CHW be less than $2.65 million. The costs of the valuation will be paid by the General Partner. Such valuation will be based on a "dividend discount" valuation or pricing model. [Emphasis added.]

(Exhibit 95 at p 17)

53 The comparable provision of the Second DALP OM stated that:

> [DALP] is purchasing these CHW shares from its prior shareholders for a total price of $2,535,688 in total [sic]. The General Partner has engaged a third party "business valuator" firm, to valuate the fair market value of CHW. The price [DALP] will pay for acquiring all of the issued and outstanding shares of CHW [sic] $2,535,688 for a full purchase which is at the midpoint of the valuation determined by the valuator. The costs of the valuation will be paid by the Partnership. [Emphasis added.]

(Exhibit 549 at p 19)

54 Of the proceeds derived from the sale of DALP Securities, $5.0 million was received prior to, and $650,000 was received after, February 28, 2009, the date of the Second DALP OM.

D. Deloitte & Touche LLP Valuation

55 On November 25, 2008, Sanfelice had a telephone conversation with Polisuk to discuss the valuation that would be required in connection with the sale of CHW. Sanfelice had been introduced to Polisuk by Polisuk's brother, who was an acquaintance of Sanfelice.

56 During their initial telephone conversation, Sanfelice and Polisuk agreed that Deloitte would prepare an estimate valuation report, which Polisuk testified is the second or midlevel of three levels of assurance that can be provided by a valuation, a comprehensive valuation being the highest level of assurance.

57 On November 27, 2008, Polisuk sent an engagement letter dated December 11, 2008 to Sanfelice by e-mail which set out the terms and conditions on which Deloitte would conduct an estimate of the fair value of all of the issued and outstanding shares of CHW. Sanfelice forwarded the e-mail message and engagement letter to Nagy, noting that he was concerned about retaining

Deloitte to conduct the valuation given that their fees were expensive and open-ended. He also suggested to Nagy that they should have a further meeting with Figov, another business valuator who was known to Nagy, with whom they met earlier in 2008.

58 Notwithstanding Sanfelice's concerns, CHW accepted the terms of the engagement letter on the day on which it was sent by Polisuk.

59 In addition to its customary terms and conditions of engagement, Deloitte's engagement letter set out the valuation methodology that would be employed by Deloitte and its estimated fees of $25,000 to $35,000. The engagement letter confirmed that Tom Strezos ("Strezos") and Polisuk, a partner and senior manager, respectively, in Deloitte's Financial Advisory group, would have overall responsibility for the engagement. Strezos and Polisuk were joined in the CHW valuation project by Mohamed, at the time a Manager in Deloitte's Financial Advisory group.

60 On December 12, 2008, Polisuk sent a letter to Sanfelice setting out in detail the documents and information that Deloitte required for their valuation analysis. On December 22, 2008, Sanfelice met with Polisuk to provide him with a document entitled "CHW's Business Plan (updated Nov 2008)" which included CHW's audited revenues and expenses for 2007 and 2008 and five year forecasts of revenues, expenses, EBITDA and income before taxes for the years 2009 to 2013 which had been prepared by Sanfelice (the "Initial CHW Business Plan"). Sanfelice further responded to Polisuk's detailed request for information on December 29, 2008.

61 On January 5, 2009, and in response to Sanfelice's indication by e-mail that he would like the valuation to be completed prior to his absence for holidays during the week of January 26, 2015, Mohamed advised Sanfelice that he should be able to provide a copy of the valuation report to Sanfelice by the end of January, at the latest. During the ensuing period, Deloitte continued to request and Sanfelice continued to provide information relating to the valuation.

62 On January 9, 2009, Sanfelice, Polisuk and Mohamed participated in a scheduled conference call for the purpose of discussing, among other things, CHW's revenue forecasts which Deloitte, according to Mohamed's testimony at the Hearing, had found "too high, too aggressive". In anticipation of the call, Mohamed prepared a list of questions to ask Sanfelice relating to the main revenue streams on which CHW relied, namely, the revenues derived from conferences, education programs, licensing, reports and data and advertising.

63 Mohamed, with the assistance of Polisuk, prepared an initial draft of the valuation report which estimated that the fair market value of all of the issued and outstanding shares of CHW, considered together, as at October 31, 2008 was in the range of $3.2 million to $3.8 million. The draft valuation report noted that, if a specific value was required, Deloitte would suggest $3.5 million as the mid-point of the range.

64 Polisuk sent the initial draft of the valuation report to Strezos for his review. Strezos provided Polisuk and Mohamed with numerous hand-written comments on the draft report, including a recommendation that the industry and specific risk premium be increased from a range of 7% to 9% to a range of 9% to 11%. This resulted in an increase in the weighted average cost of capital which, in turn, increased the discount factor being used in the valuation from a range of 23.9% (high) to 26.9% (low) to a range of 25.7% (high) to 28.8% (low). The increase in the discount factor resulted in a reduction in the range of the estimated fair market value from $2.8 million to $3.4 million with a mid-point of the range of $3.1 million.

65 On January 12, 2009, Polisuk sent a revised draft of the valuation report dated January 15, 2009, which reflected the comments provided by Strezos, to Iseo Pasquali, the partner responsible for Deloitte's valuation practice in the Toronto area ("Pasquali"). In his covering e-mail message, Polisuk advised Pasquali that he was sending the report to him as it was "a greater than normal risk" and would therefore require the approval of a second partner.

66 During a conference call with Polisuk and Mohamed on January 16, 2009, Pasquali raised a number of concerns with respect to the revised draft valuation report, which concerns were summarized in an e-mail message that Mohamed sent to Polisuk on the same day. In essence, Pasquali thought that (i) the revenue forecasts were very aggressive; (ii) the proposed valuation in the draft valuation report ranging from $2.6 million to $3.2 million with a mid-point of $2.9 million was "really high"; and (iii) a value of $500,000 to $1.0 million was "about right". Pasquali also expressed concern about the frequency of the prior redemptions of shares, the prices at which the redemptions were effected and the state of the hedge fund industry, as there were a number of hedge funds in trouble.

67 As Pasquali did not testify at the Hearing, I rely on Polisuk's evidence with respect to Pasquali's comments on the draft valuation report as the hearsay evidence is corroborated by both Mohamed's testimony, which I found to be credible, and by a contemporaneous e-mail message sent by Mohamed to Polisuk following the conversation. Accordingly, the hearsay evidence relating to Pasquali's comments has sufficient indicia of reliability.

68 As a result of Pasquali's comments, the schedules to the draft valuation report were amended to reflect an increase in the discount factor to a range of 35.6% (high) to 42.1% (low), which had the effect of reducing the mid-point of the valuation to $1.535 million. The schedules resulting in a mid-point valuation of $1.535 million were one of several similar schedules based on different assumptions that were prepared by Mohamed, including the schedules which resulted in the mid-point valuation of $2.9 million which formed part of the draft valuation report to which reference is made in paragraph [66] above.

69 On January 19, 2009, following a telephone conversation with Sanfelice, Polisuk sent Sanfelice an e-mail message at 1:20 p.m. requesting support for CHW's $2.6 million valuation, documentation relating to the share redemptions and support for the education revenues in CHW's financial projections. Sanfelice sent two replies to Polisuk, the first of which was sent at 6:48 p.m. on the same day with submissions relating to the valuation and details of a recent sale of shares and the education projections raised by Polisuk. With respect to CHW's $2.6 million valuation, Sanfelice attached three separate valuations using the discounted cash flow method. The valuations, which were based on discount rates of 24%, 22% and 20%, resulted in valuations of $3.3 million, $3.67 million and $4.08 million, respectively. With respect to the education projections, Sanfelice referred only to the projected increase in the number of students.

70 Sanfelice's second e-mail message to Polisuk, which was sent at 6:54 p.m. on the same day, responded to Polisuk's request for documentation relating to share redemptions by attaching a summary of share redemptions by Nagy and Sanfelice in 2008. The summary reflects the redemption of a total of 11,268 common shares by Nagy and Sanfelice which Sanfelice indicated in his message had been redeemed at what he described as the "conservative value" of $15.00 per share. (Exhibit 259)

71 The CHW valuations to which reference is made in paragraph [69] above were prepared by Nagy using a template that he obtained from the website of Valtech Technologies, Inc. The overview on each of the valuations states that:

> A standard way to value a company, or any investment, is the Dividend Discount approach (DD). Other closely related approaches are: Discounted Cash Flow, Free Cash Flow, and Economic Value Added (EVA), a trademark of Stern & Stewart.
>
> ...
>
> Future cash flows are discounted by the rate commensurate with the risk level of the investment. [Emphasis in original.]
>
> (Exhibit 96 at p 1)

72 Sanfelice and Polisuk spoke again on the morning of January 20, 2009, following which Sanfelice sent Polisuk details of CHW's payroll. Polisuk did not have an independent recollection of his discussion with Sanfelice on January 20, 2008. He did, however, confirm that he had prepared the undated handwritten notes which were produced in evidence by Staff as Exhibit 254 following his and Mohamed's telephone conversation with Pasquali to obtain Pasquali's comments on the draft valuation report (see paragraph [69] above). The following is an abridged summary of some of Polisuk's notes on the Exhibit:

1. We are coming up to a value well below the $2.65 million in the offering memorandum - can't bridge gap.

2. CHW has no actual normalized income in 2008.

3. Company has no tangible value.

4. Projections are very aggressive. Appear to have missed boat on hedge fund growth.

73 Attached as the second page of Exhibit 254 is Schedule 1 to a further version of CHW's discounted cash flow as at October 31, 2008, as prepared by Deloitte. The Schedule sets out the valuation calculation based on discount rates ranging from 35.6% (high) to 42.1% (low), resulting in a range of values from $1,280,000 to $1,791,000 with a mid-point of $1,535,000.

74 Attached as the third page of Exhibit 254 is a discounted cash flow calculation of CHW as at October 31, 2008 on which Polisuk made a number of handwritten notes under the heading "Tony", which Polisuk assumed in his testimony was a reference to Sanfelice. One of the notes stated that "Everything else sub 1 million. I don't see us bridging the gap b/w that and 2.6 million." Polisuk testified that it was information that he passed on to Sanfelice. Adjacent to the foregoing notes is the notation "1.53" with an arrow pointing to "2.65". When asked to indicate what the numbers represented, Polisuk said that he guessed that they referred to the difference between the $1.53 million to which reference is made in paragraph [68] above and the Respondents' targeted amount of $2.65 million. When cross-examined on what he recalled telling Sanfelice, Polisuk replied that: "I can definitely tell you I indicated we weren't coming close to the 2.65 million, and I can't tell you for sure what this note means sitting here in 2015." (Hearing Transcript, May 1, 2015 at p 89 and May 13, 2015 at p 64)

75 Polisuk also made the following notations on the third page of Exhibit 254: (i) "Re-do forecast normalized cash flow"; (ii) "Salary costs normalized basis"; and (iii) "Tony give a less aggressive scenario, moderate pace". When asked if he recalled having a discussion with Sanfelice about making the forecast less aggressive, Polisuk testified:

> I am assuming I did. I think what these notes are is [sic], now I can't say for certain, but my feeling is that these are notes I made when I was talking to [Sanfelice] after this whole Iseo [Pasquali] thing came up.
>
> (Hearing Transcript, May 1, 2015 at p 90)

E. Termination of Deloitte & Touche LLP

76 In the evening of January 20, 2009, following the conversation between Sanfelice and Polisuk earlier on the same day, Sanfelice left a voice message for Polisuk terminating Deloitte's engagement.

77 At the Hearing, Nagy testified that:

> As time progressed into January 2009, Mr. Sanfelice became more and more dissatisfied with the time it was taking for Deloitte to complete their valuation. We both became concerned that these further delays in obtaining the report, that costs were escalating with no end in sight. We had expected the valuation to have been complete by mid-January, but by January 20th we still had not received Deloitte's report, neither the draft nor the final report. They were continuing to ask Mr. Sanfelice for additional information, and we had no idea when they might ultimately render an opinion of the value of CHW. In short, we both lost confidence in Mr. Polisuk.
>
> (Hearing Transcript, October 2, 2015 at pp 31-32)

78 Sanfelice's evidence with respect to the reasons for terminating Deloitte's engagement is essentially the same as Nagy's evidence.

79 When questioned at the Hearing about the reasons for the termination of Deloitte's engagement, Mohamed testified that:

> [The Deloitte engagement] ended because we couldn't support the 2.65 million value that was being referred to in the confidential offering memorandum.
>
> ...
>
> Based on our analysis and our understanding of the forecast, and we thought the forecast could not be obtained, which ultimately would reduce -- which reduced the overall value we were coming up with. So we were getting a value lower than the 2.65 million, based on our calculations.
>
> (Hearing Transcript, April 24, 2015 at p 93)

80 On January 21, 2009, Polisuk sent an e-mail message to Sanfelice confirming his receipt of Sanfelice's voice message terminating the Deloitte engagement and enclosing Deloitte's statement of account. The statement reflected Deloitte's services to January 21, 2009, including the preparation of their financial model and their "draft report not issued", and their total fees of

$18,800. As a courtesy, Deloitte wrote-off the fees and GST which exceeded the $15,000 retainer which they had received.

F. HJF Financial Inc. Valuation

81 On or about January 23, 2009, Nagy and Sanfelice met with Figov for the purpose of retaining his firm, HJF, to value CHW. This was the second time that Nagy and Sanfelice had approached Figov with respect to the preparation of a valuation. Figov testified that he had declined to conduct the valuation when first approached as he felt that the forecasts were "too aggressive relative to [CHW's] historical financial statements...which did not include 2008 financials." (Hearing Transcript, September 21, 2015 at p 185)

82 Figov also testified that he agreed to undertake the valuation as Nagy and Sanfelice were able to provide him with CHW's 2008 audited financial statements, which reflected substantially higher revenues and profitability than the 2007 statements he had seen earlier in 2008. Figov also noted that, as the 2008 statements were audited, they provided a higher level of assurance than the 2007 statements he had previously reviewed, which had only been subjected to review engagements.

83 HJF was formally retained to provide an estimate of the fair value of the equity of CHW by letter of engagement dated February 10, 2009. The letter states, among other things, that the engagement was undertaken in connection with a potential acquisition of CHW by DALP and that the proceeds of the purchase would be used to buy out the existing shareholders of CHW (see paragraph [39] above).

84 At his first meeting with Nagy and Sanfelice, Figov received the CHW forecasts that formed part of the Initial CHW Business Plan. On February 2, 2009, Figov received from Sanfelice a summary of the audited revenue details for 2008 together with revised forecasts on a line-by-line basis for the five years from 2009 to 2013 (the "Revised Forecasts") and a Statement of Income and Deficit. Although is unclear from the record on what date the Respondents prepared the Revised Forecasts, it would appear that they did so on or about January 19, 2009, the date on which Sanfelice sent the three valuations to Polisuk.

85 On February 10, 2009, Sanfelice sent Figov CHW's balance sheet as at October 31, 2008 which included balance sheet forecasts for the five years from 2009 to 2013. On or about February 17, 2009, Sanfelice sent Figov a copy of a CHW business plan which included the Revised Forecasts which Figov had already received (the "Second CHW Business Plan").

86 On March 1, 2009, Figov provided Sanfelice and Nagy with a draft valuation report for their review. Sanfelice testified that, having corrected some typographical errors in the narrative, he returned the draft to Figov on the same day. Figov sent his final valuation report, which was dated February 27, 2009, to the Respondents in which he estimated that the fair market value of all of the issued and outstanding shares of CHW as at October 31, 2008 ranged from a low of $2,099,397 to a high of $2,971,978 with a mid-point of $2,535,688. The mid-point value of $2,535,688 was the amount used in the Second DALP OM as the price of the shares of CHW as noted in paragraph [41] above.

87 Ho, one of the Commission's Senior Forensic Accountants, testified at the Hearing that, when compared to the Initial CHW Business Plan provided to Deloitte, the Second CHW Business Plan provided to Figov reflected increases in CHW's EBITDA in each year of the five year forecast. The aggregate amount of the increase in EBITDA over the five years was $1,656,450 which resulted from an increase in revenues totalling $627,250 and a decrease in expenses totalling $1,029,200. Ho concluded that the increases in the forecasted revenues resulted from increases in projected subscription revenue, mainly attributable to increases in new subscribers and three bulk deals, and increases in licensing revenue attributable to two matters identified in the Second CHW Business Plan as "Second deal - Quadrexx, S&P or other" and "Third deal - Quadrexx, S&P or other".

88 It is Sanfelice's evidence that the changes reflected in the Revised Forecasts resulted from: (i) the Software License and Service Agreement entered into by Henton Information Systems Ltd. ("Henton") and CHW dated January 1, 2009 (the "Henton Agreement"); and (ii) CHW's 2008 audited statements which were received in January 2009 and which resulted in further adjustments to the overall forecast. The Henton Agreement provided CHW with a perpetual E-Learning Software License on the terms set out in the Henton Agreement.

89 Sanfelice also testified that he had made it clear to Figov when they met on February 17, 2009 that the Second CHW Business Plan included the effect of the Henton Agreement on CHW. However, when cross-examined, Sanfelice acknowledged that, when describing CHW's expansion of its education initiatives, the Second CHW Business Plan made no reference to the Henton Agreement or its effects on the financial performance of CHW. Sanfelice testified that only the numbers were updated and there was no reference to e-learning in the text of the Second CHW Business Plan.

90 It should be noted that, although dated on and made effective as of January 1, 2009, the Henton Agreement was only finalized on March 5, 2009. It is Sanfelice's evidence through his counsel, however, that "as of February 2, 2009 (the date when the forecast was provided to HJF) there was a high degree of certainty the deal would close in order to permit including the impact of the deal in the forecasts." (Exhibit 400 at pp 1-2)

91 Nagy testified that:

> We were in negotiation prior to October 31st, 2008 in respect to an acquisition of Henton, an e-learning business, and believed that it was appropriate to update our forecast after this deal became very likely in January 2009. The fact that Mr. Figov asked for Quadrexx's Q1 financial results was consistent with our belief that it was reasonable to use an updated forecast.

(Hearing Transcript, October 2, 2015 at p 34)

92 During Figov's cross-examination, counsel to Sanfelice suggested that Sanfelice told Figov about the e-learning platform when they met on February 17, 2009 and that CHW was relying on the estimates that had been provided to Figov. Figov replied that he was more inclined to say that he did not believe that he was so informed but, given the passage of time, he could not be 100% certain.

93 Ho testified at length with respect to the implications of the Henton Agreement, both in chief and on cross-examination. When cross-examined by counsel to Sanfelice, Ho was asked if, in his consideration of the reasonableness or adequacy of the explanations that had been provided to Staff prior to the Hearing with respect to the differences between the forecasts provided to Deloitte and HJF, Ho gave any consideration to the actual impact the Henton Agreement had on CHW's business. Ho replied that, while he saw the changes in the forecasts, they did not "match what [he] would expect to see happening if the Henton deal was the reason for the changes to the forecast." (Hearing Transcript, May 15, 2015 at p 139)

94 It should be noted that, during Ho's examination-in-chief, he did agree that an increase in the education fees of $30,000 shown in the forecast for 2010 and a smaller amount of $25,000 for 2011 were plausibly attributable to increased revenue derived from the Henton Agreement. When cross-examined by Nagy, Ho also acknowledged that (i) the Henton Agreement could potentially reduce CHW's education costs as well as its research, data and information technology expenses; (ii) CHW did not have an e-learning platform prior to the Henton Agreement; and (iii) if the Henton Agreement had come into effect, it would have had an effect both on revenue and expenses and one cannot necessarily predict what the interaction of the two factors would be.

95 When cross-examined by counsel to Sanfelice, Ho acknowledged that he was a forensic accountant and had no particular expertise in the area of opining on whether the forecasts relating to CHW's business were fair or not.

G. Disclosure

96 The First DALP OM stated, among other things, that (i) QHCM, the general partner of DALP, would engage a third party business valuator to valuate the fair market value of CHW; (ii) the price that DALP would pay for acquiring the shares might be adjusted downward, should the valuation be less than $2.65 million; and (iii) the costs of the valuation would be paid by QHCM. The comparable provisions of the Second DALP OM were modified to provide that DALP would pay $2,535,688 for the shares of CHW, which was the mid-point of the valuation, and that the costs of the valuation would be paid by DALP.

97 By February 28, 2009, the date of the Second DALP OM, CHW, rather than QHCM, had already retained and paid the fees of both Deloitte and HJF for conducting a valuation of DALP. Although the fees for both valuations were originally paid by CHW, Sanfelice, Nagy and Terry

Krotowski, a co-founder, shareholder and Vice-President of CHW, reimbursed CHW for such fees.

98 On April 9, 2009, a special meeting of the limited partners of DALP was held in Calgary. By means of proxies filed prior to the meeting, the limited partners approved a special resolution which extended the final closing date for the offering of the DALP Securities and amended the DALP Partnership Agreement to provide, among other things, that DALP would pay for the costs of any business valuation undertaken in respect of DALP's investment in CHW.

99 None of the following was disclosed to DALP investors: (i) the retention of two different third party valuators, Deloitte and HJF, to conduct valuations of CHW; (ii) the circumstances relating to such retention and the subsequent termination of the engagement of Deloitte; (iii) the methodology employed in the valuations, other than a reference in the First DALP OM that the valuation would be based on a "dividend discount" valuation or pricing model; or (iv) the fees paid to each of Deloitte and HJF by CHW or the reimbursement of such fees. Similarly, none of the foregoing information was provided to DALP investors in either the special resolution to which reference is made in paragraph [98] above or the accompanying explanatory letter to unitholders.

H. Acquisition of CHW by DALP

100 As contemplated by the terms of the First DALP OM, QHCM, as the general partner of DALP, commenced purchasing the shares of CHW prior to the completion of the valuation and prior to the completion of the offering of DALP Securities. More specifically, QHCM purchased the shares in a series of transactions which commenced on August 25, 2008 with the purchase from the Respondents of 16,123 common shares and 17,210.33 preferred shares at an average price of $15.00 per share. The final purchase of CHW shares took place on March 2, 2009 with the purchase from the Respondents and Terry Krotowski of 46,927 common shares and 38,284 preferred shares at an average price of $14.61 per share.

101 The Second DALP OM, which was dated one day after the date of the HJF valuation, reflected the fact that DALP had acquired all of the issued and outstanding shares of CHW for a total price of $2,535,688. It also stated that the price paid by DALP was the lesser of $2.65 million and the mid-point of the valuation range determined by the valuator.

102 Nagy and Sanfelice received a total of $1,223,035.43 and $819,432.80, respectively, from the proceeds of the sale of their respective shares of CHW.

I. Submissions of the Parties

1. Termination of Deloitte

103 Staff submits that the Respondents terminated the Deloitte engagement before Deloitte issued its valuation report because the Respondents knew that Deloitte would not provide a valuation that was close to the $2.65 million amount contemplated by the First DALP OM. Such a lower valuation would mean a reduction in the amount received by the Respondents as shareholders of CHW on the sale of their shares to DALP.

104 Staff submits that, as Deloitte was conducting their review and analysis for the purpose of their valuation report, they made it increasingly clear to Nagy and Sanfelice that they viewed the CHW forecasts as aggressive and asked Sanfelice for additional information to justify a number of the assumptions employed by Sanfelice in preparing the forecasts. Staff also submits that the evidence discloses that, consistent with their concerns relating to the forecasts, Deloitte gradually increased the discount rate that they were using in versions of the schedules to their draft valuation report to reflect what they perceived as the increased level of risk (see paragraphs [64], [68] and [73] above).

105 The Respondents submit that (i) there is no evidence that a valuation report, draft or otherwise, was ever provided by Deloitte to CHW; (ii) there is no documented communication from Deloitte to CHW confirming that CHW was advised orally of a conclusion with respect to the valuation; and (iii) the testimony of Mohamed respecting Pasquali's requests for additional information makes it clear that Deloitte had not reached any conclusion with respect to the valuation.

106 Sanfelice testified that the Respondents decided to terminate Deloitte on or about January 20, 2009 because (i) Deloitte still had work to do; (ii) there was no indication as to when Deloitte was going to finish its work or when Deloitte would provide CHW with an opinion; and (iii) the Respondents were losing confidence in Polisuk. For the foregoing reasons, the Respondents decided to terminate Deloitte and proceed with Figov as they had received audited financial statements for CHW and a fixed price and timeline from Figov.

107 Staff submits that the Respondents' assertions that they were unaware of Deloitte's likely valuation are not credible and points, in particular, to the testimony of Polisuk who testified as follows when cross-examined about what he had said to Sanfelice with respect to value:

> And as I said previously, I can't tell you for sure what was said, what I said to him and when I said to him and whether I gave him a number or I didn't give him a number.
>
> I can definitely tell you I indicated we weren't coming close to the 2.65 million, and I can't tell you for sure what this note means sitting here in 2015.
>
> (Hearing Transcript, May 13, 2015 at p 64)

108 Polisuk's evidence with respect to the reason for the termination of Deloitte's engagement was confirmed by Mohamed who testified that the engagement was terminated because Deloitte "couldn't support the 2.65 million value that was being referred to in the confidential offering memorandum." (See paragraph [79] above.)

109 Staff submits that:

(a) The reason for the termination of Deloitte's engagement was its inability to provide a valuation close to $2.65 million;

(b) There was no undue delay on the part of Deloitte in preparing their valuation, given the fact that its engagement was terminated within two weeks after receiving payment of the $15,000 retainer which Deloitte had requested;

(c) Deloitte had already completed a third draft of their valuation report at the time its engagement was terminated;

(d) Mohamed indicated in an e-mail message to Sanfelice on January 5, 2009 that Deloitte should be able to provide its valuation report in a couple of weeks or by the end of the month, at the latest and there was no suggestion that Deloitte would not meet that deadline; and

(e) Although Sanfelice testified that HJF had agreed to a fixed time frame for the delivery of its valuation report and a fixed fee, there is no mention of either in the HJF letter of engagement in which HJF's fees are stated to be based on an hourly rate.

2. Revised Forecasts

110 The essence of Staff's submissions relating to the Revised Forecasts is that, having become aware of the probable outcome of the Deloitte valuation, the Respondents prepared a second set of forecasts that both increased revenues and decreased expenses. The Revised Forecasts were then provided to a second valuator, HJF, which Staff suggests was done in the hope or expectation of obtaining a more favourable valuation that would support the Respondents' desired valuation of the CHW shares.

111 Staff relies on the forensic analysis undertaken by Ho and summarized at a high level in paragraph [87] above. Of particular importance, Ho also testified that, of the total increase in revenues of $627,250, the Revised Forecasts projected an increase in education revenue for the five year forecast period of only $41,250.

112 Ho also testified that the decreases in forecasted expenses were entirely attributable to decreases in projected personnel expenses. This projected decrease is inconsistent with the use of proceeds description in the First DALP OM which was drafted by Sanfelice and stated that CHW intended "to use the proceeds of the offering as working capital and to hire senior management, sales, research, media and administration personnel to allow it to capitalize on its expansion plans over the next five years." (Exhibit 95 at p 16)

113 Sanfelice responded through his counsel to Staff's enforcement notice dated October 23, 2013, in which Staff raised issues with respect to the Revised Forecasts, by stating that:

> The fact is the forecasts provided to HJF were revised as a consequence of a deal entered into between Henton Information Systems Ltd. and CHW dated January 1, 2009, the impact of which was not incorporated into the previous forecasts provided to Deloitte prior to the Henton agreement. The Henton agreement reasonably resulted in a material change in the forecasts.
>
> (Exhibit 375 at p 6)

114 In a subsequent letter responding to written enquiries from Ho, Sanfelice, through his counsel, stated that:

> It should be noted that in addition to the impact of the "Henton" deal on the forecasts, other factors which also impacted the forecast provide to HJF (in contrast to the November 2008 forecast provided to Deloitte) were that CHW had received its audited statements in January 2009 which resulted in further adjustments to the overall forecast.
>
> It should also be noted that although the "Henton" deal was struck effective January 1, 2009 as per the agreement, the transaction agreement was not finalized until March 5, 2009. However, as of February 2, 2009 (the date when the forecast was provided to HJF) there was a high degree of certainty the deal would close in order to permit including the impact of the deal in the forecasts.
>
> Finally, corroborative of the honest and reasonable belief that the Henton deal materially impacted the value of CHW is the fact that since its acquisition, Henton has exceeded the revenues forecasted in January 2009. [Emphasis added.]

(Exhibit 400 at p 2)

115 Staff disputes Sanfelice's assertion that, by February 2, 2009, there was a high degree of certainty that the transaction contemplated by the Henton Agreement (the "Henton Transaction") would close. Staff points to the exchange of e-mail messages between Sanfelice and Michael Gallimore, a consultant who was being paid by Quadrexx to assist CHW in its negotiations with Henton, and between Sanfelice and Sharp during the period from December 8, 2008 until the Henton Agreement was signed on March 5, 2009. In Staff's submission, the foregoing correspondence establishes that, by February 11, 2009, Sanfelice had still not received legal advice with respect to the draft Henton Agreement from Sharp. Staff also points to the fact that, even though there was no change to the draft Henton Agreement between the dates of the forecasts provided to Deloitte and Figov, the Respondents allege that the changes between the two sets of forecasts were attributable to the Henton Agreement.

116 Staff cross-examined Sanfelice with respect to his assertion that the Revised Forecasts included "the impact of the [Henton] deal" by raising the absence of any details relating to Henton in the Second CHW Business Plan provided to Figov. Sanfelice acknowledged that only the numbers were updated and that there was no mention of Henton, the expansion of the education initiatives or e-learning in the text of the Second CHW Business Plan. Sanfelice also acknowledged that the balance sheet that he provided to Figov on February 10, 2009 made no provision for acquisitions.

117 The absence of any reference to the Henton Agreement in the Second CHW Business Plan and the Revised Forecasts is consistent with the following representations made by Nagy in his representation letter to Figov dated March 2, 2009:

> 3. You [Figov] have been informed of all significant factors, contracts or agreements, in effect at the Valuation Date, that bear on the value of [CHW], and they are reflected in the Valuation Report;
>
> 4. At the Valuation Date, no contracts or agreements were in effect or being negotiated, that would have a material effect on the future operations of [CHW] or on the value of the Assets, that have not been referred to in your Valuation Report;
>
> (Exhibit 489 at p 1)

There is no reference to the Henton Transaction in HJF's valuation report.

118 The Respondents' extensive submissions with respect to the Revised Forecasts are substantially based on the Henton Transaction, the receipt of CHW's 2008 audited financial statements and improvements in CHW's financial performance. In addition, the Respondents repeatedly assert that Staff failed to accept, or recognize as reasonable, Sanfelice's explanations with respect to the projected increases in revenue and decreases in expenses reflected in the Revised Forecasts.

119 Sanfelice testified that, in response to Figov's request to see the results for CHW's first quarter (which ended on January 31, 2009), he provided Figov with an excerpt from CHW's general ledger which reflected the profit and loss details for the quarter. Sanfelice testified that the "numbers were coming in stronger for Q1 than...the forecast we gave [Figov]." Sanfelice also testified that he had expressly informed Figov that the Revised Forecasts included the forecasted effects of the acquisition by CHW of an e-learning platform but acknowledged that he had not provided Figov with a copy of the Henton Agreement, as the parties had not completed the agreement at that time. (Hearing Transcript, December 9, 2015 at pp 143-144)

120 In response to inquiries from Staff prior to the Hearing, Sanfelice submitted through his counsel that the primary reason for the decrease in the forecasted expenses from the forecast provided to Deloitte was the decrease in personnel costs. The projected decrease was attributed to the Henton Transaction and the fact that the Respondents felt that certain personnel costs were too high having regard to the future plans for the business. Management personnel costs were similarly reduced given the anticipated reduction in the amount of time that each of Nagy and Sanfelice would spend on CHW's daily operations.

121 Sanfelice testified that the Henton Agreement had a positive impact on CHW's business and introduced into evidence two schedules which, in his view, supported his assertion that Staff had not considered the actual impact of the Henton Transaction on CHW's business. The first schedule is a comparison prepared by Ho of the forecasted revenues provided to each of Deloitte and Figov to which Sanfelice, who testified that he did not dispute Ho's numbers, appended his comments. Of the total amount by which forecasted revenues increased from 2009 to 2013, only $41,250 was attributable to education. The second schedule, also prepared by Ho, compared the benefits derived from the Henton Transaction to the forecasted benefits. Of the total net forecasted benefits of $425,000 over the same five year period, only $35,000 was attributable to education.

122 Sanfelice submits that the Revised Forecasts were largely predicated on Henton and that he had "demonstrated that there was actual benefit consistent with and even better than what had been forecasted". (Hearing Transcript, December 10, 2015 at p 14)

123 Finally, Sanfelice submits that (i) the HJF valuation was the only valuation obtained by the Respondents as Deloitte never provided a valuation; (ii) the Revised Forecasts, which were provided to Figov by the Respondents, were based on their good faith expectations, including the effect of the proposed Henton Transaction; (iii) there was no falsehood, deceit or other fraudulent means engaged in by the Respondents; and (iv) there is no evidence that DALP, which was purchased by CHW, was not worth what the DALP investors paid to acquire it.

124 In response to Staff's submissions that there did not appear to be any movement in the Henton Transaction (see paragraph [115] above), the Respondents point to Michael Gallimore's e-mail message to Sanfelice dated January 22, 2009 advising of the need to "kick off work on closing Henton" which the Respondents submit is evidence that progress was being made. (Exhibit 428 at p 81)

125 In their submissions, the Respondents point to a number of acknowledgements by Ho during his testimony, including that:

(a) The Henton Transaction could potentially have reduced CHW's education, research, data, information technology and sales expenses;

(b) Prior to the Henton Transaction, CHW did not have an e-learning platform;

(c) The revenues of CHW would be "impacted" as the result of the Henton Transaction;

(d) Ho did not testify that the Henton Transaction was not a significant event; and

(e) Ho is a forensic accountant and "had no particular expertise" that would allow him to offer an opinion on whether the Revised Forecasts were fair or not.

126 In reply to the Respondents' submissions, Staff refutes the assertions of the Respondents that the reasons for Staff's fraud allegation relating to DALP resulted from: (i) Staff's disbelief that the Henton Transaction would have the economic benefits forecasted by Sanfelice; and (ii) Ho's lack of certainty that the Henton Transaction was as significant as made out by the Respondents in the Revised Forecasts provided to Figov.

127 Staff submits that, following his investigation, Ho was unable to conclude that the revisions reflected in the Revised Forecasts could be attributed to the Henton Transaction. Staff also submits that the comparative document produced in evidence as Exhibit 695 (see paragraph [121] above), which was provided to Staff for the first time immediately prior to Sanfelice's examination-in-chief, was an attempt by the Respondents to justify the Revised Forecasts on the basis of actual performance. Staff submits that the Respondents appear to be relying on hindsight and an ever-expanding list of reasons to justify the revisions reflected in the Revised Forecasts, well after the fact and that the Revised Forecasts do not correspond to the actual costs and revenues associated with the Henton Transaction.

128 The Respondents submit that Staff called no evidence to dispute the valuation of CHW and has, therefore, no basis to allege fraud with respect to DALP. Staff refutes the Respondents' submission and submits that fraud consists of dishonest conduct that results in at least a risk of deprivation to the victim and that the Respondents' conduct, which was not disclosed to DALP investors, put the financial interests of DALP investors at risk. As a result, there is no need to call expert evidence relating to the value of CHW in February 2009 to establish the fraudulent conduct.

129 Finally, Staff submits that the Respondents made no mention of the Henton Agreement or e-learning when responding to Deloitte's request for support for the Respondents' forecasts relating to education.

3. Allegation of Fraud

130 Staff alleges that the Respondents, directly or indirectly, engaged or participated in an act, practice or course of conduct relating to the DALP Securities that they knew or reasonably ought to have known perpetrated a fraud on DALP investors, thereby breaching subsection 126.1(1)(b) of the Act and acting contrary to the public interest.

131 The basis for Staff's allegation of fraud relating to the DALP Securities can be summarized as follows:

(a) As soon as it became evident to Nagy and Sanfelice that Deloitte would not provide a valuation that would support the maximum purchase price for CHW's shares of $2.65 million reflected in the First DALP OM, the Respondents terminated Deloitte's engagement before they received a formal valuation.

(b) At essentially the same time as Deloitte was terminated, the Respondents prepared the Revised Forecasts and retained a second business valuator, Figov, to whom they provided the Revised Forecasts in the hope or expectation that the Revised Forecasts would provide the basis for a valuation that would come close to the $2.65 million amount.

(c) The increased revenues and decreased expenses reflected in the Revised Forecasts were not based on the Henton Transaction, as alleged by the Respondents, and most of the Respondents' evidence in this regard was prepared with the benefit of hindsight.

(d) Nagy and Sanfelice were in a conflict of interest as (i) the directing minds of QHCM, the general partner of DALP; (ii) the majority shareholders of CHW; and (iii) the shareholders, directors and officers of Quadrexx. As shareholders of

CHW, Nagy and Sanfelice received more for their CHW shares than they would have received if the sale had been based on the likely lower valuation that would have been provided by Deloitte. As a result of their actions, Nagy and Sanfelice prejudiced the economic interests of, and caused actual economic harm to, the DALP investors.

(e) The Respondents failed to disclose to investors any of the circumstances surrounding the retention and termination of Deloitte, the subsequent retention of HJF, the Revised Forecasts provided to HJF, or the payment of fees to the two firms and, therefore, represented that a situation was of a certain character when, in reality, it was not.

132 Staff submits that, having considered all of the evidence, the Commission should conclude on the balance of probabilities that the explanations provided by the Respondents are not consistent with the testimony of other witnesses and the exhibits filed at the Hearing. Staff further submits that, on the basis of clear, convincing and cogent evidence, including that of the Respondents, the actus reus and mens rea elements of fraud have been established on a balance of probabilities against Nagy, Sanfelice and QHCM.

133 In their Closing Written Submissions dated April 25, 2016 ("Respondents' Written Submissions"), the Respondents submit that Staff's allegation that the investors of DALP were defrauded is unfounded on the basis that:

(a) The Respondents did what they disclosed to the investors they intended to do;

(b) The HJF valuation report obtained and relied on by Nagy and Sanfelice, and reported to investors, was prepared in accordance with the appropriate standards and was the only valuation obtained;

(c) The Revised Forecasts were based on Nagy's and Sanfelice's good faith expectations, including the effect of the Henton Transaction;

(d) The Respondents did not engage in deceit, falsehood or other fraudulent means; and

(e) There is no evidence that the CHW asset purchased by DALP was not worth what was paid for it.

J. Analysis and Finding

134 As noted in paragraph [19] above, fraud has two components, the first of which is the actus reus, or prohibited act, which is established by proof of an act of deceit, a falsehood or some other fraudulent means, and deprivation caused by the prohibited act. The deprivation may be actual loss or the placing of the victim's pecuniary interests at risk. The second element is the mens rea, or criminal intent, which is established by subjective knowledge of the prohibited act and subjective knowledge that the prohibited act could have as a consequence the deprivation of another, which may include the knowledge that the victim's pecuniary interests are placed at risk.

135 For the purpose of assessing the evidence and the submissions of the parties, I will address the issues in the same order as the submissions of the parties above.

1. Termination of Deloitte

136 During his cross-examination by Staff, Nagy was asked about the state of his knowledge of Deloitte's views relating to the valuation of CHW at the time he prepared the three CHW valuations that Sanfelice sent to Deloitte on January 19, 2009 (see paragraph [69] above). Nagy denied that he knew that Deloitte could not get to a valuation as high as $2.65 million and, when asked by Staff if he wanted to have a valuation of $2.6 million, Nagy replied "No, we want to have a valuation, period." (Hearing Transcript, October 5, 2015 at p 124)

137 I find that the facts do not support Nagy's foregoing assertion. The evidence establishes that, at the time that Sanfelice terminated Deloitte's engagement on December 19, 2009, Deloitte had already prepared a draft valuation report which was undergoing an internal quality assurance review. Polisuk, on behalf of Deloitte, requested additional support for the $2.65 million purchase price reflected in the First DALP OM as Deloitte's internal reviews had disclosed a number of significant concerns with the Respondents' assessment of value including (i) the aggressive nature of the revenue forecasts set out in the First CHW Business Plan; (ii) the frequency of prior redemptions of CHW shares and the prices at which the redemptions had been effected; (iii) the absence of normalized income; and (iii) the state of the hedge fund industry.

138 Some of the foregoing concerns were communicated to Sanfelice by Polisuk and Mohamed on January 9, 2009 and again by Polisuk during telephone conversations with Sanfelice on January 19 and 20, 2009. The latter conversations were quite clearly focused on the fact that Deloitte could not bridge the gap between its then current assessment of value and $2.65 million. As a result, Polisuk requested additional evidence that would support Nagy's and Sanfelice's views with respect to the value of CHW's shares.

139 Nagy testified about his and Sanfelice's loss of confidence in Polisuk and their concerns relating to the timing of the delivery and the costs of Deloitte's valuation report given the additional information being requested by Deloitte (see paragraph [77] above). There is, however, no evidence that either Nagy or Sanfelice raised concerns with Deloitte about the timing or the costs of Deloitte's valuation. In fact, by the date of the termination of Deloitte's engagement, Deloitte had incurred fees of $18,800 for the preparation of its financial model and draft report, far less than its original estimate of $25,000 to $35,000 for the entire project.

140 With respect to timing, Mohamed advised Sanfelice by e-mail on January 5, 2009 that Deloitte should be able to provide him with a copy of its report "in a couple of weeks (end of this month latest)." As there is no evidence of any other communication between Deloitte and the Respondents with respect to timing, there is no reason to conclude that the Deloitte valuation report would not have been delivered to the Respondents by January 31, 2009. It should also be noted that the HJF engagement letter did not include any commitments with respect to costs or timing (see in this regard paragraph [109](d) above.)

141 Polisuk's testimony with respect to the matters discussed with Sanfelice during their telephone conversations on January 19 and 20, 2009 was evasive, particularly as it related to whether or not he had provided Sanfelice with any indication of Deloitte's views with respect to the valuation of CHW. Two exchanges during Polisuk's cross-examination by Sanfelice's counsel are relevant. The following is the first such exchange:

> Q. So, again, are you able to testify today, sir, under oath whether you told Mr. Sanfelice a value?
>
> A. I can't say for certain if I did or not.
>
> Q. And, therefore, you can't indicate, as you previously testified, that when you told Mr. Sanfelice a value, he didn't want the report?
>
> A. I can't say that we told him that the value was not the 2.6 million or near there and that he said okay, forget it. I seem to recall -- I can't say for sure, I'm not a hundred percent positive what he said, but I know that was the end of the engagement. [Emphasis added.]
>
> (Hearing Transcript, May 13, 2015 at p 59)

142 In the second exchange, Polisuk testified that:

> And as I said previously, I can't tell you for sure what was said, what I said to him and when I said to him and whether I gave him a number or I didn't give him a number.

> I can definitely tell you I indicated we weren't coming close to the 2.65 million, and I can't tell you for sure what this note means sitting here in 2015. [Emphasis added.]

(Hearing Transcript, May 13, 2015 at p 64)

143 Notwithstanding the fact that parts of Polisuk's testimony were evasive, his evidence, taken as a whole, is consistent with his written notes which were prepared before and/or during his telephone conversations with Sanfelice on January 19 and 20, 2009. I find that, on a balance of probabilities, Polisuk communicated to Sanfelice the fact that Deloitte could not provide a valuation in the amount of $2.65 million and that he made it clear to Sanfelice that Deloitte's valuation would be well below $2.65 million. Polisuk's telephone conversations with Sanfelice were, in my view, the proximate cause for Nagy's and Sanfelice's decision to terminate Deloitte's engagement only a few hours after the telephone conversation on January 20, 2009.

144 Given the foregoing evidence, I find that, on a balance of probabilities, Nagy and Sanfelice terminated the Deloitte engagement because the almost certain outcome of Deloitte's valuation of CHW would have been far less than the $2.65 million amount described in the First DALP OM. Such a valuation would, in turn, have reduced the proceeds of the sale received by Nagy and Sanfelice as the majority shareholders of CHW.

2. Revised Forecasts

145 The parties led a considerable amount of evidence at the Hearing and provided extensive written submissions with respect to the Revised Forecasts, including (i) extensive financial analyses; (ii) details relating to the timing of the preparation of the Revised Forecasts and the assumptions that were employed in their preparation; (iii) details about what was known about the Henton Transaction at the time the Revised Forecasts were prepared; and (iv) details about what, if anything, was communicated to each of Deloitte and HJF with respect to CHW's proposed e-learning platform.

146 It is Sanfelice's evidence that he revised the Initial CHW Business Plan (provided to Deloitte) to give effect to the Henton Agreement and reflect CHW's 2008 audited financial statements, which were received in January 2009 and resulted in further adjustments to the overall forecast. The Revised Forecasts were prepared on or about January 19, 2009, the date on which Sanfelice sent Nagy's three valuations to Polisuk.

147 Nagy testified that it was appropriate to update the forecasts after the Henton Transaction "became very likely in January 2009." (See also paragraph [91] above.) Sanfelice, through his counsel, advised the Commission in a letter dated November 25, 2013 that:

> It should also be noted that although the "Henton" deal was struck effective

> January 1, 2009 as per the agreement, the transaction agreement was not finalized until March 5, 2009. However, as of February 2, 2009 (the date when the forecast was provided to HJF) there was a high degree of certainty the deal would close in order to permit including the impact of the deal in the forecasts.

> (Exhibit 400 at p 2)

148 Notwithstanding their assertions about the high degree of certainty of an agreement with Henton on February 2, 2009, neither Nagy nor Sanfelice even raised with Deloitte the possibility of an agreement with Henton on January 20, 2009 when Deloitte expressly requested that they justify their revenue projections relating to education. Yet, within the ensuing 13 days, Nagy and Sanfelice terminated the Deloitte engagement, retained HJF, concluded that "there was a high degree of certainty" that the Henton Agreement would close and prepared the Revised Forecasts, primarily on the basis of the anticipated Henton Agreement, and delivered the Revised Forecasts to Figov. In my view, the improbability of the foregoing events as recounted by Nagy and Sanfelice seriously undermines the credibility of their assertions that they terminated the Deloitte engagement because they had lost confidence in Polisuk, Deloitte were taking too long to prepare a valuation, were continuing to request information and would be expensive and that the Henton Agreement was the primary reason they felt justified in increasing their revenue projections beyond the forecasted amounts which Deloitte viewed as unsupportable.

149 In addition, Sanfelice testified that he had made it clear to Figov when they met on February 17, 2009 that the Second CHW Business Plan included the effect of the Henton Agreement. However, when cross-examined, Sanfelice acknowledged that he made no reference to the Henton Agreement or its effect on the financial performance of CHW when describing the expansion of CHW's educational initiatives in the Second CHW Business Plan.

150 Figov testified that he did not recall being advised about the Henton Agreement but, on cross-examination, acknowledged that it was possible that either Sanfelice or Nagy told him about the e-learning business. Given the importance that Nagy and Sanfelice subsequently ascribed to the Henton Agreement in this proceeding, it would be reasonable to expect that such importance would have been communicated to Figov in a memorable manner. It should also be noted that, in paragraph 4 of his letter of representations to HJF dated March 2, 2009, Nagy represented that:

> At the Valuation Date, no contracts or agreements were in effect or being negotiated, that would have a material effect on the future operations of [CHW] or on the value of the Assets, that have not been referred to in your Valuation Report. [Emphasis added.]

> (Exhibit 489)

151 If Nagy and Sanfelice had advised Figov that the Revised Forecasts were substantially based on an agreement that would not be concluded for more than another month, it would be reasonable to expect that Figov would have undertaken some form of review to ensure that the revenue forecasts were reasonable. In this regard, the following exchange between Staff and Mohamed is instructive:

> Q. ...And in this estimate of valuation approach that Deloitte is taking, these growth assumptions, how much are they just accepted and how much do you test them? Like, what's part of the retainer or the engagement?
>
> A. So under an estimate, we are required to corroborate the significant assumptions, so we wouldn't corroborate all assumptions, but the more significant. And revenues would be the most significant assumption.
>
> (Hearing Transcript, April 24, 2015 at p 31)
>
> The HJF valuation report does not disclose any consideration by Figov of the Henton Transaction or any other contract or agreement in effect or being negotiated that would have had a material effect on CHW's future operations.

152 Ho testified at length with respect to his analysis of the financial information set out in the Initial and Second CHW Business Plans. The essence of Ho's evidence was that the aggregate increase in CHW's EBITDA of $1,656,450 over the five year forecast period resulted from an increase in revenues of $627,250 and a decrease in expenses of $1,029,200. Ho also testified that, of the $627,250 increase in revenues set out in the Revised Forecasts provided to HJF, only $41,250 was attributable to an increase in education revenue while the balance was attributable to an increase in subscription revenues. With respect to the decrease in expenses reflected in the Revised Forecasts, Ho testified that only the personnel expenses had changed. I accept Ho's evidence, which I found credible and based on a thorough analysis of the financial information provided to him by the Respondents. In addition, and notwithstanding the acknowledgements by Ho summarized in paragraph [125] above, none of which affect Ho's analyses or conclusions, the Respondents have failed to demonstrate that Ho's financial analyses were incorrect or deficient in any material respect.

153 The numerous explanations for the differences between the forecasts included in the Initial CHW Business Plan and the Second CHW Business Plan provided by Sanfelice through his counsel prior to the Hearing and in his testimony at the Hearing are inconsistent with the facts described above. Had Nagy and Sanfelice been as certain of the economic effects of the Henton Agreement as they purported to be after the fact, it stands to reason that they would have attempted to use the information to provide support for their assumptions, as they were asked to do by Deloitte, and would have made significant changes to the narrative of the Second CHW Business Plan. In addition, I found Sanfelice to be hesitant and less than forthright when testifying with respect to these issues.

154 I find that Nagy's and Sanfelice's submissions that the Henton Agreement was the primary reason for CHW's enhanced forecasted financial performance, as reflected in the Second CHW Business Plan, are not supported by, and are inconsistent with, other proven or undisputed facts including the following:

(a) The projected increase in education revenue during the five year forecast period reflected in the Revised Forecasts of only $41,250 and the total net forecasted benefits attributable to education during the same period of only $35,000 (see paragraphs [111] and [121] above);

(b) The absence of any evidence that, by February 2, 2009, the negotiations relating to the Henton Agreement were any more advanced than they were on January 20, 2009 (see paragraphs [115] and [124] above);

(c) The absence of any details relating to the Henton Agreement in the Second CHW Business Plan (see paragraph [116] above);

(d) The absence of any provision for acquisitions in the balance sheet provided by Sanfelice to Figov on February 10, 2009 and Nagy's representation to HJF on March 2, 2009 that there were no contracts or agreements in effect or being negotiated that would have a material effect on the future operations of CHW (see paragraphs [116] and [117] above); and

(e) Nagy's and Sanfelice's failure to make any reference to the Henton Agreement in their discussions with Deloitte, despite being expressly requested to provide support for their forecasts relating to education (see paragraph [129] above).

155 Having carefully observed and considered Polisuk's testimony in which he attempted to avoid definitive responses, and the explanations that he provided with respect to his written notes, I find that, on a balance of probabilities, Polisuk did communicate Deloitte's evolving views with respect to its valuation of CHW to Sanfelice. More particularly, I find that Nagy and Sanfelice knew that they would receive a valuation from Deloitte that would be well below the $2.65 million described in the First DALP OM and, as soon as they acquired that knowledge, they swiftly terminated the Deloitte engagement before they could receive a formal valuation report. Nagy and Sanfelice then altered the revenues and expenses in their five year forecast by just enough to support a valuation that they knew from their own calculations would approximate their target value of $2.65 million and provided them to HJF.

156 I also find that the Revised Forecasts were not prepared in good faith and that the purported reliance by the Respondents on the Henton Agreement as the primary justification for the improved financial forecasts of CHW was dishonest and deceitful.

3. Allegation of Fraud

157 As described in paragraph [19] above, to establish that the Respondents directly or indirectly engaged or participated in an act, practice or course of conduct related to the DALP Securities that they knew or reasonably ought to have known perpetrated a fraud on DALP investors in breach of subsection 126.1(1)(b) of the Act, Staff must establish both elements of fraud, namely, the actus reus and mens rea of fraud.

158 As the general partner of DALP, QHCM was required by the terms of both the First and Second DALP OMs "to exercise its powers and discharge its duties honestly, in good faith and in the best interests of [DALP] and to exercise the care, diligence and skill of a prudent and qualified manager." Given that QHCM was controlled and directed by Nagy and Sanfelice who, between them, owned more than 80% of CHW's shares, the need for the Respondents to act honestly, in good faith and in the best interests of DALP was particularly compelling.

159 As summarized above, the Respondents embarked on a process to sell CHW that entailed the formation of a limited partnership, which they effectively controlled through the general partner, and the retention of a third party business valuator to value the fair market value of CHW. The use of the terms "third party business valuator" and "fair market value" in the First DALP OM were undoubtedly intended to convey to investors that the purchase price for the shares of CHW would be determined by a professional valuator independently of QHCM and would reflect "the highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market between informed and prudent parties, acting at arm's length and under no compulsion to transact."

160 On the basis of the analysis described above, I find that, on a balance of probabilities, Nagy and Sanfelice created the Revised Forecasts for the sole purpose of improving CHW's EBITDA to support a valuation that would approximate the $2.65 million reflected in the First DALP OM. I also find that, following the initiation of Staff's investigation, Nagy and Sanfelice seized on the Henton Agreement and CHW's 2008 audited financial statements as a seemingly plausible basis for justifying the changes to the initial forecasts, after the fact.

161 By manipulating the valuation process as described above, the Respondents acted deceitfully and caused DALP to pay a higher price for the CHW shares than it would have paid had the Respondents permitted Deloitte to complete and issue its valuation report, which Nagy testified was their sole objective.

162 The conduct of the Respondents was dishonest and deceitful and enriched Nagy and

Sanfelice as the owners of more than 80% of CHW's shares at the expense of DALP and its investors. The Respondents' dishonest and deceitful conduct and the deprivation suffered by the investors establish the actus reus of fraud and it is not an answer to the foregoing for the Respondents to assert that Deloitte had never issued its report on value and that they did not think that they were "doing [any]thing wrong or because of a sanguine belief that all will come out right in the end." In addition, by abruptly terminating the Deloitte engagement to preclude what Nagy and Sanfelice viewed as an unacceptable risk of receiving a valuation that was adverse to their personal interests and by immediately retaining a different business valuator who was provided with artificially enhanced economic forecasts, Nagy and Sanfelice knowingly undertook acts which were deceitful and which they knew would prejudice the economic interests of the DALP investors. The foregoing conduct by Nagy and Sanfelice establishes the mens rea of fraud.

163 Based on the foregoing, I find that Nagy, Sanfelice and QHCM directly or indirectly engaged or participated in an act, practice or course of conduct relating to DALP Securities that they knew or reasonably ought to have known perpetrated a fraud on DALP investors in breach of subsection 126.1(1)(b) of the Act and contrary to the public interest.

IV. USE OF INVESTOR FUNDS BY QUADREXX TO PAY DIVIDENDS TO PREVIOUS QUADREXX INVESTORS

A. Overview

164 During the period from August 2009 to March 2011, Quadrexx issued and sold its QAM31 Class I Cumulative, Redeemable, Retractable Convertible Preference Shares (the "QAM I Shares") which raised a total of $7,970,000 (the "QAM I Offering"). The QAM I Shares paid dividends at the rate of 13.5% per annum, paid as to 6.75% on June 30 and December of each year. In the event that Quadrexx missed any dividend payments, the dividends would be due and payable upon redemption or retraction together with an additional dividend payment of 0.5% for each month the cumulative dividend was in arrears.

165 During the period from March 2011 to June 2012, Quadrexx issued and sold its QAM Class II Cumulative, Redeemable, Retractable Convertible Preference Shares (the "QAM II Shares") which raised a total of $4,105,780 (the "QAM II Offering"). The QAM II Shares paid dividends at the rate of 12.0% per annum, paid as to 6.0% on June 30 and December 31 of each year, commencing on June 30, 2011. In the event that Quadrexx missed any dividend payments, the dividends would be due and payable upon redemption or retraction together with an additional dividend payment of 0.5% for each month the cumulative dividend was in arrears.

166 The QAM II Shares were sold pursuant to an offering memorandum dated March 8, 2011 (the "First QAM II OM") and an undated two page marketing brochure (the "QAM II Brochure"), which provided details relating to Quadrexx and the QAM II Offering. Quadrexx provided copies of the QAM II Brochure to its agents who, in turn, provided the QAM II Brochures and the First QAM OM to potential investors. Although a second offering memorandum dated May 22, 2012 (the

"Second QAM II OM") was prepared, Sanfelice testified that it was not provided to investors.

B. Staff's Allegations

167 Staff alleges that, during the period from July 1, 2011 to May 1, 2012, Quadrexx paid dividends to investors of approximately $1.3 million using in whole or in part funds raised from the QAM II Offering. From July 1, 2011 to June 12, 2012, Quadrexx raised $3,175,000 from the QAM II Offering without advising investors that QAM II investor funds had been and/or would be used in whole or in part to pay dividends to Quadrexx investors.

168 Staff alleges that, as a result of the foregoing, Nagy, Sanfelice and Quadrexx, directly or indirectly, engaged or participated in a course of conduct relating to the QAM II Offering that they knew or reasonably ought to have known perpetrated a fraud on Quadrexx investors, contrary to subsection 126.1(1)(b) of the Act and contrary to the public interest.

C. QAM II Offering and Intended Use of Proceeds

169 Item 1.2 of the First QAM II OM stated that, assuming the maximum offering of $7.0 million, the net proceeds were intended to be applied in the following order of priority:

(a) Working capital in the amount of $4,894,116 with any balance of net proceeds not used for the stated purposes to be added to working capital;

(b) The repayment of a loan from CHW in the amount of $376,435; and

(c) The purchase for cancellation of up to 1.0 million Class I non-voting, non-cumulative, non-participating, redeemable, retractable preference shares in the aggregate amount of $750,000. A footnote disclosed that certain of the shares expected to be purchased by Quadrexx were held by the principals of Quadrexx.

170 Item 1.3 of the First QAM II OM stated that Quadrexx could only reallocate all or a portion of the net proceeds from the QAM II Offering after the payment of commissions, fees and offering costs (the "QAM II Proceeds") for sound business reasons. Items 1.2 and 1.3 of the Second QAM II OM were identical to the corresponding provisions of the First QAM II OM.

171 Under the heading "Short Term Objective and How We Intend to Achieve It", both the First QAM II OM and the Second QAM II OM stated that Quadrexx's intent was to "expand its distribution network through hiring additional sales force [sic] and the acquisition of financial advisory business(es) (ideally with assets under management of between $40,000,000 and $100,000,000)." (Exhibit 67 at p 12)

172 The principal purpose of the QAM II Offering was summarized in the QAM II Brochure as follows:

> Primarily Working Capital for business growth and expansion purposes (offices and agents), business acquisitions, product creation and to a lesser extent, debt reduction and share repurchase.
>
> (Exhibit 237 at p 1)

173 In Item 8, entitled "Risk Factors", the First QAM II OM stated:

> There can be no assurance that Quadrexx will, or will be permitted under applicable corporate law to, pay dividends on the QAM Class II Shares in the stated amounts or at the stated times.
>
> (Exhibit 67 at p 29)

D. Payment of Dividends

174 The QAM II Proceeds were initially deposited to TD Account Number 5238170 which was described in Quadrexx's General Ledger as "TD Trust - DALP I and II" (the "DALP I and II Account"). TD Account Number 5407218, which was described in Quadrexx's General Ledger as the "TD - QAM II operating account" (the "QAM II Account"), was opened on April 14, 2011 and, thereafter, the QAM II Proceeds were deposited to that account. There was also a third relevant account, namely, TD Account Number 5206589, which was described in Quadrexx's General Ledger as "TD - Corporate Quadrexx" (the "Quadrexx Corporate Account").

175 During the period from July 1 to September 16, 2011, Quadrexx paid dividends relating to the June 30, 2011 dividend obligations of the QAM I Shares and the QAM II Shares in the aggregate amount of $585,292.50 (the "June 2011 Dividends"). During the period from January 24 to March 23, 2012, Quadrexx paid dividends relating to the December 31, 2011 dividend obligations of the QAM I Shares and the QAM II Shares in the aggregate amount of amount of $712,702.50 (the "December 2011 Dividends").

176 Following his analysis of Quadrexx's bank accounts and bank statements, Ho testified that:

(a) Of the total amount of $3,514,444.93 deposited to the QAM II Account, $3,514,261.03 were QAM II Proceeds and all but $472.92 of such amount was transferred to the Quadrexx Corporate Account;

(b) During the period from July 1 to September 16, 2011, (i) $1,403,326.06 was transferred from the QAM II Account to the Quadrexx Corporate Account; (ii)

$585,292.50 was disbursed from the Quadrexx Corporate Account in relation to the June 2011 Dividends; (iii) the Quadrexx Corporate Account was credited with a total of $282,363.56 from sources other than the QAM II Account which, together with the opening balance in the Quadrexx Corporate Account of $43,916.88, was insufficient to fund the June 2011 Dividends; and

(c) During the period from January 24 to March 23, 2012, (i) $690,020 was transferred from the QAM II Account to the Quadrexx Corporate Account; (ii) $685,515 of the December 2011 Dividends, including a single June 2011 Dividend payment of $1,678.50, were disbursed from the Quadrexx Corporate Account; and (iii) the Quadrexx Corporate Account was credited with a total of $368,078.48 from sources other than the QAM II Account which, together with the opening balance in the Quadrexx Corporate Account on January 24, 2012 of $67,050.43, was insufficient to fund the December 2011 Dividends.

177 The last of the cheques drawn on the Quadrexx Corporate Account to pay the June 2011 Dividends did not clear the account until September 16, 2011. The last of the cheques drawn on the Quadrexx Corporate Account to pay the December 2011 Dividends did not clear the account until May 1, 2012.

178 Quadrexx continued to sell QAM II Shares until June 19, 2012. On the following day, Staff required, and Quadrexx provided, the written undertaking of Quadrexx, Nagy and Sanfelice to cease trading in the securities of Quadrexx until Staff was satisfied that Quadrexx was in compliance with section 42 of the Canada Business Corporations Act. See also paragraph [218] below. Following the payment of the December 2011 Dividends, Quadrexx did not pay any dividends to the holders of the QAM I Shares or QAM II Shares, including the holders of QAM II Shares purchased after January 2012.

E. Quadrexx's Financial Situation

179 Quadrexx experienced losses from at least 2007 to 2011. The 2009 and 2010 net losses were disclosed in the audited financial statements attached to the First QAM II OM. Quadrexx's loss before other items for 2010 was $2,154,373 and $2,310,279 for 2011. Quadrexx's deficit grew from approximately $4.2 million as at December 31, 2007 to approximately $9.2 million as at December 31, 2010 and approximately $12.9 million as at December 31, 2011.

180 Given the losses, among other things, the following going concern note was included as Note 1 to Quadrexx's audited financial statements for each year from 2008 to 2011:

> [Quadrexx] has continued net losses for the year and has financed its operations from using a combination of debt and equity. [Quadrexx]'s ability to realize the carrying value of its assets and continue as a going concern is uncertain and is

currently dependent on the continued support of its shareholders, the providers of debt, and the growth of assets under management. The outcome of these matters cannot be determined at this time.

(Exhibits 113, 117, 125 and 43)

181 As at December 31, 2011, Quadrexx only had approximately $118,000 in the aggregate in all of its bank accounts. The cash flow problems prompted Sanfelice to decline to receive his salary for the first three months of 2012 and, in addition, he loaned Quadrexx $50,000. Nagy reduced his salary in the early part of 2012 by approximately 50% and, while both he and Sanfelice equivocated about the reason for their respective salary adjustments, it is quite clear from the evidence that they were prompted by Quadrexx's cash flow problems, including the need to fund the December 2011 Dividends.

182 Orlova, Quadrexx's Controller from 2011 to mid-2013, testified that (i) Quadrexx did not have an adequate amount of cash to pay the December 2011 Dividends; (ii) the QAM II Proceeds were being transferred from the QAM II Account to the Quadrexx Corporate Account throughout the month of January 2012 and that money was allocated "between accounts based on the needs of the company"; and (iii) Sanfelice was aware that there was not enough cash to pay all of the December 2011 Dividends at the same time. The fact that Quadrexx did not have enough cash to pay all of the December 2011 Dividends concurrently was also acknowledged by Nagy in his testimony.

183 When cross-examined by Staff with respect to the delays in the distribution of cheques in payment of the December 2011 Dividends, Sanfelice was evasive and justified the payments on the basis that "We were expecting revenues." When pressed, Sanfelice finally conceded that the money to pay the December 2011 Dividends was not in the Quadrexx Corporate Account at the end of December 2011. (Hearing Transcript, December 16, 2015 at pp 102-104)

184 Nagy and Sanfelice were both acutely and intimately aware of Quadrexx's financial condition. Sanfelice oversaw the preparation of and then reviewed Quadrexx's monthly financial statements and also reviewed and approved Quadrexx's monthly working capital calculations. Nagy reviewed Quadrexx's draft financial statements and received copies of the monthly working capital calculations. He was also kept up to date on financial matters by Sanfelice.

F. Use of QAM II Proceeds to Pay Dividends

185 In addition to the evidence relating to Quadrexx's financial condition in 2011 summarized above, the parties led a significant amount of evidence with respect to the transfer and use of the QAM II Proceeds.

186 Ho conducted an extensive review of the records relating to the QAM II Account, the

Quadrexx Corporate Account and the Quadrexx general ledger, and performed a detailed analysis of the source and application of funds. Ho determined that approximately $3.5 million of the QAM II Proceeds were deposited to the QAM II Account and that, over time, virtually all of the QAM II Proceeds were transferred from the QAM II Account to the Quadrexx Corporate Account.

187 Ho determined that the opening balance of the Quadrexx Corporate Account when payment of the June 2011 Dividends commenced, together with all other sources of funds other than the QAM II Proceeds during the period from July 1 to September 16, 2011 when the June 2011 Dividends were paid, totalled $326,290.44. That amount was far less than the aggregate amount of the June 2011 Dividends which were paid from the Quadrexx Corporate Account during the same period which totalled $585,292.50. Accordingly, Ho concluded that the difference of approximately $259,000 of the QAM II Proceeds must have been used to pay the June 2011 Dividends. Ho's analysis also shows that all of the cheques issued in payment of the June 2011 Dividends were dated June 30, 2011 or, in two cases, July 31, 2011.

188 Using the same type of analysis, Ho determined that the opening balance of the Quadrexx Corporate Account on January 24, 2012 was approximately $67,000 and, during the period from that date to March 23, 2012, approximately $690,020 of the QAM II Proceeds and approximately $368,078 of funds from other sources were transferred to the Quadrexx Corporate Account. Based on the foregoing analysis, Ho concluded that the payment of approximately $685,515 of the December 2011 Dividends could not have been effected without the use of the QAM II Proceeds.

189 It is quite clear from the evidence that Quadrexx did not have the necessary cash on hand to pay the June 2011 Dividends and that they were paid, at least in part, with the QAM II Proceeds. When questioned repeatedly with respect to this issue by Staff, Nagy consistently responded by stating that the dividend payments were made from working capital. However, he eventually acknowledged in at least the three instances that QAM II Proceeds had been used, including in the following exchange when he was cross-examined by Staff:

> Q. So, [Ho's] conclusion is that you have to be using some of the investor monies on this analysis because the 43,916, plus the 282,363, doesn't give you enough money to pay $585,292.50 in the dividend cheques that have been written?
>
> A. To describe this as investors' monies that's wrong. It's not the investors' money. The investors invested in Quadrexx. So, how can you say -- describe this as investors' money?
>
> Q. It's money that was raised through the sale of QAM II shares to the QAM investors.

A. Yes.

Q. So, you take no issue with Mr. Ho's analysis and his conclusion that monies from the sale of QAM II shares are being used to pay dividends to QAM I and QAM II investors?

A. After they have transferred to our general account, which is part of our working capital, they were used from the working capital accounts, yes. [Emphasis added.]

(Hearing Transcript, November 16, 2015 at p 106)

190 The following similar exchange took place when Nagy was cross-examined by Staff with respect to the December 2011 Dividends:

Q. So, we agree that investor monies are being used to pay these December 31, 2011, dividend cheques?

A. You use the term "investors' money". It's not the investors' money.

Q. It's monies raised from QAM II shareholders from the sale of the QAM II shares which paid a 12 percent dividend semi-annually.

A. Yes. And it moved normally as always. These monies were deposited to our general account and was forming a part of the working capital.

(Hearing Transcript, November 16, 2015 at pp 110-111)

191 The Respondents disagree with Ho's analysis, but primarily for the purpose of arguing that a smaller amount of the QAM II Proceeds was used to pay dividends than suggested by Ho. They submit that, when calculating the funds available to Quadrexx to pay the December 2011 Dividends, Ho inappropriately excluded loans from Sanfelice, another Quadrexx investor and QHCM in the aggregate amount of $160,000. As a result, Sanfelice submits that the amount of the QAM II Proceeds that was used to pay the December 2011 Dividends was overstated and points to the following portion of Ho's cross-examination:

Q. You'll agree with me that if you add the 160,000 to these other sources and opening balances, that there is sufficient funds, independent of the proceeds of QAM II, to pay the dividends?

A. Yes.

(Hearing Transcript, May 15, 2015 at p 102)

192 Staff submits that the continued reference by the Respondents to Ho's testimony as evidencing "that there were sufficient funds to pay the December 2011 Dividends without recourse to any proceeds from the QAM offering" mischaracterizes Ho's evidence. Staff also asserts that there was overwhelming evidence from Ho, Orlova and the bank documents in evidence that Quadrexx did not have sufficient funds to pay the December 2011 Dividends which were, as a result, delayed and staggered. Moreover, Quadrexx needed both the QAM II Proceeds and loans to pay the December 2011 Dividends.

193 The Respondents submit that "[i]n using, based on Mr. Ho's analysis, $259,012 to pay dividends, the Respondents have used approximately 2.1% of the entire proceeds to pay dividends, or 6.3% of the proceeds from the QAM II offering." (Respondents' Written Submissions at para 397)

194 In response, Staff submits that the over $259,000 in proceeds used for the June 2011 Dividends actually represented 18.5% of the QAM II Proceeds transferred to the Quadrexx Corporate Account (from which the dividend cheques were drawn) during the period that the cheques for the June 2011 Dividends cleared that account. Staff also argues that the effect was greater on the QAM II investors who invested just before or after dividends were declared.

G. Other Uses of the QAM II Proceeds

195 In June 2012, Sanfelice provided Staff with a schedule purporting to summarize the actual uses of the QAM II Proceeds. The schedule indicated that Quadrexx had revenues of $1,310,870 for the period of April 1, 2011 to April 30, 2012 and a minimum of $100,000 of shareholder support, including Sanfelice's loan. The schedule also indicated that Quadrexx's revenues and shareholder support amounts were used to pay for the $1.3 million in QAM I and QAM II dividends, as well as $78,000 of debenture interest. In its written Submissions on the Hearing dated February 26, 2016 ("Staff's Written Submissions"), Staff noted that the revenue amount of $1,310,870 had not accounted for selling commissions in the amount of $691,057 that Quadrexx was required to pay on the sale of products other than the QAM II Shares.

196 In May 2012, in the course of a compliance interview by Staff, Nagy was asked how the QAM II Proceeds had actually been used. According to the notes taken by Pawelek, an accountant in the CRR Branch, and Pawelek's recollection, Nagy responded that the purpose of the QAM II

Offering was to execute the business plan to reach 100 EMD agents. He also indicated that the QAM II Proceeds were used to expand operations in Calgary, including renting more office space, and for working capital, including the creation of new products, legal expenses and salaries. He did not indicate that any of the QAM II Proceeds had been used to pay, or facilitate the payment of, dividends.

197 Despite the stated purposes of the QAM II Offering, Quadrexx did not increase the number of agents as anticipated and did not acquire any financial advisory businesses after the date of the First QAM II OM.

H. 2011 Compliance Review and the Proposed Purchase of MineralFields

198 On June 24, 2011, Staff of the CRR Branch initiated a compliance review of Quadrexx for the period June 2010 to May 2011 (the "2011 Compliance Review"). There had been two prior compliance reviews which were completed successfully. The initial meeting of the 2011 Compliance Review was attended by Nagy, Sanfelice and Parent, from Quadrexx, and by Pawelek and Caruso, both accountants in the CRR Branch, and two other members of Staff who did not appear to have any subsequent involvement. The discussion at the initial meeting, which focussed on the business affairs of Quadrexx, raised, among other things, an issue relating to the sale of preferred shares by Quadrexx. The issue would have a significant and, in the submission of the Respondents, seriously adverse effect on the outcome of Staff's investigation of Quadrexx and on Quadrexx's ability to fulfill its stated investment objectives.

199 Staff alleges in its oral submissions and in Staff's Written Submissions, but not in the Statement of Allegations, that Nagy and Sanfelice failed on several occasions to inform Pawelek that Quadrexx had issued preferred shares in connection with the implementation of its business plan. Although, as noted, the matter does not form part of the Statement of Allegations, Staff placed the matter in issue over the objections of the Respondents in connection with its allegations of fraud during the Hearing, as is evident from the following paragraphs of Staff's Written Submissions:

> 833. Staff submit that Nagy and Sanfelice's conduct during the 2011 Compliance Review also casts serious doubt on their position that they thought that they weren't doing anything wrong when they used QAM II monies to pay dividends to investors.
>
> ...
>
> 838. Staff submit that if Sanfelice and Nagy truly believed that Quadrexx was not doing anything wrong in selling QAM II shares and using the proceeds to pay dividends to investors, Sanfelice and Nagy would have been forthcoming with information about QAM I and QAM II to Staff from the beginning of the 2011

Compliance Review.

200 In the Respondents' Written Submissions, the Respondents respond to the foregoing submissions by Staff as follows:

> 56. To be clear, Staff are clearly alleging that the Respondents deliberately mislead Staff by concealing the existence of the QAM II offering to conceal the fact they were doing something "wrong", specifically using proceeds from the QAM II offering to pay dividends to investors. To suggest that Staff are not alleging that the Respondents misled Staff is not accurate.
>
> 57. With respect, while Staff chose not to make a specific allegation of misleading Staff in the Statement of Allegations, they were permitted to lead such evidence and are expressly asking the Commission to make a finding that Staff were deliberately mislead in order to conceal what Staff allege was a fraud. In short they are asking [the Commission] to find that the Respondents alleged misleading of Staff is a basis to dismiss the Respondent's [sic] position as incredible, premised on the reasoning "if they didn't believe it was wrong then why would they have mislead staff."

201 During the initial meeting of the 2011 Compliance Review and in follow-up conversations, Pawelek followed the work steps set out in the CRR Branch's Portfolio Manager review program for which there were a number of templates. One of such templates, entitled "Gain an understanding of the financial condition of the Registrant", included the following statement drafted by Pawelek:

> Management's plan to improve operating results of the company in the near future. Per discussion with Tony Sanfelice, the Registrant plans to cut it's [sic] losses in half this year, and to break even next year. Slower product sales in the last few years have resulted in low revenues. Business is expected to improve with the launch of the new fund - Diversified Assets 3 and potential new wealth management clients. The Registrant's subsidiary insurance business provides revenue to the consolidated firm.
>
> (Exhibit 19 at para 1)

202 In Staff's submission, the foregoing response by Sanfelice reflected his failure to inform Pawelek that Quadrexx had issued preferred shares to further its business plan.

203 Staff came to a similar conclusion with respect to Nagy on the basis that he had failed to mention either the QAM I or QAM II Offering that were then underway when he certified a 2011 Compliance Risk Assessment Questionnaire in which Nagy indicated that:

> Quadrexx has generated a loss in both 2009 and 2010. Quadrexx forecasts to reduce its loss in 2011 and achieve break-even status by the end of 2012. Quadrexx has built the personnel structure and expects its fees revenue to increase in all areas of its business including portfolio management, investment fund management, exempt market product and insurance.
>
> (Exhibit 21 at para 8)

204 The Respondents point to the following evidence in response to the CRR Branch's assertions that they had been misled by Nagy and Sanfelice:

(a) A Report of Exempt Distribution with respect to the QAM I Shares was filed with the Commission on January 21, 2010 and on December 9, 2011;

(b) A copy of the First QAM II OM was filed with the Commission on April 15, 2011;

(c) Neither Pawelek nor Caruso ever checked the Commission's files on the basis that this did not form part of a portfolio review nor did they directly ask Nagy or Sanfelice about Quadrexx's capital raising activities but, rather, expected those details in response to the general questions in their questionnaire relating to their business plans for Quadrexx; and

(d) Pawelek's acknowledgment that there was a reference to the QAM I Shares in the notes to Quadrexx's December 2010 financing statements which she reviewed following the initial meeting with Quadrexx on June 24, 2011.

205 When Pawelek was cross-examined with respect to the filing of the First QAM II OM, the following exchange took place:

> Q. Now, when you became aware that this offering memorandum had been filed with the Ontario Securities Commission prior to your even commencing your compliance review, did that at least give you some changed perspective of whether or not there was an attempt to deliberately mislead you?
>
> A. No.

(Hearing Transcript, April 23, 2015 at p 124)

206 The Respondents further submit that the evidence makes it clear that information relating to the QAM I and QAM II Shares was included in various documents provided to the CRR Branch, including Quadrexx's Statement Concerning Conflicts of Interest and Quadrexx's financial statements and general ledger.

207 On October 4, 2011, Pawelek received a copy of an anonymous complaint that had been filed with the Commission which stated that Quadrexx had been offering preferred shares in itself to the public/accredited investors, that the disclosure appeared to be grossly inadequate and that the balance sheet showed a deficit of $6 million in shareholder equity and losses for the most recent fiscal year of $2 million.

208 During the period from October 5 to October 26, 2011, Pawelek sent six separate requests to Sanfelice requesting information about preferred shares, but received no information relating to the QAM II Shares. In April 2012, Pawelek was informed by a member of the CRR Branch who was not involved in the Quadrexx matter, that Quadrexx was planning to purchase the assets of MineralFields Fund Management Inc., Pathway Investment Counsel Inc. and Limited Market Dealer Inc. (collectively, "MineralFields").

209 To determine how Quadrexx could finance the proposed MineralFields acquisition, Pawelek and Caruso obtained and reviewed Quadrexx's unconsolidated December 31, 2011 financial statements which disclosed that over $3.3 million of the QAM II Shares had been issued in 2011. Separate but concurrent meetings were held on May 10, 2012 with Nagy, who met with Pawelek and Skuce, a legal counsel in the CRR Branch, and with Sanfelice, who met with Caruso and David Santiago, a senior accountant in the CRR Branch. Each of Nagy and Sanfelice were represented by counsel during their respective meetings. Pawelek testified at the Hearing that the purpose of the meetings was to gather more information regarding the QAM II Offering.

210 Staff of the CRR Branch prepared a detailed questionnaire for the purposes of the meetings with Nagy and Sanfelice. Nagy was asked a series of questions relating to the purpose of the QAM II Offering, given that Quadrexx had just raised approximately $8.0 million under the QAM I Offering. In response, Nagy stated that additional funds were required to execute Quadrexx's business plan and he believed that Quadrexx would break even if they had 100 agents, rather than the existing 30 agents, selling their products and third party products.

211 Pawelek kept written notes of the information provided by Nagy at the May 10, 2012 meeting which were later transcribed. With respect to her notes relating to the June 2011 and December 2011 Dividends, Pawelek testified that:

> I have written that on June 30th and December 31st they paid -- they pay all the dividends and they are getting cash to do so from the revenues of all business and from working capital which includes money that they put in. It may have

included money that they put in but that money had not been marked as such.

(Hearing Transcript, April 23, 2015 at p 40)

212 During his re-examination at the Hearing, Skuce testified that Nagy had informed him during the meeting on May 10, 2012 that QAM II Proceeds were being used to pay dividends to prior investors. Skuce testified that this information concerned him as the use of the money to pay dividends to prior investors is one of the indicia of a potential Ponzi scheme and led to the matter being referred to the Enforcement Branch.

213 On May 14, 2012, Quadrexx and MineralFields entered into a non-binding letter of intent pursuant to which MineralFields agreed to sell the assets described in the letter of intent to Quadrexx. On May 22, 2012, Sharp, on behalf of Quadrexx, filed a formal notice of the proposed acquisition of the assets of MineralFields (the "MineralFields Transaction") with the Commission pursuant to section 11.9 of NI 31-103, as the transaction could not proceed if the Commission objected. Quadrexx submitted that the MineralFields Transaction would not give rise to a conflict of interest, hinder Quadrexx from complying with securities legislation, impair investor protection or otherwise be prejudicial to the public interest.

214 Quadrexx retained Gilkes, an experienced securities law compliance consultant, to assist with, among other things, Quadrexx's compliance issues and the MineralFields Transaction. On June 18, 2012, Gilkes and Sharp had a telephone conversation with Jennifer Lynch ("Lynch") and Sean Horgan ("Horgan"), both litigation counsel with the Enforcement Branch. Gilkes testified that Sharp advised Lynch and Horgan that the MineralFields Transaction was important to and would benefit Quadrexx and its investors. Although Horgan replied that the CRR Branch, and not the Enforcement Branch, was dealing with the MineralFields matter, Gilkes testified that there had been no discussion with the CRR Branch. Gilkes also testified that, at some point in the discussion, Horgan indicated that the Enforcement Branch was concerned that investors in the QAM II Shares were paying the dividends received by the investors in the QAM I Shares, which eventually led to a discussion about an undertaking by Quadrexx to cease trading its preferred shares.

215 On June 20, 2012, Sharp advised Nagy, Sanfelice and others by e-mail that the Enforcement Branch was refusing to revise the form of undertaking they required by which the Respondents would undertake to cease all trading of the securities of Quadrexx and that the Enforcement Branch would seek a cease trade order from the Commission if the undertaking was not signed immediately. Sharp also confirmed that Quadrexx would have to deal with the CRR Branch with respect to the MineralFields Transaction and that the Enforcement Branch would not involve itself in that matter. In the evening of the same day, Gilkes sent an e-mail message to the group working on the MineralFields Transaction to indicate that he and Sharp had had a productive call with the Commission. Gilkes stated that he and Sharp had been advised that a decision to settle the preferred share matter had been reached and that, once the undertaking had been signed, Gilkes would contact

Skuce to see how the matter could be expedited.

216 By letter to Sharp dated June 20, 2012, a Manager of the CRR Branch objected to the MineralFields Transaction pursuant to subsection 11.9(5) of NI 31-103 (the "CRR Objection") on the basis that it was (i) likely to hinder Quadrexx in complying with securities legislation; (ii) inconsistent with an adequate level of investor protection; and (iii) otherwise prejudicial to the public interest. The CRR Objection followed a notice of objection dated June 14, 2012 from the Alberta Securities Commission with respect to the proposed MineralFields Transaction.

217 After listing 12 separate compliance concerns with Quadrexx, the CRR Objection specifically noted Staff's concern with respect to the sale by Quadrexx of the QAM I and II Shares including (i) the use of approximately $1.3 million of the QAM II Proceeds to pay dividends to previous investors; (ii) the use by Quadrexx of $78,000 of the QAM II Proceeds to pay interest on a debenture; and (iii) the inclusion in the First QAM II OM of a general reference to the use of investor proceeds for working capital, but not to the use of investor proceeds to pay dividends and debenture interest.

218 The CRR Objection also stated that it appeared to Staff that the payment of dividends on the QAM I and II Shares was not permitted by section 42 of the Canada Business Corporations Act (the "CBCA"). The CRR Objection also stated that Quadrexx had failed to analyse paragraph 42(b) of the CBCA and that, if it had done so, Quadrexx would have concluded that the payment of dividends was not permitted as the value of Quadrexx's assets was less than the aggregate of its liabilities and stated capital.

219 Quadrexx provided a detailed response to the CRR Objection in a letter to the CRR Branch dated July 3, 2012 (the "Quadrexx Response") in which the Respondents indicated that they were:

> ...shocked and completely blindsided, as were our advisors, to find out that Enforcement was still conducting an investigation as noted in the letter objecting [sic] the proposed MineralFields acquisition. We were further surprised to learn that Compliance and Registrant Regulation would not discuss the reasons for objection as the "matter had been referred to Enforcement". When Enforcement was contacted they noted the MineralFields acquisition was a Compliance and Registrant Regulation matter. As set out above, we do not understand the process that was followed and feel the objection was based on a very unfair characterization and assessment of our conduct and operations.
>
> (Exhibit 59 at p 16)

220 Although a number of issues were addressed in both the CRR Objection and the Quadrexx Response, I will only briefly address two matters directly relevant to these Reasons, the first being the CRR Branch's concern that approximately $1.3 million of the QAM II Proceeds had been used to pay dividends to previous investors. The Quadrexx Response barely addressed the issues that were raised in the CRR Objection including the allegation that Quadrexx's failure to disclose in the QAM II OM that investor proceeds would be used to pay dividends to other investors appeared to have been a breach of subsection 44(2) of the Act.

221 The second matter is the CRR Branch's allegations relating to section 42 of the CBCA. Although both Nagy and Sanfelice testified that they were unaware of the CBCA provision when paying the June 2011 and December 2011 Dividends, the Quadrexx Response includes a lengthy and detailed after the fact justification by Quadrexx, including a valuation of Quadrexx's assets as at December 31, 2011 and a statement that the CBCA test is flawed and outdated. As the Statement of Allegations does not allege a breach of the CBCA and there is no need for me to determine whether such a breach occurred in order to apply the relevant law to the QAM II fraud allegations, I do not propose to further address the matter.

222 On July 30, 2012, Sharp sent an e-mail message to Lynch confirming that Quadrexx had abandoned the MineralFields Transaction as its exclusivity rights had expired, given the CRR Objection. Sharp also confirmed that the CRR Branch had declined to afford Quadrexx the opportunity to be heard under NI 31-103 and had specifically instructed Quadrexx to deal with the Enforcement Branch, which they had done without success.

223 The Respondents made extensive oral and written submissions with respect to the MineralFields Transaction to the effect that Staff would not even attempt to determine if Quadrexx could address their concerns, before "rejecting the transaction out of hand, despite the transaction being wholly consistent with what the Respondents had represented to investors of QAM I and QAM II preferred shares Quadrexx intended to pursue, and which was clearly in the best interests of the preferred shareholders who since July 2009 had invested $12 million in the Company based on that business plan." (Respondents' Written Submissions at para 243)

224 The MineralFields Transaction occurred well after the matters which are central to this proceeding and which I address below and does not form any part of the allegations set out in the Statement of Allegations. The Respondents have, however, raised the circumstances relating to the MineralFields Transaction as further evidence of their repeated allegations that they were unfairly treated by Staff, and by one member of the Staff in particular, which effectively precluded the realization of Quadrexx's fading hopes of salvaging its business. Although the MineralFields Transaction is not relevant to these Reasons (and, as acknowledged by the Respondents, the CRR Branch was not obligated to approve the MineralFields Transaction), I should observe that the evidence clearly establishes that Quadrexx and its advisors were relegated to a regulatory no man's land by the CRR Branch and the Enforcement Branch. Quadrexx and its advisors Gilkes and Sharp, both of whom were experienced professionals, were doing everything possible to consummate the MineralFields Transaction in the long-term interests of Quadrexx's investors while each of the CRR Branch and the Enforcement Branch clung to its respective area of responsibility without jointly taking steps to ensure that Quadrexx's compliance and other issues were addressed on a comprehensive basis to ensure that the interests of the investors were protected to the maximum extent possible.

I. Submissions of the Parties

225 Staff submits that:

(a) The essence of the QAM II fraud allegation is that the Respondents drafted and certified the First and Second QAM II OMs and the QAM II Brochure which did not disclose that QAM II Proceeds would be, or were, used to pay dividends to QAM I and QAM II investors and provided the offering memoranda and brochure to investors when they knew that QAM II Proceeds would be, or had been, used for such purpose;

(b) Although Quadrexx represented to investors that the QAM II Proceeds would be used primarily for working capital purposes, the overwhelming message of the First QAM II OM and the QAM II Brochure was that Quadrexx intended to use the QAM II Proceeds to implement Quadrexx's expansion plans;

(c) According to the QAM II Brochure, Quadrexx's expansion plans included additional offices and agents, business acquisitions and product creation;

(d) The Respondents committed an act of deceit, falsehood or some other fraudulent means by diverting QAM II Proceeds in an unauthorized manner and, after July 1, 2011, by failing to disclose to investors Quadrexx's intention to use QAM II Proceeds to pay dividends to prior investors;

(e) Sanfelice's assertion that it never dawned on him that Pawelek would not have been aware of the QAM II Offering, which had been filed with the Commission, makes no sense given that he informed Pawelek about the QAM I Shares and provided her with the QAM I offering memorandum even though it had been filed with the Commission; and

(f) The reasonableness of Staff's objection to the MineralFields Transaction is not relevant to any of the allegations in the Statement of Allegations.

226 The Respondents submit that:

(a) Ho's analysis establishes that, of the approximately $1.3 million paid by Quadrexx in connection with the June 2011 Dividends ($585,292) and the December 2011 Dividends ($712,702), on Staff's own analysis, only $259,012 was paid from the QAM II Proceeds and that related to the June 2011 Dividends as there were sufficient funds, independent of the proceeds of the QAM II Proceeds, to pay the December 2011 Dividends;

(b) Staff made no allegation in this proceeding that any of the $12 million raised was spent inappropriately or in a manner inconsistent with what was disclosed to investors and, more specifically, investors were told that most of the QAM II Proceeds would be used for working capital;

(c) They honestly and reasonably believed that they could pay dividends from working capital, having assessed in good faith that Quadrexx had sufficient working capital (current assets less current liabilities) to do so;

(d) The only misrepresentation alleged by Staff as the basis for the alleged fraud is that the Respondents failed to disclose to investors that, among the uses of working capital (a permitted use of proceeds under the terms of the QAM I offering memorandum and the First QAM II OM), 6.3% of the QAM II Proceeds may be used to pay the June 2011 Dividends;

(e) The use of 6.3% of the QAM II Proceeds for working capital to make a dividend payment on one occasion did not represent a material change as contemplated by NI 45-106 and, therefore, did not obligate Quadrexx to amend the First QAM II OM;

(f) Even if the use of 6.3% of the QAM II Proceeds for working capital to make a dividend payment did constitute a material change, the matter should have been dealt with as a breach of the disclosure rules and not as an alleged fraud;

(g) By objecting to a clearly significant and material acquisition, i.e., the MineralFields Transaction, without any reasonable inquiry into the potential benefits to investors, Quadrexx was unreasonably impeded by Staff from pursuing its long-term goal of establishing itself as a medium-sized EMD, private wealth and private equity firm with combined assets under management of at least $4 billion;

(h) Although not alleged in the Statement of Allegations, the allegation by Staff that Sanfelice mislead Pawelek by deliberately concealing the existence of the QAM II Offering, which Staff asserts is evidence of mens rea to commit fraud in connection with the payment of dividends, is unfounded, highly prejudicial and should never have been made; and

(i) It was no more obvious to the Respondents that they were doing anything fraudulent in declaring and paying dividends in the circumstances than it was to Staff, when conducting its compliance review, Quadrexx's auditors, when they issued their audit report, or Sharp, Quadrexx's legal advisor, who worked closely with the Respondents in the preparation of the QAM I offering memorandum and the First QAM II OM.

J. Analysis and Finding

227 Staff alleges that Nagy, Sanfelice and Quadrexx, directly or indirectly, engaged or participated in an act, practice or course of conduct relating to Quadrexx securities that they knew or reasonably ought to have known perpetrated a fraud on Quadrexx investors, thereby breaching section 126.1(1)(b) of the Act and acting contrary to the public interest.

228 As noted in paragraph [19] above, fraud has two components, the first of which is the actus reus, or prohibited act, which is established by proof of an act of deceit, a falsehood or some other fraudulent means, and deprivation caused by the prohibited act which may be actual loss or the placing of the victim's pecuniary interests at risk. The second element is the mens rea, or criminal intent, which is established by subjective knowledge of the prohibited act and subjective knowledge that the prohibited act could have as a consequence the deprivation of another, which deprivation may be the knowledge that the victim's pecuniary interests are placed at risk.

229 Although the Respondents dispute that any QAM II Proceeds were used to pay any part of the December 2011 Dividends, the Respondents' Written Submissions and Sanfelice's counsel, when making his oral closing submissions, acknowledge that QAM II Proceeds were used to pay part of the June 2011 Dividends and do not seriously dispute Ho's determination that approximately $259,000 of the QAM II Proceeds were used for this purpose. On the basis of Ho's analysis and testimony, which I find persuasive, I am satisfied and find that QAM II Proceeds were also used to pay at least part of the December 2011 Dividends. I must now determine whether, by using QAM II Proceeds for the purpose of paying dividends to previous investors in the circumstances described in these Reasons, the Respondents directly or indirectly engaged or participated in an act, practise or course of conduct relating to Quadrexx securities that they knew or reasonably ought to have known perpetrated a fraud on Quadrexx investors in breach of section 126.1(1)(b) of the Act and contrary to the public interest.

1. Representations to Investors

230 The First QAM II OM stated that, assuming the maximum offering, Quadrexx intended to use approximately $4.9 million of the approximately $6.0 million of QAM II Proceeds for working capital and the balance for the repayment of a loan from CHW and the purchase for cancellation of up to 1.0 million Class "I" preference shares. Although no expert evidence was led in this regard, Staff did not object to the Respondents' reference to working capital as being the capital of a business which is used for its day-to-day operations, calculated as the current assets less the current liabilities. Pawelek testified that, when she previously worked as an auditor, working capital was current assets minus liabilities. Lo, a senior forensic accountant in the Enforcement Branch, testified that "... in my view, references to use of working capital really relate to the ongoing business operations of the -- of a company. It's the normal course operations." (Hearing Transcript, May 6, 2015 at p 35)

231 The First QAM II OM also stated that Quadrexx's short-term objective was to expand its distribution network through the employment of additional sales personnel and the acquisition of financial advisory business(es), ideally with assets under management of between $40.0 million and $100.0 million. To achieve its short-term objective, Quadrexx indicated that the full amount of the QAM II Proceeds ($7.0 million if the maximum offering was achieved) would be used for (i) working capital (without distinguishing the additional uses for debt repayment and the purchases of shares for cancellation described above); (ii) a further amount of up to $1.0 million would be used to acquire financial advisory business(es) and expanding staff and the EMD business; and (iii) a further amount of up to $500,000 would be used to expand its product line offering and geographical territory. The expenditure of the working capital had a targeted completion date of the final Closing Date (which was not defined but was rather tied to the maximum offering being attained), and the remaining expenditures had a targeted completion date of December 31, 2012. Quadrexx's ability to achieve the foregoing short-term objectives was qualified by the statement that the QAM II Proceeds may or may not be sufficient for such purposes and there was no assurance that alternative sources of financing would be available.

232 The disclosure to investors in the QAM II Brochure clearly supplements the disclosure in the First QAM II OM by stating that the principal purpose of the QAM II Offering was primarily for working capital, which would be used for business growth and expansion purposes (offices and agents), business acquisitions and product creation, and to a lesser extent, debt reduction and share repurchase.

233 On July 6, 2011, the Quadrexx Corporate Account had a balance of only $34,290.64. On the following date, Doody, at the time the Controller of Quadrexx, transferred $600,000 from the QAM II Account to the Quadrexx Corporate Account. When Nagy was cross-examined about the transfer, the following exchange took place:

Q. ... So, as of, for example, July 6th, when that $600,000 comes over from the

QAM II account, that at that point in time you know that that money isn't going to be used for business acquisition. It's also not going to be used for product creation. Rather, it's going to be used to pay dividends.

A. Only for the time being until we have revenues. So, that's only partially true.

(Hearing Transcript, November 16, 2015 at p 136)

2. Other Factors

234 Sanfelice testified that, when he and Nagy made the decision to pay the June 2011 Dividends, he relied on a cash flow projection entitled "Consolidated Cash Projection 2011" which had been prepared by Doody and was sent to him by Doody on November 3, 2011. The Consolidated Cash Projection reflected actual information for the first ten months of 2011 and forecasted cash inflows and outflows for November and December 2011. According to Sanfelice, the Consolidated Cash Projection supported his and Nagy's decision to declare the June 2011 Dividends in the aggregate amount of approximately $585,000 as it showed that Quadrexx's closing cash position on May 31, 2011 was $700,272. When cross-examined, however, Sanfelice conceded that the Total Inflows shown in the Consolidated Cash Projection included two adjustments which alone would have reduced the closing cash position from the $700,272 reflected in the Consolidated Cash Projection to $490,273, far less than the amount of the June 2011 Dividends.

235 On March 8, 2011, the date on which Nagy and Sanfelice certified that the First QAM II OM did not contain a misrepresentation, Nagy and Sanfelice knew that, for the year ended December 31, 2010, Quadrexx had revenues of only $396,795 and had experienced a net loss and comprehensive loss exceeding $2.5 million. Being acutely aware of Quadrexx's financial circumstances, Nagy and Sanfelice had to have known that the cash flow forecasts prepared by Doody were inaccurate, overly-optimistic and highly improbable based on Quadrexx's most recent financial results and were a totally inadequate basis for making the decision to pay dividends.

236 Although the risk section of the First QAM II OM stated that there could be no assurance that Quadrexx would be permitted under applicable corporate law to pay dividends on the QAM II Shares, the Respondents did not seek legal advice with respect to the payment of the June 2011 and December 2011 Dividends or otherwise ensure that the payment of the dividends complied with applicable corporate law. In fact, Sanfelice acknowledged that he was unaware of section 42 of the CBCA.

237 Contrary to the submissions of the Respondents, it was not the responsibility of Quadrexx's auditors to determine whether Quadrexx had the financial capacity, or that it was legally entitled, to use QAM II Proceeds to pay dividends in the absence of a specific retainer to do so.

3. Disclosure Obligations

238 When Sharp sent the First QAM II OM to the various provincial securities regulators, he indicated that the QAM II Offering was proposed to be made pursuant to the prospectus exemption provided by section 2.9 of NI 45-106 (in all provinces other than Ontario) and, potentially, sections 2.3 and 2.10 of NI 45-106 (in all provinces).

239 Form 45-106F2 prescribes the form that must be completed and filed with provincial securities regulations and was the form appended to Sharp's letter. In 2011, paragraph 3 under the heading Instructions for Completing - Form 45-106F2 Offering Memorandum for Non-Qualifying Issuers stated that:

> The issuer may include additional information in the offering memorandum other than that specifically required by the form. An offering memorandum is generally not required to contain the level of detail and extent of disclosure required by a prospectus. Generally, this description should not exceed 2 pages. However, an offering memorandum must provide a prospective purchaser with sufficient information to make an informed investment decision. [Emphasis added.]

240 The investors in QAM II Shares were entitled to rely on the representations by Quadrexx set out in the First QAM II OM and the QAM II Brochure. At no time were existing investors apprised of the use of the QAM II Proceeds to pay dividends to prior investors and neither the First QAM II OM nor the QAM II Brochure was amended to reflect this fact. In addition, Nagy admitted to continuing to sell QAM II Shares in 2012 at approximately the same time as the staggered delivery of the cheques in payment of the December 2011 Dividends without advising prospective investors that there had been delays in the payment of the December 2011 Dividends as the result of Quadrexx's cash flow issues. The diversion of the QAM II Proceeds to a use of which investors and prospective investors had not been informed clearly created an increased financial risk and prejudiced their economic interests.

241 When testifying at the Hearing, both Nagy and Sanfelice acknowledged that the QAM II Proceeds used to pay dividends could not be used by Quadrexx for the growth of its business, as the Respondents had represented to investors. I do not accept the submission by Sanfelice that Quadrexx was not obligated to amend Quadrexx's disclosure documents as the amount of the QAM II Proceeds that was diverted to the payment of dividends was relatively small and did not constitute a material change. I agree with the position of the CRR Branch set out in the CRR Objection in which they suggested, among other things, that it appeared that the disclosure to investors by means of the First QAM II OM and the QAM II Brochure omitted information necessary to prevent the statements set out in such documents from being false or misleading in the circumstances. The accurate disclosure of information is one of the basic tenets of Ontario securities law and is equally applicable to exempt market dealers. There is also no de minimis exception to compliance with the disclosure obligations under Ontario securities law.

242 By using QAM II Proceeds in an undisclosed fashion, the Respondents diminished Quadrexx's ability to remain a viable enterprise and thereby increased the risk of economic loss to investors. The conduct of the Respondents also placed the pecuniary interests of the investors at significantly increased risk.

4. Allegation of Fraud

243 As described in paragraph [19] above, to establish that the Respondents directly or indirectly engaged or participated in an act, practice or course of conduct related to the QAM II Offering that they knew or reasonably ought to have known perpetrated a fraud on QAM II investors in breach of subsection 126.1(1)(b) of the Act, Staff must establish both elements of fraud, namely, the actus reus and mens rea of fraud.

244 The Respondents represented to potential investors that the QAM II Proceeds would be primarily used for working capital which would be employed for business growth, including the expansion of offices, additional agents, business acquisitions and product creation, and, to a lesser extent, debt reduction and the repurchase of certain shares. Nagy and Sanfelice did not, at any time, obtain the approval of the board of directors of Quadrexx to reallocate all or any portion of the QAM II Proceeds to the payment of dividends which, as required by Item 1.3 of the QAM II OM, would have had to be for sound business reasons, as such use would impair Quadrexx's ability to fulfill the representations made to its investors.

245 The Respondents intentionally used the QAM II Proceeds in a manner other than for the purposes represented to investors, so that the First QAM II OM and the QAM II Brochure effectively "conveyed a thoroughly misleading picture of what investors were buying into and what was happening with their money." (Re Capital Alternatives Inc., 2007 ABASC 482 ("Re Brost") at para 61; aff'd at Alberta (Securities Commission) v Brost, 2008 ABCA 326 ("Brost CA"))

246 Similarly, the Respondents acted deceitfully and created and perpetuated a falsehood by diverting the use of the QAM II Proceeds to the payment of dividends rather than to the growth and expansion of the Quadrexx business. The Respondents failed to (i) amend the provisions of the First QAM II OM and the QAM II Brochure to reflect the change in the intended use of the QAM II Proceeds by at least July 1, 2011; and (ii) inform prospective investors of the change in use of the QAM II Proceeds after the Respondents had become aware that they would be needed to pay the December 2011 Dividends.

247 The actus reus of the offence of fraud will be established by proof of the prohibited act, be it an act of deceit, a falsehood or some other fraudulent means and deprivation caused by the prohibited act, which may consist in actual loss or the placing of the victim's pecuniary interests at risk. Furthermore:

> ...where it is alleged that the actus reus of a particular fraud is "other fraudulent means", the existence of such means will be determined by what reasonable people consider to be dishonest dealing. In instances of fraud by deceit or falsehood, it will not be necessary to undertake such an inquiry; all that need to be determined is whether the accused, as a matter of fact, represented that a situation was of a certain character, when, in reality, it was not.

(Théroux at paras 16 and 18)

248 The Commission has previously found payments of new investor money to prior investors to be an act of deceit, falsehood or some other fraudulent means. (Re North American Financial Group (2013), 36 OSCB 12095 at para 310)

249 It is clear that the misuse of the QAM II Proceeds described above deprived Quadrexx of the funds it needed to generate revenue through the growth and expansion of its business. This placed the pecuniary interests of Quadrexx's investors at increased risk. As the evidence discloses, on June 18, 2013, Quadrexx filed an assignment in bankruptcy with no prospect that the investors in QAM II Shares would recover any part of their investments, thereby causing actual loss of the investors' pecuniary interests.

250 Based on the foregoing, I find that the actus reus of fraud has been established by proof of Quadrexx's deceit and the falsehood resulting from its intentional use of new investor money to pay dividends to prior investors. The conduct of the Respondents caused the investors' pecuniary interests to be subject to increased risk which was eventually realized when Quadrexx became bankrupt.

251 Staff led a great deal of evidence at the Hearing for the purpose of establishing the Respondents' mens rea, a significant amount of which was based on the communications between Sanfelice and Pawelek as summarized in paragraphs [195] and following above. The failure of Pawelek and Caruso to have reviewed the Commission's own files relating to Quadrexx before commencing a compliance review may have been consistent with the CRR Branch's policies with respect to such matters, however, it is clearly not a tenable basis for Staff's submission that Sanfelice's failure to advise them of the existence of the QAM II Shares, all of the required filings relating to which had been made with the Commission, was evidence that Sanfelice was intending to mislead the Commission. Similarly, Pawelek's subsequent e-mail messages to Sanfelice relating to Quadrexx's preferred shares were imprecise and lacked clarity and do not provide a reliable basis for concluding that, on the basis of Pawelek's evidence alone, Staff has established mens rea on the part of the Respondents.

252 Notwithstanding the foregoing, the evidence is clear that, from and after July 1, 2011, the date on which the Respondents commenced the transfer of QAM II Proceeds from the QAM II Account to the Quadrexx Corporate Account, the Respondents knew that the QAM II Proceeds were being used, at least in part, for the payment of the June 2011 Dividends and the December 2011 Dividends. This fact, and the fact that the actual payment of dividends had been delayed and staggered given the cash flow problems being experienced by Quadrexx, were not disclosed to prospective investors, who continued to be advised that the QAM II Proceeds would be primarily used for the expansion of Quadrexx's business. In short, investors were not apprised of the resulting altered risk profile of the QAM II Offering.

253 Nagy's assertions during his testimony that he and Sanfelice reasonably believed that Quadrexx would generate sufficient revenue to cover the dividends, notwithstanding Quadrexx's historical results to the contrary, are clearly not an acceptable justification for the diversion of the QAM II Proceeds. As noted by the Supreme Court of Canada in R v Zlatic (1993), 100 DLR (4th) 642 (SCC) ("Zlatic"):

> ...there is nothing in the evidence which negates the natural inference that when a person gambles with funds in which others have a pecuniary interest, he knows that he puts that interest at risk: see Théroux, at pp. 12 and 15 [ante, pp. 634 and 636]. On the contrary, the accused expressly acknowledged that he was aware of the risk.
>
> The foregoing establishes mens rea. It is no defence that the accused believed he would win at the casinos and be able to pay his creditors.
>
> (Zlatic at p 657)

254 In Théroux, the Supreme Court of Canada stated at paragraph 36 that:

> A person who deprives another person of what the latter has should not escape criminal responsibility merely because, according to his moral or her personal code, he or she was doing nothing wrong or because of a sanguine believe that all will come out right in the end. Many frauds are perpetrated by people who think there is nothing wrong in what they are doing or who sincerely believe that their act of placing other people's property at risk will not ultimately result in actual loss to those persons.

255 Based on the foregoing, I find that the mens rea of fraud has been established by proof that the Respondents' had subjective knowledge of their acts of deceit and falsehood and subjective knowledge that such acts could have as a consequence the deprivation of the investors in QAM II Shares.

256 Accordingly, I find that Nagy, Sanfelice and Quadrexx directly or indirectly engaged or participated in an act, practice or course of conduct relating to Quadrexx securities that they knew or reasonably ought to have known perpetrated a fraud on Quadrexx investors in breach of subsection 126.1(1)(b) of the Act and contrary to the public interest.

V. MISAPPROPRIATION OF QSA INVESTOR FUNDS

A. Staff's Allegations

257 Staff alleges that the Respondents perpetrated a fraud on QSA investors by using funds raised from QSA investors to pay Quadrexx more than Quadrexx was entitled to receive for Quadrexx's selling commissions and cost recovery, in a manner inconsistent with the representations made in the QSA offering memoranda and marketing brochures.

258 The Respondents admit that the language included in QSA's offering memoranda and marketing brochures is ambiguous, but deny that their conduct amounts to fraud. The Respondents argue that, at most, their conduct reflects a deficiency in QSA's disclosure, which is not alleged in the Statement of Allegations.

B. QSA Offering

259 QSA was established to provide investors with a return derived from an investment portfolio of U.S. residential mortgage-backed securities which would be managed by Quadrexx or by a sub-advisor retained by Quadrexx. The offering (the "QSA Offering") would be of notional units comprised of 20 non-voting participating Class A Shares of QSA (collectively, the "Class A Shares") having an issue price of $5.00 per share and a promissory note in the principal amount of $900.00 (collectively, the "Notes"), for a total of $1,000 per unit (collectively, the "QSA Units"). The Notes would bear interest at the rate of 13.35% to the note maturity date which would represent an annual rate of return of 12%, not compounded, over the term of the investment based on the aggregate amount invested in the Class A Shares and the Notes. The maximum amount of the QSA Offering that was contemplated was $40 million with a minimum amount of $250,000.

260 Quadrexx was to be responsible for managing the assets of QSA and Quadrexx Residual Income Ltd., a wholly-owned subsidiary of QSA ("Quadrexx Residual"), pursuant to a Management and Distribution Agreement dated as of June 15, 2011. The sub-advisor, Samas Capital LLC, a U.S. based investment management firm ("Samas"), would manage the proceeds of the QSA Offering. Pursuant to Section 8.1.1 of the Investment Management Agreement among Samas, Quadrexx, QSA and Quadrexx Residual dated as of August 18, 2011 (the "Investment Agreement"), 14% of the amount raised through the QSA Offering would be used to pay Quadrexx for agents' commissions, legal expenses, marketing, etc. and the balance of 86% would be loaned by QSA to Quadrexx Residual and invested in the account to be managed by Samas.

C. Use of Proceeds

261 The initial QSA offering memorandum setting out the terms of the QSA Offering was prepared by Nagy and Sharp and dated August 15, 2011 (the "First QSA OM"). The First QSA OM included a chart which described the use of proceeds from the sale of the QSA Units, assuming both the minimum and maximum offerings, net of selling commissions of 10% per unit payable to Quadrexx, and offering costs. The offering costs were stated to be $10,000, assuming the minimum offering, and $1.6 million, assuming the maximum offering. A footnote to the offering costs stated that:

> [QSA] will be responsible for paying 4% of the gross proceeds realized to [Quadrexx] in respect of all legal, accounting, audit, printing, some Directors' compensation, design, marketing, travel and other costs associated with the setting up of [QSA], as well as the other costs of Offering. Any costs in excess of this amount will be borne by [Quadrexx].
>
> (Exhibit 182 at p 9)

262 Although Sharp provided a copy of the First QSA OM to the various provincial Securities Commissions by letter dated September 1, 2011, the First QSA OM was not provided to prospective investors. At about the same time, the initial QSA marketing brochure (the "First QSA Brochure") was distributed to Quadrexx's dealing representatives. The First QSA Brochure stated that the "Total Initial Costs/Fees" would be "14.0% (10% to selling agents, 4% for legal, marketing printing etc.)". (Exhibit 179 at p 1)

263 The First QSA Brochure also stated that there would be no Additional Costs/Fees to QSA and that Quadrexx "covered other structuring costs and will receive nominal interest payments from portfolio holdings". (Exhibit 179 at p 1)

D. Delays Following the First QSA Offering Memorandum

264 After the First QSA OM and First QSA Brochure were drafted, Quadrexx experienced lengthy delays securing the approval of at least one of the two trust companies which would deal with EMD products. There were delays in ensuring that the Class A Shares and Notes would be qualified investments for the purposes of Registered Retirement Savings Plan ("RRSP") and other similar plans.

265 Nagy testified that the process of qualifying the Class A Shares and Notes as registered products entailed additional costs that were not anticipated at the time that the First QSA OM was drafted and that the costs were significantly greater than the Respondents had incurred to launch previous products. Sanfelice testified that the expenses of the QSA Offering in the amount of approximately $187,000 were similar to those incurred in other offerings, such as the DALP Securities in respect of which expenses of $250,000 were incurred.

266 Quadrexx's balance sheet as of March 31, 2012, which was submitted to the CRR Branch as part of Quadrexx's Form 31-103F1 Calculation of Excess Working Capital as at the same date, includes an account receivable in the amount of $187,749 relating to QSA under the heading "Due from Related Parties". When Pawelek inquired about the amount by e-mail message to Sanfelice dated May 15, 2012, Sanfelice replied that the receivable related to start-up costs (legal, structuring, audit and accounting) during the period from August to December 2011 and that payment was expected in August 2012.

267 n a further e-mail message to Pawelek on May 16, 2012 to which Sanfelice attached, among other things, a copy of QSA's unaudited financial statements for the period ended April 30, 2012, Sanfelice clarified the list of expenses to be covered by the 4% charge as follows:

> For Quadrexx Secured Assets (QSA) we expected to have launched May 1st. I have been told that we should launch by June 1st and we expect to have $3-4 million in assets raised in QSA by July 31, 2012. Based on the QSA OM Quadrexx Asset Management is entitled to be reimbursed up to 4% of gross proceeds raised for all legal, accounting, audit, printing, other costs associated with setting up the company and initial costs of the offering.
>
> (Exhibit 55 at p 1)

E. Revised QSA Offering Memoranda

268 Nagy testified that, when preparing QSA's audited financial statements in July 2012, it became apparent that, given Quadrexx's financial circumstances, it was necessary for Quadrexx to recover the costs associated with the QSA Offering as soon as possible. Sanfelice testified that, as the result of Quadrexx's voluntary undertaking to Staff on June 20, 2012 to cease trading in the securities of Quadrexx, QSA was Quadrexx's "main lifeline" for revenues in mid-2012. This also followed Quadrexx's failure to obtain the Commission's approval to complete the MineralFields Transaction.

269 Nagy testified that he and Sanfelice decided to achieve the recovery of the costs associated with the QSA Offering "...by amending the QSA OM to permit Quadrexx to take the $187,000 from the first money raised under the QSA offering rather than simply recovering the costs from the 4 percent fee Quadrexx was to receive." (Hearing Transcript, October 2, 2015 at p 65) To effect the change, Nagy sent Sharp an e-mail message on August 1, 2012, in which he wrote:

> One additional thing [Sanfelice] wanted to clarify more clearly is that we want the 4% one-time initial charge classified as for reimbursement of expenses, marketing and otherwise and an [sic] an extra fee for Quadrexx. We don't want to be accused on use of proceeds hence we want to add this minor clarification to the OM.

(Exhibit 204 at p 3)

270 Nagy acknowledged that his instructing e-mail message to Sharp "may not have been as clear as it could have been. However, based on that instruction, Mr. Sharp took steps to amend the OM, to address the ability of take the $187,000 as a one-time charge off the top from the proceeds raised." Sharp amended the First QSA OM and provided a black-lined version dated August 1, 2012 (the "Second QSA OM") to Nagy and Sanfelice. The Second QSA OM was not provided to prospective investors. (Hearing Transcript, October 2, 2015 at pp 65-66)

271 Only two of the changes reflected in the Second QSA OM are relevant for the purposes of these Reasons. The first such change was to replace the reference to "Offering costs" in the chart relating to the use of proceeds with the words "Organizational and offering costs" (see paragraph [261] above). The second, and more important, change was to replace the text of the footnote relating to such costs with the following (the "OM Footnote"):

> [QSA] will pay 4% of the issue price of the Units ($40 per Unit) to Quadrexx. The first $187,749 so received by Quadrexx shall be treated as the repayment of amounts advanced by Quadrexx to [QSA], and thereafter shall be treated as a one-time management fee to Quadrexx. Out of such repayment and management fee, Quadrexx will be responsible for all of the costs of establishing [QSA], including all legal, audit and accounting fees, for compensating some of [QSA]'s Directors and for marketing the offering of Units. Any costs in excess of this amount will be borne by Quadrexx. [Emphasis added.]

(Exhibit 178 at p 11)

272 When cross-examined by Staff with respect to the interpretation of the revised fee section set out in paragraph [271] above, Nagy acknowledged that the use of proceeds provision did not show the payment of the $187,749 amount as an additional fee (the "Additional Fee"). Nagy also acknowledged that, if only the minimum subscription of $250,000 was achieved, the deduction of the Additional Fee would only leave an amount of approximately $27,000 for investment purposes.

273 During the same cross-examination, Staff suggested to Nagy that what he was really concerned about when he asked Sharp to revise the use of proceeds provision was the possible criticism of Quadrexx for taking a 4% charge when only the amount of the Additional Fee was shown in the financial statements. Nagy responded as follows:

A. No. My intention was to have this being able to recover that from off the top.

Q. Well, that's not what you've set out in your use of proceeds chart, is it, sir?

> A. Yeah, I know. We made the language is [sic] ambiguous and the chart was not done properly.
>
> (Hearing Transcript, October 9, 2015 at p 149)

274 A third offering memorandum dated August 31, 2012 (the "Third QSA OM") was prepared and provided to investors. The use of proceeds provisions of the Third QSA OM, including the OM Footnote, were identical to those found in the Second QSA OM. When cross-examined about his failure to correct the use of proceeds section in the Third QSA OM to reflect the purported deduction of the Additional Fee off the top, Nagy testified that he had made a mistake and it was not intentional.

275 The Third QSA OM was amended to create a fourth offering memorandum dated November 30, 2012 (the "Fourth QSA OM") to reflect the issuance of Class A Shares only in blocks of 100 shares at a price of $5.00 per Class A Share up to a maximum of 150 Class A Share blocks. Nagy explained that the change was required to ensure that QSA had at least 150 shareholders to meet the RRSP eligibility requirements of the Income Tax Act. The use of proceeds provisions of the Fourth QSA OM, including the OM Footnote, were identical to those found in the Second QSA OM and the Third QSA OM.

276 Nagy testified that, by November 30, 2012 (the date on which Nagy certified the Fourth QSA OM), the QSA Offering had raised approximately $321,000 of which $221,024 had been transferred from the QSA accounts to Quadrexx. Nagy acknowledged that the use of proceeds section of the Fourth QSA OM did not reflect the proceeds received to that time, which exceeded the minimum offering set out in the Fourth QSA OM, or the amounts paid to Quadrexx on account of the Additional Fee or otherwise.

277 It should be noted that the revised text of the use of proceeds provision of the Third QSA OM, including the OM Footnote, was also reflected in the description of the Management and Distribution Agreement with Quadrexx in both the Third QSA OM and the Fourth QSA OM. Item 4.2 of the Third QSA OM, which describes QSA's Long Term Debt, states that QSA had borrowed an amount of $187,749, being the amount of the Additional Fee, from Quadrexx, which amount would be repaid out of the proceeds of the QSA Offering. An adjacent chart reflects such amount as evidenced by a promissory note payable on demand, without interest. The comparable provision of the Fourth QSA OM shows only that no amount was outstanding under an unidentified promissory note that was payable on demand, without interest. In other words, it only shows that the promissory note evidencing the purported debt to Quadrexx had been repaid in full.

278 When cross-examined by Staff with respect to the documentation of the purported loan by Quadrexx to QSA, Sanfelice acknowledged that there was no written agreement between Quadrexx and QSA with respect to the repayment of QSA's start-up costs.

279 Recording the QSA start-up costs as a liability was a departure from Quadrexx's previous offerings for which the offering costs were not recorded as liabilities. Nagy and Sanfelice both testified that the decision to record the offering costs as a liability of QSA was made in consultation with QSA's auditor although there was no corroboration of this purported advice. The liability was also reflected in QSA's financial statements for the period ended May 31, 2012 which were attached to the Third QSA OM.

F. Revised QSA Brochures

280 The First QSA Brochure was amended twice, once in September 2012 and once in October 2012 (the "Second QSA Brochure" and the "Third QSA Brochure", respectively, and, collectively with the First QSA Brochure, the "QSA Brochures"). The description of "Total Initial Costs/Fees" in the Second and Third QSA Brochures is identical to the disclosure in the First QSA Brochure, i.e., "14.0% (10% to selling agents, 4% for legal, marketing printing etc.)". There is no reference in the Second and Third QSA Brochures to the Additional Fee or the subject matter of the OM Footnote.

281 Nagy acknowledged when cross-examined that, having relied on whichever of the marketing brochures they reviewed, the initial investors, in particular, would have been unaware that the Additional Amount was being "taken off the top of their investment" and characterized the failure to inform the investors as a mistake. When asked to acknowledge that the behaviour of the Respondents in this regard was deceitful, Nagy replied that it would not be deceitful if the deception was unintended. Sanfelice testified that the failure to refer to the Additional Fee in the QSA Brochures was an oversight on their part.

G. Risk Acknowledgement Form

282 The Risk Acknowledgement Forms attached to the Subscription Agreement of all three QSA investor witnesses does include the identical text of the OM Footnote. However, as noted below, only one of such investors read the provision.

H. QSA Sales and Payments to Quadrexx

283 The distribution of QSA Units took place during the period from August 31 to December 22, 2012 using the Third and Fourth QSA OMs and raised a total of $470,660. The distribution of the Class A Share blocks using the Fourth QSA OM took place between November 29 and December 22, 2012 and raised a total of $30,500. The proceeds from the QSA Offering were never transferred to the investment account which Samas was retained to manage.

284 In October 2012, the Respondents started transferring funds from the QSA bank accounts to Quadrexx. By the end of October 2012, approximately $81,000 of the approximately $109,330 of QSA Offering proceeds raised to that time had been transferred to Quadrexx. By November 30, 2012 (the date on which the Respondents certified the Fourth QSA OM), QSA had collected approximately $327,534 and Quadrexx had paid itself approximately $218,348, or approximately two-thirds of the QSA Offering proceeds raised to that date.

285 Sanfelice acknowledged that, by November 30, 2012, Quadrexx had paid itself the full amount of the Additional Fee and that he was aware of the transfers of funds to Quadrexx made on October 29, 30 and 31, 2012. Sanfelice testified that the transfer of funds "was money off the top, the $187,000, so [Quadrexx] could transfer that at any time." (Hearing Transcript, December 17, 2015 at p 84)

286 By letter dated May 28, 2013, Quadrexx advised the QSA investors that, as Quadrexx would be filing an assignment in bankruptcy, QSA would be dissolved and the funds held in trust would be distributed to them on a pro rata basis, net of all fees. The letter also included the following table:

Total Subscription Amount:

$502,385.64

Total Commission Paid:

$45,100.00

Fee of 4% per Offering Memorandum:

$18,040.00

Fee of $187,476 per Offering Memorandum:

$186,949.00

Net Invested Amount:

$250,896.64

Percentage of Investment Returned versus Investment Amount:

49.94
%

(Exhibit 248)

I. Sanfelice's Compelled Testimony and Subsequent Retractions

287 On January 13, 2013, during his compelled examination by Staff under subsection 13(1) of the Act, Sanfelice was questioned about QSA, among other things. Sanfelice agreed with Staff that, once approximately $4.7 million of the QSA Units had been sold, Quadrexx would have been entitled to take the first $187,749 out of the 4% charge. Sanfelice also stated that QSA had forecasted up to $5.0 million in sales to the end of December 2012 and, as a result, Orlova, who had questioned the payment of the amount up front, agreed to make the $187,749 payment to Quadrexx.

288 When questioned about his response to Orlova during his cross-examination by Staff at the Hearing, Sanfelice testified as follows:

> A. [Orlova] was asking me why 187 upfront and I was explaining to her. And Mr. Nagy and I had made the decision that, because the offering is large, and that this was an extraneous circumstance where Quadrexx had advanced the money over a year, that we would be raising 5 million, you know, in short order.
>
> ...
>
> Q. So you took that money in the expectation that the sales of QSA shares and notes to investors would reach that 4 million or 5 million figure -
>
> A. Yes, yes, because - -
>
> Q. By the end of the year? Or...
>
> A. Yes, because Mr. Nagy mentioned to us that there were several large clients in the wealth management that were very interested in this fund. So there were a couple of million dollars right there.
>
> (Hearing Transcript, December 17, 2015 at pp 104-106)

289 Sanfelice was also asked during his compelled examination whether Quadrexx had been overpaid and that the maximum amount it should have received was 4% of the $600,000 of QSA Units that were sold rather than $4.7 million, the maximum amount of the QSA Offering. Sanfelice replied as follows:

> And we are talking to Samas to give us some money back as well. So, we are -- yes, we are -- but like I said, there were 2 million or 3 million in assets that can be put into this fund. But there was a 90-day redemption period number one, and number two was I am not sure if Miklos [Nagy] has done it yet because he was hesitant with this.
>
> (Hearing Transcript, December 17, 2015 at pp 107-108)

290 During the compelled examination, Sanfelice confirmed that the Additional Fee was taken by Quadrexx in the expectation that the sale of QSA Units would reach $4.0 to $5.0 million and that it was taken "to ease cash flow issues at Quadrexx at the time." When asked about the foregoing answer, Sanfelice testified that: "So, because the MineralField[s] deal was rejected and then we had the undertaking. So, we needed it for working capital for cash flow." (Hearing Transcript, December 17, 2015 at p 107)

291 On the day following his compelled examination, Sanfelice sent an e-mail message to Ryder Gilliland, the colleague of Sharp who attended the examination with him, stating that the pressure of attending the recorded examination with five representatives of the Commission had caused him to be nervous in some instances and, as a result, he incorrectly answered certain questions which he wanted to retract. He then stated that:

> One of the main reasons we updated the Aug 15th OM was to add the $187,749 in fees in the August 31st OM as a start up fee reimbursement for Quadrexx to be paid on the first dollars raised by the QSA fund. This amount of $187,749 was not intended to be included in the management fee of 4%. Based on the QSA forecast for 2012 of $3-5 million out of the gate [Nagy] and I felt comfortable adding this amount in the August 31st OM to be taken on the first dollars raised as it would quickly become a small % of QSA funds raised overall even if we didn't get to the entire $40 million raise. This is what I was attempting to relay in the meeting yesterday with the OSC.
>
> The other thing I was trying to relay yesterday in the OSC meeting was that we are now in discussions with Samas to pay $90k back. This is for obvious reasons with the issues at Quadrexx presently and the monies they owe us we felt it reasonable to ask them to pay 50% of this cost.

(Exhibit 204 at p 56)

292 During his cross-examination by Staff at the Hearing, Sanfelice retracted that part of his compelled evidence in which he agreed that Quadrexx would have been entitled to take the first $187,749 out of the 4% charge, once approximately $4.7 million of QSA Units had been sold. Sanfelice testified that he intended to say that Quadrexx was entitled to take the $187,749 Additional Fee "off the top" as Quadrexx "was raising 5 million in short order." (Hearing Transcript, December 17, 2015 at p 106)

293 Sanfelice also retracted that part of his compelled evidence in which he stated that Samas had agreed to "give us some money back" and testified that Quadrexx had received the full amount of the Additional Fee, but the QSA investors "were only sitting at $600,000 in assets." Sanfelice testified that Quadrexx's sales manager in Alberta had advised them that Samas was receptive to paying $90,000, but there was no written agreement to that effect. Sanfelice also retracted an answer provided during his compelled evidence to the effect that, if QSA was unsuccessful in raising the full amount of $4.7 million, Quadrexx would try to repay the difference between the Additional Fee and 4% of the amount actually raised.

J. Evidence of Investor Witnesses

294 Staff called three witnesses, RL, JS and MS, each of whom had invested in QSA. Both RL and JS testified that they had not read the Risk Acknowledgement Form attached to their QSA Subscription Agreements which incorporated the text of the OM Footnote. MS, who was a dealing representative for Quadrexx and sold QSA Units to both RL and JS, testified that he attended the launch of the product at Quadrexx's Calgary office and used the Second and Third QSA Brochures to market the QSA Units to investors.

295 Sanfelice's counsel objected to much of the evidence of the three QSA investors which he viewed as highly prejudicial given that Staff made no allegations relating to the suitability of the QSA Units as investments or Quadrexx's sales practices. Given the foregoing objection and as the evidence of the QSA investors is of limited relevance to the fraud allegations relating to QSA set out in the Statement of Allegations, I have not relied on such evidence in making the findings that are set out below.

K. Submissions of the Parties

296 Staff submits that none of the Second, Third and Fourth QSA OMs (collectively, the "QSA OMs") provide for the payment of the Additional Fee to Quadrexx out of the initial proceeds from the QSA Offering and in addition to the 4% charge. It is Staff's position that the OM Footnote provided that the Additional Fee was to be paid out of the 4% charge as and when the QSA Units were sold. Staff further submits that, on each occasion that Nagy and Sanfelice certified the Second, Third and Fourth QSA OMs and thereby confirmed that they did not contain a misrepresentation, they had the opportunity to make the required revisions to reflect what they allege was the intended objective of the OM Footnote. Staff also submits that there is no corroboration of Nagy's and Sanfelice's testimony with respect to what they allege were mistakes and oversights in the drafting of the offering memoranda and the QSA Brochures.

297 Staff submits that the testimony of Nagy and Sanfelice is inconsistent with the use of proceeds provisions of the QSA OMs and the Total Initial Costs/Fees and Additional Costs/Fees provisions of the QSA Brochures and that Nagy's and Sanfelice's repeated assertions that the failure of the QSA OMs and QSA Brochures to reflect their purported intended meanings was the result of mistakes and oversight are simply not credible.

298 Staff also submits that Sanfelice's retraction of the evidence he provided under oath during his compelled examination adversely affects his credibility as his compelled testimony contradicts his and Nagy's assertions that they intended to amend the QSA OMs to permit the up-front payment of the Additional Fee to Quadrexx in addition to the 4% charge.

299 On the basis of an analysis undertaken by Lo, Staff submits that QSA overpaid Quadrexx by $185,397, calculated as follows:

Amount Paid to Quadrexx

$254,96
4

Amount Owed to Quadrexx

Sales Commission (10% of proceeds of QSA unit sales)

($47,006)

Cost Recovery (4% of proceeds of QSA unit sales)

($18,826)

Repayment of working capital

($3,675)

Amount of Alleged Overpayment of Quadrexx

$185,39
7

300 Staff submits that the Commission has previously found that using investor funds in a manner contrary to the representations made to investors constitutes the actus reus of fraud. In this regard, Staff relies on Re Pogachar (2012), 35 OSCB 3389 ("Pogachar") at para 96, Re Axcess Automation LLC (2012), 35 OSCB 9019 ("Axcess") at paras 249-269 and Re Lewis (2011), 34 OSCB 11127 ("Lewis") at para 231.

301 Staff submits that, by paying itself approximately $218,893, or approximately two-thirds of the total proceeds received from the QSA Offering at the time, Quadrexx failed to comply with the modified 4% cost recovery provision reflected in the OM Footnote in the Third and Fourth QSA OMs.

302 Staff submits that the misappropriation of proceeds from the QSA Offering without following the 4% cost recovery provisions set out in the Third and Fourth QSA OMs and in a manner contrary to the QSA Brochures were dishonest acts and, together with the deprivation experienced by the investors who recovered less than half of the amounts they invested following Quadrexx's bankruptcy, establish the actus reus of fraud.

303 Finally, Staff submits that the requisite mental elements of mens rea set out in Théroux have been established and that, as the directing minds of Quadrexx, Nagy and Sanfelice knew that they were using the proceeds of the QSA Offering in a manner that was inconsistent with the representations made to investors and that such use would place the investors' funds at risk. In this regard, Staff relies on Pogachar at para 98, Axcess at paras 249-269, Lewis at para 232, and Re New Found Freedom (2012), 35 OSCB 11522 at para 201.

304 The Respondents submit that Quadrexx's receipt of the Additional Fee from the initial proceeds of the QSA Offering satisfied legitimate expenses that had been incurred by Quadrexx in connection with the QSA Offering and were shown as a current liability on QSA's balance sheet. Given the financial condition of Quadrexx at the time, the Respondents decided to recover the QSA start-up costs as soon as possible and amended the First QSA OM prior to the sale of any QSA Units.

305 The Respondents further submit that the First QSA OM was amended so that the Additional Fee would be deducted first from the initial proceeds of the QSA Offering. They admit that the amendment was ambiguous and that mistakes were made, but submit that the amendment was solely intended to permit the recovery of the Additional Fee from the initial QSA proceeds and that they honestly and reasonably believed that they were entitled to do so. The Respondents submit that they had no intention of deceiving investors when they used the proceeds of the QSA Offering to satisfy a liability recorded on the QSA balance sheet, which, they submit, was reviewed and approved by QSA's auditors.

306 The Respondents submit that they made a mistake by failing to revise the First QSA Brochure to reflect the Additional Fee, which they describe as a debt of QSA owing to Quadrexx. The Respondents do, however, point to the Risk Acknowledgement Form signed by investors which includes, under the heading "Distribution Fees and Related Expenses of the Offering", a statement relating to the Additional Fee which is identical to the OM Footnote.

307 Finally, the Respondents deny Staff's submissions relating to the real intention for amending the cost recovery provision of the First QSA OM. They submit that there would have been no reason to amend the First QSA OM if the sole objective was to recover the Additional Fee from the 4% charge being received by Quadrexx on the sale of each QSA Unit. The Respondents further submit that, even though the disclosure relating to the Additional Fee was ambiguous, the deficiency in disclosure does not constitute fraud.

L. Analysis and Finding

1. Representations to Investors

308 It is clear from the evidence that prospective QSA investors were provided with copies of the Third or Fourth QSA OM and not either of the First or the Second QSA OM. As a result, QSA represented to all prospective investors by means of the OM Footnote that:

> [QSA] will pay 4% of the issue price of the Units ($40 per Unit) to Quadrexx. The first $187,749 so received by Quadrexx shall be treated as the repayment of amounts advanced by Quadrexx to [QSA], and thereafter shall be treated as a one-time management fee to Quadrexx. Out of such repayment and management fee, Quadrexx will be responsible for all of the costs of establishing [QSA], including all legal, audit and accounting fees, for compensating some of [QSA]'s Directors and for marketing the offering of Units. Any costs in excess of this amount will be borne by Quadrexx. [Emphasis added.]
>
> (Exhibit 178 at p 11)

309 The Fourth QSA OM was dated November 30, 2012 and certified on the same date by Nagy and Sanfelice on behalf of QSA as containing no misrepresentation. By that date, Quadrexx had already paid itself approximately $221,024 of the approximately $321,000 received by QSA from the QSA Offering at that time, however, no disclosure of that fact was made in the Fourth QSA OM.

310 As noted in paragraph [262] above, the description of "Total Initial Costs/Fees" in the QSA

Brochures is identical, i.e., "14.0% (10% to selling agents, 4% for legal, marketing printing etc.)". As a result, QSA represented to all prospective investors by means of the QSA Brochures, under the heading "Additional Costs/Fees", that the fees would be equal to 14% of the issue price of the QSA Units that were sold and further represented that no additional fees would be payable to Quadrexx.

311 There is no reference in any of the QSA Brochures to the Additional Fee or the subject matter of the OM Footnote. Nagy and Sanfelice testified that their failure to update the representations and disclosure relating to fees in the QSA Brochures, including the payment of the Additional Fee, was the result of mistake and oversight.

312 On the basis of the Risk Acknowledgement Forms signed by each of the QSA investors who testified at the Hearing, it appears that such Forms did include the identical text of the OM Footnote in the use of proceeds provisions of the Third and Fourth QSA OMs. That said, each of the QSA investor witnesses testified that they had not read the Risk Acknowledgement Form or could not recall having done so even though each of them signed their respective Risk Acknowledgement Forms.

2. Meaning of the OM Footnote

313 As noted above, the parties made extensive submissions with respect to the meaning and interpretation of the OM Footnote. It is Staff's submission that, when Sharp amended the First QSA OM, he accurately reflected the instructions he received from Nagy on August 1, 2012 when he drafted the revised text of the OM Footnote (see paragraphs [269] and [271] above). The Respondents submit that (i) the First QSA OM was amended so that the Additional Fee would be deducted first from the initial proceeds of the QSA Offering; (ii) the amount of the Additional Fee was a liability recorded on QSA's balance sheet with the approval of QSA's auditors; and (iii) the Respondents had no intention of deceiving investors.

314 I have considered the plain meaning of the OM Footnote and the extensive evidence relating to the issue and have reached the following conclusions:

(a) The critical clause in the OM Footnote, "The first $187,749 so received by Quadrexx" and the following words "and thereafter" clearly modify the first sentence "[QSA] will pay 4% of the issue price of the Units ($40 per Unit) to Quadrexx". As a result, the OM Footnote clearly stipulates that the first $187,749 received by Quadrexx from the payment by QSA of the 4% charge would be treated as the repayment of the start-up costs relating to QSA by Quadrexx. Thereafter, i.e., after the payment of $187,749, the remaining payments by QSA of the 4% charge would be treated as the payment of a one-time management fee to Quadrexx. In my view, the text of the OM Footnote is consistent with the written instructions provided by Nagy to Sharp.

(b) The text of the OM Footnote is also consistent with the QSA Brochures which state that no fees would be paid by QSA in addition to the 10% commission to selling agents and 4% of the issue price of the QSA Units. I do not find credible Nagy's and Sanfelice's testimony that their purported failure to amend the QSA Brochures to reflect the use of the proceeds of the QSA Offering to repay the Additional Fee and then to pay an additional 4% of the issue price of the QSA Units was the result of multiple mistakes and instances of oversight. Rather, I believe that attributing the disclosure failures to mistakes and oversight was nothing more than a convenient stratagem developed after the fact to conceal the reality that disclosing the diversion of the initial proceeds of the QSA Offering to the payment of the Additional Fee with a minimum offering of only $250,000 would have likely precluded any further sales of the QSA Units to properly informed investors.

(c) Sanfelice's evidence during his compelled examination relating to the payment of the Additional Fee was consistent with my conclusion that the OM Footnote accurately reflected Nagy's instructions to Sharp and Sanfelice's and Nagy's objectives at the time. His retraction of his evidence in this regard does raise the issue of his credibility given that his compelled evidence, but not his testimony at the Hearing, is consistent with the other evidence in this matter.

(d) The QSA Brochures make no reference to the repayment of a debt, i.e., the amount of the Additional Fee, from the initial proceeds of the QSA Offering in addition to the 4% charge.

(e) The imposition of a debt repayment obligation to be paid from the initial proceeds of the QSA Offering prior to the payment of the 4% charge would not have been a "minor clarification to the OM" and would have likely raised issues in Sharp's mind. That was the case in 2008, when Nagy was advised by Sharp that he could not use the initial proceeds relating to the CHW offering to pay commissions to agents if there was a minimum offering (see paragraph [47] above).

(f) Giving effect to the Respondents' proposed interpretation of the OM Footnote would have produced an unconscionable economic outcome for QSA investors in the event that only the minimum amount of the offering, namely, $250,000, was achieved thereby leaving approximately $27,000 for investment purposes. This would be particularly true for eligible investors 44 who, as noted by Sharp in a message to Nagy relating to the CHW offering, are a significantly less sophisticated class of investors (see paragraph [46] above).

(g) The timing and amounts of the transfers of funds from QSA to Quadrexx were far more consistent with Quadrexx's need for cash flow than the repayment of amounts due and payable from, and to the extent of, the 4% charge.

3. Other Factors

315 In the Respondents' Written Submissions, the Respondents argue that, although they consistently acknowledge that the language in the QSA OMs is ambiguous and that mistakes were made, other parts of the QSA OMs were entirely consistent with the position taken by the Respondents. In this regard, they submit that the table under the heading "Long Term Debt" refers to the amount of the Additional Fee "as a debt payable on demand, and makes no mention of any amount of the debt being outstanding assuming the minimum offering of $250,000." I reject the submission as the only offering memorandum that shows a nil balance is the Fourth QSA OM dated November 30, 2012, by which date, Quadrexx had paid itself approximately $218,348, which exceeded the amount of the Additional Fee. In other words, there was a nil balance as the amount had been fully paid (see paragraph [285]).

316 The Respondents also submit that there was no need to amend the 4% cost recovery provision for the sole purpose of confirming that it could be used to pay the Additional Fee. Staff submits in response, and I agree, that the change by means of the OM Footnote removed any uncertainty as to Quadrexx's entitlement to receive 4% of the issue price of all QSA Units even if Quadrexx's costs did not exceed the amount of the Additional Fee. In fact, Staff's response is consistent with the last sentence of Nagy's e-mail to Sharp dated August 1, 2012 in which he stated that "We don't want to be accused on use of proceed hence we want to add this minor clarification to the OM." (Exhibit 204 at p 3)

4. Allegation of Fraud

317 As described in paragraph [19] above, to establish that the Respondents directly or indirectly engaged or participated in an act, practice or course of conduct related to the QSA Offering that they knew or reasonably ought to have known perpetrated a fraud on QSA investors in breach of subsection 126.1(1)(b) of the Act, Staff must establish both elements of fraud, namely, the actus reus and mens rea of fraud.

318 The Respondents represented to the QSA investors by means of the Third and Fourth QSA OMs and the QSA Brochures that the proceeds of the QSA Offering would be subject to selling commissions of 10% per QSA Unit and organizational and offering costs equal to 4% of the issue price of the QSA Units and that the net proceeds of the QSA Offering would be invested in a portfolio of U.S. residential mortgage-backed securities.

319 During the period from October 28 to November 30, 2012, Quadrexx transferred to itself from QSA's accounts approximately $218,893. This amount represented approximately two-thirds of the total proceeds from the QSA Offering received to that date and exceeded the amount which Quadrexx was entitled to receive under the terms of the Third or Fourth QSA OM by at least $185,397.

320 It is clear from the evidence that, by October 2012, Quadrexx was in serious financial distress and the proceeds of the QSA Offering were the only new source of funds available to Quadrexx. In my view, the evidence, which is summarized above, establishes beyond a balance of probabilities, that Nagy and Sanfelice determined that they could divert the initial proceeds from the QSA Offering to repay Quadrexx for the start-up costs relating to the QSA Offering and justify the diversion on the basis of the text of the OM Footnote. They then transferred such proceeds from QSA to Quadrexx as and when required to meet Quadrexx's cash flow requirements while continuing to market the QSA Units without advising either existing or prospective investors of that diversion of funds.

321 The testimony of Nagy and Sanfelice to the effect that the OM Footnote was intended to entitle Quadrexx to receive the Additional Fee prior to the intended use of the proceeds of the QSA Offering (and in addition to the 4% charge) is not consistent with Nagy's instructions to his counsel or with any of the written disclosure documents and representations to investors. In short, Nagy's and Sanfelice's testimony in this regard and their assertions that their failure to amend the QSA OMs and the QSA Brochures to reflect their purported interpretation of the OM Footnote was attributable to mistakes and oversight are simply not credible.

322 It follows from the foregoing and I find that, on the basis of the written representations made to QSA investors by Quadrexx pursuant to the Third and Fourth QSA OMs and the QSA Brochures, Quadrexx was only entitled to receive its share of the 10% selling commission and 4% of the issue price of the QSA Units as set out in the Third and Fourth QSA OMs and the QSA Brochures. Accordingly, the payments to Quadrexx from QSA's accounts of amounts that exceeded its entitlement to sales commissions and 4% of the issue price of the QSA Units were made by the Respondents in a deceitful and dishonest manner.

323 The net proceeds of the QSA Offering were never transferred to the investment account which Samas was retained to manage and were returned to the QSA investors following the bankruptcy of Quadrexx. As a result of the fees and expenses that had been paid to Quadrexx and others, the QSA investors lost more than 50% of the amounts that they invested in QSA Units and thereby suffered significant deprivation.

324 As the Respondents intentionally used the QSA proceeds in a manner other than for the purposes represented to investors, the Third and Fourth QSA OMs and the QSA Brochures effectively "conveyed a thoroughly misleading picture of what investors were buying into and what was happening with their money." (Re Brost at para 61; aff'd at Brost CA)

325 Based on the foregoing, I find that the actus reus of fraud has been established by proof of an act of deceit, a falsehood or other fraudulent means which caused the QSA investors to incur serious financial losses.

326 As noted in paragraph [22] above, to establish the mens rea of fraud, Staff must prove that the Respondents knowingly undertook the acts which constituted the falsehood, deceit or other fraudulent means and that the Respondents knew that deprivation could result from such conduct.

327 Nagy and Sanfelice certified that the Third and Fourth QSA OMs did not contain a misrepresentation. Given the fact that Nagy and Sanfelice were instrumental in drafting the Third and Fourth QSA OMs and the QSA Brochures, it is simply not credible that Nagy and Sanfelice were unaware that the written representations provided to investors misrepresented the use of proceeds which is clearly one of the most important pieces of information provided to investors.

328 The failure of the Respondents to disclose the payment of the Additional Fee from the initial proceeds of the QSA Offering was egregious given that, at the very least, the payment of such amount was not contingent on a minimum level of subscriptions that would far exceed the amount of the Additional Fee. In fact, by November 30, 2012, only $109,186 remained for investment purposes after Quadrexx had paid itself approximately two-thirds of the funds raised from the QSA Offering to that date, a fact that would have been of considerable importance to existing and prospective investors.

329 Nagy and Sanfelice were fully aware that their attempts to establish successful ventures in the exempt market had achieved mixed to very poor results and that Quadrexx was continuing to incur significant monthly operating losses, as it had almost from its inception. Under the circumstances, their purported belief that the QSA Offering would be successful was unrealistic and unreasonable. As noted in Théroux:

> A person who deprives another person of what the latter has should not escape criminal responsibility merely because, according to his moral or her personal code, he or she was doing nothing wrong or because of a sanguine belief that all will come out right in the end. Many frauds are perpetrated by people who think there is nothing wrong in what they are doing or who sincerely believe that their act of placing other people's property at risk will not ultimately result in actual loss to those persons.
>
> (Théroux at para 36)

330 I am satisfied, beyond a balance of probabilities, that, on the basis of the evidence including, in particular, their own testimony and the matters summarized in paragraph [314] above, Nagy and

Sanfelice had subjective knowledge that they were deceiving the QSA investors and that they also had subjective knowledge that their deceit and falsehoods were placing the investors' pecuniary interests at serious and increased risk.

331 Accordingly, I find that Nagy, Sanfelice, Quadrexx and QSA directly or indirectly engaged or participated in an act, practice or course of conduct relating to QSA securities that they knew or reasonably ought to have known perpetrated a fraud on QSA investors in breach of subsection 126.1(1)(b) of the Act and contrary to the public interest.

VI. MAINTENANCE AND REPORTING OF EXCESS WORKING CAPITAL

A. Staff's Allegations

332 As set out in Section V of these Reasons, Staff alleges that, commencing in October 2012, Quadrexx began to pay itself fees from the initial proceeds of the QSA Offering which exceeded the amount of fees to which it was entitled. Staff further alleges that the excess payments inflated Quadrexx's cash position and that, if Quadrexx had only taken the fees to which it was entitled, Quadrexx's excess working capital would have been below zero by October 31, 2012.

333 As Quadrexx did not notify the Commission that its excess working capital was less than zero until January 14, 2013, Staff alleges that Quadrexx was in breach of subsections 12.1(1) and (2) of NI 31-103 during the period from October 31, 2012 to January 14, 2013.

B. Working Capital Obligation

334 Section 12.1 of NI 31-103 provides that:

> (1) If, at any time, the excess working capital of a registered firm, as calculated using Form 31-103F1 Calculation of Excess Working Capital, is less than zero, the registered firm must notify the regulator as soon as possible.
>
> (2) A registered firm must ensure that its excess working capital, as calculated using Form 31-103F1 Calculation of Excess Working Capital, is not less than zero for 2 consecutive days.

C. Submissions of the Parties

335 Staff submits that maintaining adequate working capital is a basic obligation of continuing registration as solvency is one of the three pillars of suitability for registration. However, Staff concedes that, if I conclude that Quadrexx was entitled to take the Additional Fee out of the first proceeds of the QSA Offering, Staff's allegation that Quadrexx had a working capital deficiency by October 31, 2012 and failed to notify the Commission would fail.

336 Sanfelice testified that, even if Quadrexx had not taken the Additional Fee from the initial proceeds of the QSA Offering, the amount was recorded as a current liability on the audited financial statements of QSA for the period from June 15, 2011 to May 31, 2012 and as a current asset on Quadrexx's balance sheet. Accordingly, in Sanfelice's submission, even if the Additional Fee had not been paid by QSA, Quadrexx would have been entitled to continue to reflect the amount receivable from QSA as a current asset which would have been included in the calculation of excess working capital resulting in a positive amount of excess working capital. Sanfelice also testified that the financial statements of QSA reflecting the Additional Fee as a liability had been audited by QSA's external auditors who had not, according to Sanfelice, raised any issue with respect to the matter.

337 The Respondents submit that, as Quadrexx was entitled to the payment of the Additional Fee from the initial proceeds of the QSA Offering, there was no working capital deficiency until December 31, 2012, at which time Quadrexx promptly reported the deficiency to the Commission.

338 Staff submits that Quadrexx's excess working capital calculations should be adjusted in the manner reflected in the "Adjusted Form 31-103F1 Calculation of Excess Working Capital of Quadrexx Assets Management Inc. for the months ended October, November and December 2012" which was prepared by Lo and entered into evidence as Exhibit 167 (the "Adjusted Calculation"). The principal adjustments reflected in the Adjusted Calculation were the deduction of the amount of the QSA receivable at the time and the amount by which the 4% charge had been overpaid. Lo testified that, because the QSA receivable was not readily convertible into cash as required by Form 31-103F1, it could not be included as a current asset. With respect to the overpayment of the management fee, Lo testified that Quadrexx was paid $49,350 in October 2012, but was only entitled to receive $4,373, resulting in an overpayment of $44,977. The two adjustments, and the effect of two smaller adjustments, resulted in an adjusted working capital deficiency of $161,956 as of October 30, 2012.

D. Analysis and Finding

339 The issue of the inclusion of receivables in working capital calculations has been addressed in a number of Commission Staff Notices. For instance, in September 2011, a Commission Staff Notice expressed the following concern about accounts receivables, particularly from related parties, being improperly included in current assets when the receivables were not readily convertible into cash:

> When calculating their excess working capital, registered firms should exclude any current assets that are not readily convertible into cash, such as prepaid expenses and security deposits with service providers. We also have concerns with firms that include accounts receivables, especially from related parties, that are not readily convertible to cash. Any receivables that are not able to be converted to cash in a prompt and timely manner should be excluded from the

excess working capital calculation.

> ... Registrants should review items that are included in current assets on Line 1 of Form 31-103F1 to identify those that are not readily convertible into cash, and deduct these items on Line 2 of the form.
>
> (OSC Staff Notice 33-736 - 2011 Annual Summary Report for Dealers, Advisers and Investment Fund Managers, 34 OSCB 9750)

340 It is clear from the evidence that there was no written agreement between Quadrexx and QSA with respect to the payment by QSA of the offering costs incurred by Quadrexx in the amount of the Additional Fee. As noted in paragraph [336] above, the amount of the Additional Fee was recorded as a current liability on QSA's audited financial statements and as a current asset on Quadrexx's balance sheet. Sanfelice testified that, as a current liability of QSA, the amount was payable within one year although, as noted above in these Reasons, the QSA OMs listed the amount as long term debt evidenced by a promissory note, payable on demand.

341 Lo's evidence was that the amount of the Additional Fee owing as at October 31, 2012 and the overpayment of the 4% charge should not have been included by Quadrexx in the calculation of excess working capital. Given my finding in paragraph [322] above that the Additional Fee was payable out of the amount of the 4% charge received by Quadrexx and not as and when required by Quadrexx, as determined by Nagy and Sanfelice, I accept Lo's evidence which was not seriously contested by the Respondents. As a consequence, I find that (i) Quadrexx was capital deficient as at October 31, 2012; (ii) Quadrexx's excess working capital was less than zero for two consecutive days; and (iii) Quadrexx failed to notify the Commission, contrary to subsections 12.1(1) and (2) of NI 31-103.

VII. LOAN BY DALP TO QUADREXX

A. Staff's Allegations

342 Staff alleges that, on December 1, 2008, Quadrexx transferred $200,000 from DALP's bank account to CHW's bank account. On the same day, CHW transferred $170,000 to Quadrexx which recorded the transfer in its accounting records as a loan from CHW. Staff further alleges that, based on CHW's bank balance on December 1, 2008, it would not have been capable of making the loan to Quadrexx without having previously received $200,000 from DALP.

343 Staff alleges that, as the portfolio manager of DALP, Quadrexx knowingly caused DALP to lend $170,000 to Quadrexx in breach of subsection 118(2)(c) of the Act as in effect in 2008 and contrary to the public interest.

B. Prohibited Loans by Investment Portfolios to Portfolio Managers

344 Portfolio managers are prohibited from knowingly causing any investment portfolio they manage to make loans to the portfolio manager. In 2008, subsection 118(2)(c) of the Act in effect at the time provided that:

> (2) The portfolio manager shall not knowingly cause any investment portfolio managed by it to,
>
> ...
>
> (c) make a loan to a responsible person or an associate of a responsible person or the portfolio manager.
>
> (Securities Act, RSO 1990, c S.5, s 118, as repealed by the Budget Measures Act, 2009, SO 2009, c 18, Schedule 26, s 15)

345 The term "responsible person", which appears in subsection 118(2)(c) of the Act, was defined for the purposes of the section by subsection 118(1) of the Act as follows:

> "responsible person" means a portfolio manager and every individual who is a partner, director or officer of a portfolio manager together with every affiliate of a portfolio manager and every individual who is a director, officer or employee of such affiliate or who is an employee of the portfolio manager, if the affiliate or the individual participates in the formulation of, or has access prior to implementation to investment decisions made on behalf of or the advice given to the client of the portfolio manager.

C. Submissions of the Parties

346 Staff submits that, prior to receiving the transfer from DALP of $200,000 on December 1, 2008, CHW's bank account balance was $13,550.26 and the balance in Quadrexx's bank account prior to receipt of the $170,000 from CHW was $19,191.54. Accordingly, without the receipt of the $200,000 transfer from DALP, CHW would not have had sufficient funds to lend $170,000 to Quadrexx.

347 Staff submits that Quadrexx used the proceeds of the loan from CHW to make a final loan repayment of $90,000 to Sanfelice and to make a payment of $78,687.50 as the first instalment due by Quadrexx in connection with another investment.

348 Staff submits that the former subsection 118(2)(c) of the Act prohibits Quadrexx, as portfolio manager, from knowingly causing DALP, an investment portfolio it manages, from making a loan to Quadrexx, as portfolio manager.

349 Staff also submits that the indirect loan from DALP, as an investment portfolio, to Quadrexx, its investment advisor, through CHW is the type of self-dealing conduct prohibited by the former subsection 118(2)(c) of the Act. Staff argues that, as portfolio manager, Quadrexx should not be permitted to accept a loan through an intermediary when the source of the loan is investor monies managed by Quadrexx.

350 Nagy testified that he saw no conflict or potential conflict arising from the loan by DALP to Quadrexx because he was "100 percent sure the loan will be paid back" (Hearing Transcript, October 5, 2015 at p 49). Nagy also testified that, at the time, he may not have been aware that the Act prohibited portfolio managers from borrowing from assets that it was managing. Sanfelice testified that the loan was repaid and that he did not believe that the loan breached the Act.

351 The Respondents submit that the provision by DALP of the $200,000 loan to CHW was specifically contemplated in the First and Second DALP OMs in which the possible investment by DALP in CHW of additional amounts by way of equity or debt is expressly contemplated. They also submit that the loan from DALP to CHW was part of a series of loans by DALP to CHW that were fully documented. Finally, they submit that the loan by CHW to Quadrexx in the amount of $170,000 did not constitute a loan prohibited by the former subsection 118(2)(c) of the Act as CHW was not an investment portfolio managed by Quadrexx.

D. Analysis and Finding

352 The principal role of a portfolio manager is to make investment decisions with respect to fund assets. As the Commission stated in Re Crown Hill Capital Corp. (2013), 36 OSCB 8721 ("Crown Hill"):

> Section 118 of the Act was intended to prevent self-dealing transactions between a portfolio manager and the fund it manages. A portfolio manager's principal role is to make investments of fund assets. Among other things, section 118 of the Act prevented a portfolio manager from making a decision to invest fund assets, including by way of loan, in an affiliate of the portfolio manager if that affiliate participated in or had access prior to implementation to investment decisions made by the portfolio manager.
>
> (Crown Hill at para 358)

353 In Crown Hill, the Commission determined that the appointment of a third party to act as portfolio manager in connection with a proposed loan transaction was designed to avoid the application of former section 118 of the Act and that the decision by the new portfolio manager to make the loan was not an independent investment decision. The Commission concluded that the entering into of the loan in the foregoing circumstances was contrary to and breached the respondent's duty to act in good faith and in the best interests of the investment fund, contrary to section 116(a) of the Act.

354 Although the Respondents' submission that the provision by DALP of the $200,000 loan to CHW was specifically contemplated in the First and Second DALP OMs is not entirely accurate, the First and Second DALP OMs do contemplate that additional amounts would be invested by way of debt or equity as its investment advisor, Quadrexx, may determine. However, the First and Second DALP OMs also state that such additional funds "will permit CHW to plan and execute on a major expansion plan" and make no reference to the making of loans with such additional funds. (Exhibit 95 at p 8)

355 The fact that the First and Second DALP OMs contemplated additional investments by way of debt did not, and could not, absolve DALP from complying with former section 118 of the Act. That said, in the absence of any evidence that the loan by DALP to CHW was made for a legitimate business purpose and given that the loan by CHW to Quadrexx was not made for the purpose of permitting CHW to plan and execute on a major expansion plan, I can only conclude that the initial loan by DALP to CHW was made for the sole purpose of avoiding the application of former section 118 of the Act.

356 In its written reply submissions, Staff submits that, by causing CHW, an asset within DALP's portfolio, to make the loan to Quadrexx of $170,000 at a time that Quadrexx was the investment advisor, Quadrexx and Sanfelice, as Quadrexx's CCO and as a person who benefitted from the loan, engaged in a prohibited loan. Staff does not, however, cite any authority for the proposition that I may look through the transaction and treat the two loans as a single transaction that was prohibited by former subsection 118(2)(c) of the Act.

357 As Quadrexx, in its capacity as portfolio manager, did not knowingly cause the investment portfolio it managed to make a loan to Quadrexx for the foregoing reasons, I am unable to find a breach of former section 118(2)(c) of the Act. I do, however, find that, having undertaken a loan transaction which amounted to self-dealing by a portfolio manager and which I have concluded was structured for the purpose of avoiding the application of former section 118(2)(c) of the Act, Quadrexx acted contrary to the public interest.

VIII. FAILURE BY QUADREXX TO DEAL FAIRLY, HONESTLY AND IN GOOD FAITH WITH ITS CLIENTS

A. Staff's Allegations

358 Staff alleges that Quadrexx sold DALP Securities, QAM II Shares and QSA Units with knowledge of the facts described in Sections III, IV and V of these Reasons without disclosing those facts to investors. As a result, Staff alleges that, as a registrant, Quadrexx failed to deal fairly, honestly and in good faith with its clients, in breach of section 2.1 of OSC Rule 31-505 which provides that:

> (1) A registered dealer or adviser shall deal fairly, honestly and in good faith with its clients.
>
> (2) A representative of a registered dealer or a registered adviser shall deal fairly, honestly and in good faith with his or her clients.

B. Submissions of the Parties

359 As the phrase "fairly, honestly and in good faith" is not defined in the Act, Staff points to the following definitions of "fairly" and "honest" found in Webster's Encyclopaedic Dictionary and the definition of "good faith" found in Black's Law Dictionary.

> Fairly: in a just and equitable manner;
>
> Honest: never deceiving, stealing or taking advantage of the trust of others; sincere, truthful; and
>
> Good faith: a state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage.

360 Staff submits that, in addition to its allegations of fraud, Quadrexx's:

(a) Failure to disclose important information to DALP investors;

(b) Conduct in raising funds in connection with the QAM II Offering purportedly to carry out its expansion plans when, in fact, QAM II Proceeds were used, or had been used, in whole or in part, to pay dividends to Quadrexx investors; and

(c) Conduct in raising funds in connection with the QSA Offering that were subject to a 14% cap on fees when, in fact, Quadrexx paid itself an up-front fee of $187,749 in addition to the 14% fee;

constituted a breach of Quadrexx's obligation as a registrant to deal fairly, honestly and in good faith with its clients.

361 Staff also submits that, as Nagy and Sanfelice were the directing minds of Quadrexx during the Material Time, Quadrexx had knowledge of the matters referred to above by virtue of Nagy's and Sanfelice's knowledge.

362 The Respondents' submit that, given their position that the allegations of fraud against them are unfounded, there is no basis for the Commission to find that the Respondents breached their duties to deal fairly, honestly and in good faith with their clients.

C. Analysis and Finding

363 In Re Norshield Asset Management (Canada) Ltd. (2010), 33 OSCB 7171, the Commission found that two registrants breached their duties under section 2.1 of Rule 31-505 when they communicated information to investors which was based on artificially inflated net asset values and engaged in transactions that amounted to giving preference to particular redemption requests over others. As stated by the Commission at paragraph 79, "The duty to deal fairly, honestly and in good faith goes to the heart of what securities regulation is about and a breach of this obligation is especially serious."

364 Although the terms are not defined, the Commission has previously held that the words "honestly" and "in good faith" can be applied to the conduct of respondents using the ordinary, every-day meaning of the words. See in this regard, paragraph [359] above.

365 Both Nagy, as Quadrexx's UDP, and Sanfelice, as Quadrexx's CCO, testified that they understood Quadrexx's duty to deal fairly, honestly and in good faith as required by section 2.1 of Rule 31-505. Quadrexx's duty was also expressly stated in section 2 of Quadrexx's Policies and Procedures Manual.

366 It is clear from the evidence, which is summarized in detail in these Reasons, that relying on the ordinary, every-day meaning of the phrase "fairly, honestly and in good faith", the Respondents, in each of the matters summarized in Sections III, IV and V of these Reasons (i) did not deal with investors justly or in an equitable manner; (ii) deceived investors and took advantage of their trust; (iii) were not faithful in discharging their contractual and legal duties to investors; (iv) did not observe reasonable commercial standards of fair dealing; and (v) defrauded investors and took unconscionable advantage of them.

367 Accordingly, I find that Quadrexx failed to deal fairly, honestly and in good faith with its clients in breach of subsection 2.1(1) of Rule 31-505.

IX. FAILURE BY NAGY AND SANFELICE TO FULFILL THEIR RESPONSIBILITIES AS UDP AND CCO OF QUADREXX

A. Staff's Allegations

368 Staff alleges that, as the UDP of Quadrexx, Nagy had an obligation pursuant to section 5.1 of NI 31-103 to supervise the activities of Quadrexx that were directed towards ensuring compliance with securities legislation by Quadrexx and individuals acting on its behalf and an obligation to promote compliance by them with securities legislation. Staff further alleges that Nagy breached his foregoing obligations as a result of his conduct referred to in these Reasons and also acted contrary to the public interest.

369 Staff alleges that Sanfelice, as the CCO of Quadrexx from December 3, 2007 to May 15, 2013, had monitoring and reporting obligations in connection with assessing and ensuring Quadrexx's compliance with securities legislation pursuant to subsection 1.3(1) of OSC Rule 31-505, before September 28, 2009, and pursuant to section 5.2 of NI 31-103 on and after September 28, 2009. Staff further alleges that Sanfelice breached his foregoing obligations as a result of his conduct referred to in these Reasons and also acted contrary to the public interest.

B. Nagy's Obligations as Ultimate Designated Person

370 Pursuant to section 11.2 of NI 31-103, a registered firm is required to designate an individual who is registered under securities legislation and is either the chief executive officer, the sole proprietor or the officer in charge of a division, in the category of UDP to perform the functions described in section 5.1 of NI 31-103, which provides as follows:

> 5.1 Responsibilities of the ultimate designated person - The ultimate designated person of a registered firm must do all of the following:
>
> (a) supervise the activities of the firm that are directed towards ensuring compliance with securities legislation by the firm and each individual acting on the firm's behalf;
>
> (b) promote compliance by the firm, and individuals acting on its behalf, with securities legislation.

371 Nagy was registered as the UDP of Quadrexx from December 18, 2009 to May 15, 2013. Accordingly, his actions prior to December 18, 2009, which included dealings with the DALP Securities and the loan from DALP to Quadrexx through CHW, cannot be considered in determining whether Nagy breached his obligations as the UDP.

372 Nagy updated Quadrexx's Policies and Procedures Manual, which provided that the UDP was responsible for monitoring Quadrexx's due diligence procedures and sustaining ethical and professional standards on a continuous basis. In addition, the UDP was expressly responsible for ensuring that appropriate internal controls were in place and that Quadrexx was in compliance with supervisory and regulatory guidance. The UDP's supervisory responsibilities were to include not only a review of policies and procedures, but also a review of client files and the sampling of accounts. The UDP had the right to access all documentation related to client accounts.

373 Nagy testified that he understood his responsibilities as the UDP and also agreed that one of his responsibilities as the UDP was to ensure that marketing brochures were accurate.

C. Sanfelice's Obligations as Chief Compliance Officer

374 Since September 28, 2009, the responsibilities of a CCO have been listed in section 5.2 of NI 31-103 and are as follows:

> 5.2 Responsibilities of the chief compliance officer - The chief compliance officer of a registered firm must do all of the following:
>
> (a) establish and maintain policies and procedures for assessing compliance by the firm, and individuals acting on its behalf, with securities legislation;
>
> (b) monitor and assess compliance by the firm, and individuals acting on its behalf, with securities legislation;
>
> (c) report to the ultimate designated person of the firm as soon as possible if the chief compliance officer becomes aware of any circumstances indicating that the firm, or any individual acting on its behalf, may be in non-compliance with securities legislation and any of the following apply:
>
> (i) the non-compliance creates, in the opinion of a reasonable person, a risk of harm to a client;
>
> (ii) the non-compliance creates, in the opinion of a reasonable person, a risk of harm to the capital markets;
>
> (iii) the non-compliance is part of a pattern of non-compliance;
>
> (d) submit an annual report to the firm's board of directors, or individuals acting in a similar capacity for the firm, for the purpose of assessing compliance by the firm,

and individuals acting on its behalf, with securities legislation.

375 For the period from July 2008 to September 27, 2009, the CCO obligations were set out in subsection 1.3(1) of OSC Rule 31-105 which provided as follows:

> (a) A registered dealer shall designate a registered partner or officer as the compliance officer who is responsible for discharging the obligations of the registered dealer under Ontario securities law.
>
> (b) The person designated under paragraph (a) by a registered dealer shall also be responsible for opening each new account, supervising trades made for or with each client or, if a branch manager is designated under subsection 1.4(1), for supervising the branch manager's conduct of the activities specified in subsection 1.4(2).
>
> (c) Despite paragraphs (a) and (b), the designated compliance officer may delegate supervisory functions to an individual who reports to the compliance officer and who meets the proficiency requirements under Rule 31-502 Proficiency Requirements for Registrants for a salesperson in the same category of registration as the dealer that has designated the compliance officer.
>
> (d) An applicant for registration or reinstatement of registration as a dealer shall deliver to the Commission, with the application, written notice of the name of the person proposed to be designated under paragraph (a).

376 Sanfelice was the CCO of Quadrexx from December 3, 2007 to May 15, 2013. In that period, pursuant to OSC Rule 31-505, before September 28, 2009, and pursuant to NI 31-103 thereafter, Sanfelice had monitoring and reporting obligations in connection with assessing and ensuring Quadrexx's compliance with securities legislation.

D. Submissions of the Parties

377 Staff submits that Nagy's knowledge and participation in the following demonstrate Nagy's failure to comply with his obligations as the UDP of Quadrexx:

> (a) The use of QAM II Proceeds, in whole or in part, to pay dividends to QAM I and QAM II investors;
>
> (b) The non-disclosure to QAM II investors that QAM II Proceeds would in fact be

used, in whole or in part, to pay dividends to QAM I and QAM II investors;

(c) The taking by Quadrexx of QSA investor monies above the permitted fees referred to in the QSA OMs and the QSA Brochures;

(d) The non-disclosure to QSA investors of Quadrexx's intention to take fees from QSA investor monies beyond the fees disclosed in the QSA OMs and the QSA Brochures; and/or

(e) The failure to properly identify and notify the Commission of Quadrexx's excess working capital deficiency as at October 31, 2012.

378 Staff submits that Sanfelice's knowledge and participation in the following demonstrate Sanfelice's failure to comply with his obligations as the CCO of Quadrexx:

(a) The use of QAM II Proceeds, in whole or in part, to pay dividends to QAM I and QAM II investors;

(b) The non-disclosure to QAM II investors that QAM II Proceeds would in fact be used, in whole or in part, to pay dividends to QAM I and QAM II investors;

(c) The taking by Quadrexx of QSA investor monies above the permitted fees referred to in the QSA OMs and the QSA Brochures;

(d) The non-disclosure to QSA investors of Quadrexx's intention to take fees from QSA investor monies beyond the fees disclosed in the QSA OMs and the QSA Brochures;

(e) The failure to properly identify and notify the Commission of Quadrexx's excess working capital deficiency as at October 31, 2012;

(f) The engagement of Deloitte by CHW to prepare a valuation of CHW, the termination of Deloitte because Deloitte's anticipated estimate was well below $2.65 million, the retaining of a second valuator, the increase in the second set of CHW forecasts given to the second valuator and the non-disclosure to DALP investors of this information; and/or

(g) The prohibited loan provided to Quadrexx in December 2001 from DALP investor funds.

379 The Respondents deny the alleged breaches and submit that none of the alleged deficiencies purportedly identified by Staff during the 2011 Compliance Review form any part of Staff's allegations in the enforcement proceedings commenced in January 2014. In particular, the Respondents emphasize that the Statement of Allegations does not make any allegations about the suitability or eligibility of the investments made.

380 The Respondents submit that they did not breach the Act and that Nagy and Sanfelice did not fail in their duties as the UDP and CCO, respectively, of Quadrexx.

E. Analysis and Finding

381 As stated by the Commission in Re Sterling Grace & Co. (2014), 37 OSCB 8298 at para 255:

> ...the UDP and CCO roles are critical to securities law compliance oversight. Subsection 3.4(1) of NI 31-103, which sets out the proficiency requirements to be registered, establishes that a registrant must not engage in registerable activity unless he or she has "education, training and experience that a reasonable person would consider necessary to perform the activity competently". As a result, a registrant should not assume the role of UDP and/or CCO unless he or she is able to exercise the diligence and judgment required to fulfill the specific requirements of these roles. While the legislation accommodates different sizes of firms and levels of resources, including instances where one person fulfills multiple roles, that should not be used as an excuse for non-compliance with the regulatory requirements.

382 Nagy's and Sanfelice's conduct throughout the transactions and events that are the subject matter of these Reasons demonstrate repeatedly their commitment to the survival of Quadrexx without regard to the consequences of their actions. That they were the UDP and CCO, respectively, of Quadrexx was merely incidental to their roles as Chief Executive Office and Chief Financial Officer and there is no evidence that they paid any attention to their respective obligations under NI 31-103.

383 Based on the foregoing and my other findings in these Reasons, I find that, other than in respect of the allegations against the Respondents relating to the loan transaction involving DALP, CHW and Quadrexx:

(a) Nagy breached his obligations as the UDP of Quadrexx pursuant to section 5.1

of NI 31-103 and also acted contrary to the public interest; and

(b) Sanfelice breached his obligations as the CCO of Quadrexx pursuant to subsection 1.3(1) of Rule 31-505, from July 2008 to September 27, 2009, and pursuant to section 5.2 of NI-31-103, from September 28, 2009 to January 14, 2013 and also acted contrary to the public interest.

X. NAGY'S AND SANFELICE'S LIABILITY AS OFFICERS AND DIRECTORS

A. Staff's Allegations

384 Staff alleges that, as officers and/or directors of Quadrexx, QSA and QHCM, Nagy and Sanfelice authorized, permitted or acquiesced in the breaches of Ontario securities law by Quadrexx, QSA and QHCM referred to in these Reasons and, pursuant to section 129.2 of the Act, are deemed to have also not complied with Ontario securities law.

B. Legislation

385 Section 129.2 of the Act attaches liability to directors and officers who authorize, permit or acquiesce in the non-compliance of a company, whether or not any proceedings have been commenced against the company itself, as follows:

> For the purposes of this Act, if a company or a person other than an individual has not complied with Ontario securities law, a director or officer of the company or person who authorized, permitted or acquiesced in the non-compliance shall be deemed to also have not complied with Ontario securities law, whether or not any proceeding has been commenced against the company or person under Ontario securities law or any order has been made against the company or person under section 127.

C. Submissions of the Parties

386 Nagy was an officer and director of Quadrexx since its incorporation on March 12, 2003. Sanfelice was a founding officer and director of Quadrexx at the time of Quadrexx's incorporation and then resigned as both an officer and director. Sanfelice again became an officer of Quadrexx on December 6, 2004, with primary responsibility for Quadrexx's finances, and a director on October 10, 2007. Staff submits that, as officers and directors, Nagy and Sanfelice authorized, permitted or acquiesced in the breaches of the Act by Quadrexx as evidenced by the following:

(a) Nagy and Sanfelice were the signatories for all of the Quadrexx bank accounts;

(b) Nagy signed the First and Second QAM II OMs as a director, President and Chief Executive Officer of Quadrexx;

(c) Sanfelice signed the First and Second QAM II OMs as a director and Senior Vice-President and CCO;

(d) Nagy and Sanfelice were the only members of Quadrexx's board of directors when the decisions were made to declare the June 2011 Dividends and the December 2011 Dividends;

(e) Nagy and Sanfelice signed all of the cheques to pay the June 2011 Dividends, all but two of which were dated June 30, 2011 with the remaining two dated July 30, 2011;

(f) Nagy and Sanfelice signed all of the cheques to pay the December 2011 Dividends which were dated between January 24 and February 17, 2012;

(g) Nagy and Sanfelice were the signatories for the DALP bank account from which $200,000 was transferred on December 1, 2008;

(h) Nagy and Sanfelice were the directing minds of both Quadrexx and QSA and directed the payments from QSA to Quadrexx from October to December 2012;

(i) Both Nagy and Sanfelice signed the Quadrexx cheque payable to CHW dated December 1, 2008 in the amount of $200,000;

(j) Sanfelice signed Quadrexx's Form 31-103F1 Calculation of Excess Working Capital as Senior Vice-President and CCO of Quadrexx; and

(k) As set out in Staff's submissions, Nagy and Sanfelice were aware at all material times of, and/or participated in, the conduct that formed the basis of the frauds relating to QAM II and QSA, the unreported excess working capital deficiency and the failure to deal fairly, honestly and in good faith with clients.

387 Nagy has been an officer, director and a directing mind of QHCM since its incorporation on May 22, 2007. Sanfelice was an officer, director and a directing mind of QHCM from its incorporation on May 22, 2007 to November 24, 2009. Staff submits that, as officers and directors, Nagy and Sanfelice authorized, permitted or acquiesced in the breach by QHCM of the fraud provisions of the Act as evidenced by the following:

(a) The First DALP OM was signed and certified by Nagy as President and a director of QHCM and by Sanfelice as Secretary and a director of QHCM;

(b) The Second DALP OM was signed and certified by Nagy as President and a director of QHCM and by Sanfelice as Secretary and a director of QHCM;

(c) The investment advisory agreement between Quadrexx and QHCM on behalf of DALP was signed by Sanfelice on behalf of QHCM and Nagy on behalf of Quadrexx;

(d) The DALP bank account into which all DALP investor monies were paid was opened by QHCM on behalf of DALP, with Nagy and Sanfelice as the signing officers; and

(e) As set out in Staff's submissions, Nagy and Sanfelice were aware at all material times of, and/or participated in, the conduct that formed the basis of the fraud relating to DALP.

388 Nagy was an officer and director of QSA, and Sanfelice was an officer of QSA, between June 15, 2011 and March 25, 2013. Nagy and Sanfelice were the directing minds of QSA from June 15, 2011 to March 25, 2013. Staff submits that, as officers and directors, Nagy and Sanfelice authorized, permitted or acquiesced in the breach by QSA of the fraud provisions of the Act as evidenced by the following:

(a) Sanfelice was the Chief Financial Officer of QSA;

(b) Nagy signed each of the four QSA OMs as the President and Chief Executive Officer of QSA;

(c) Sanfelice signed each of the four QSA OMs as the Chief Financial Officer of QSA;

(d) Each of the QSA Brochures listed Nagy as the President and Chief Executive Officer of QSA;

(e) Each of the three QSA Brochures listed Sanfelice as the Chief Compliance Officer and Chief Financial Officer of QSA;

(f) Nagy and Sanfelice were involved in the drafting or approval of the CHW Brochures;

(g) Nagy and Sanfelice had signing authority on QSA's bank accounts: and

(h) As set out in Staff's submissions, Nagy and Sanfelice were aware at all material times of, and participated in, the conduct that formed the basis of the fraud relating to QSA.

D. Analysis and Finding

389 The Commission considered the threshold for finding a director or officer liable under section 129.2 in Re Momentas Corp. (2006), 29 OSCB 7408 and, at para 118, stated that:

> Although these terms have been interpreted to include some form of knowledge or intention, the threshold for liability under section 122 and 129.2 is a low one, as merely acquiescing in the conduct or activity in question will satisfy the requirement of liability. The degree of knowledge of intention found in each of the terms "authorize", "permit" and "acquiesce" varies significantly. "Acquiesce" means to agree or consent quietly without protest. "Permit" means to allow, consent, tolerate, give permission, particularly in writing. "Authorize" means to give official approval or permission, to give power or authority or to give justification.

390 It is quite clear from the evidence that, at all material times, Nagy and Sanfelice made all decisions on behalf of Quadrexx, QHCM and QSA. In fact, it would be accurate to say that Nagy and Sanfelice directed all matters pertaining to Quadrexx, QHCM and QSA, a standard well beyond that required to establish that they authorized, permitted or acquiesced in the non-compliance by Quadrexx, QHCM and QSA with Ontario securities law and thereby are deemed to also have not complied with Ontario securities law.

391 Accordingly, I find that:

(a) Nagy and Sanfelice, as officers and directors of Quadrexx, authorized, permitted or acquiesced in the breaches by Quadrexx of subsection 126.1(1)(b) of the Act, subsections 12.1(1) and (2) of NI 31-103, and subsection 2.1(1) of OSC Rule 31-505 and Quadrexx's conduct contrary to the public interest, and are thereby deemed to have breached subsection 126.1(1)(b) of the Act, subsections 12.1(1) and (2) of NI 31-103 and subsection 2.1(1) of OSC Rule 31-505 pursuant to section 129.2 of the Act and to have acted contrary to the public interest;

(b) Nagy and Sanfelice, as officers and directors of QHCM, authorized, permitted or acquiesced in the breach by QHCM of subsection 126.1(1)(b) of the Act and are thereby deemed to have breached subsection 126.1(1)(b) of the Act pursuant to section 129.2 of the Act; and

(c) Nagy and Sanfelice, as officers and directors of QSA, authorized, permitted or acquiesced in the breach by QSA of subsection 126.1(1)(b) of the Act and are thereby deemed to have breached subsection 126.1(1)(b) of the Act pursuant to section 129.2 of the Act.

XI. FINDINGS AND CONCLUSIONS

392 Based on the foregoing, I make the following findings:

(a) Nagy, Sanfelice and QHCM directly or indirectly engaged or participated in an act, practice or course of conduct relating to DALP Securities that they knew or reasonably ought to have known perpetrated a fraud on DALP investors in breach of subsection 126.1(1)(b) of the Act and contrary to the public interest;

(b) Nagy, Sanfelice and Quadrexx directly or indirectly engaged or participated in an act, practice or course of conduct relating to Quadrexx securities that they knew or reasonably ought to have known perpetrated a fraud on Quadrexx investors in breach of subsection 126.1(1)(b) of the Act and contrary to the public interest;

(c) Nagy, Sanfelice, Quadrexx and QSA directly or indirectly engaged or participated in an act, practice or course of conduct relating to QSA securities that they knew or reasonably ought to have known perpetrated a fraud on QSA investors in breach of subsection 126.1(1) (b) of the Act and contrary to the public interest;

(d) Quadrexx failed to notify the Commission as soon as possible that its excess working capital was less than zero and Quadrexx's excess working capital was less than zero for two consecutive days in breach of subsections 12.1(1) and (2) of NI 31-103 and contrary to the public interest;

(e) Quadrexx knowingly caused an investment portfolio managed by it to make a loan to Quadrexx contrary to the public interest;

(f) Quadrexx failed to deal fairly, honestly and in good faith with its clients in breach of subsection 2.1(1) of OSC Rule 31-505;

(g) Nagy and Sanfelice, as officers and directors of Quadrexx, authorized, permitted or acquiesced in the breaches by Quadrexx of subsection 126.1(1)(b) of the Act, subsections 12.1(1) and (2) of NI 31-103, and subsection 2.1(1) of OSC Rule 31-505, and thereby, Nagy and Sanfelice are deemed to have breached subsection 126.1(1)(b) of the Act, subsections 12.1(1) and (2) of NI 31-103, and subsection 2.1(1) of OSC Rule 31-505 pursuant to section 129.2 of the Act;

(h) Nagy and Sanfelice, as officers and directors of QHCM, authorized, permitted or acquiesced in the breach by QHCM of subsection 126.1(1)(b) of the Act and thereby Nagy and Sanfelice are deemed to have breached subsection 126.1(1)(b) of the Act pursuant to section 129.2 of the Act;

(i) Nagy and Sanfelice, as officers and directors of QSA, authorized, permitted or acquiesced in the breach by QSA of subsection 126.1(1)(b) of the Act and thereby Nagy and Sanfelice are deemed to have breached subsection 126.1(1)(b) of the Act pursuant to section 129.2 of the Act;

(j) Sanfelice breached his obligations as CCO of Quadrexx contrary to subsection 1.3(1) of OSC Rule 31-505 and, on and after September 28, 2009 contrary to section 5.2 of NI 31-103 and contrary to the public interest; and

(k) Nagy breached his obligations as UDP of Quadrexx contrary to section 5.1 of NI 31-103 and contrary to the public interest.

393 The parties are requested to contact the Office of the Secretary of the Commission within 30 days of the date of these Reasons to schedule a sanctions hearing.

Dated at Toronto this 6th day of February, 2017.

"Christopher Portner"

Indexed as:

Pezim v. British Columbia (Superintendent of Brokers)

The Superintendent of Brokers, appellant;
v.
Murray Pezim, Lawrence Page and John Ivany, respondents, and The Attorney General of British Columbia, the Ontario Securities Commission, the Alberta Securities Commission and the Securities Dealers Society of Ontario, interveners.
And between
The British Columbia Securities Commission, appellant;
v.
Murray Pezim, Lawrence Page and John Ivany, respondents, and The Attorney General of British Columbia, the Ontario Securities Commission, the Alberta Securities Commission and the Securities Dealers Society of Ontario, interveners.

[1994] 2 S.C.R. 557

[1994] 2 R.C.S. 557

[1994] S.C.J. No. 58

[1994] A.C.S. no 58

File Nos.: 23107, 23113.

Supreme Court of Canada

1994: February 24; 1994: June 23.

Present: Lamer C.J. and La Forest, Sopinka, Gonthier, McLachlin, Iacobucci and Major JJ.

ON APPEAL FROM THE COURT OF APPEAL FOR BRITISH COLUMBIA

Administrative law -- Judicial review -- Securities Commission -- Commission part of larger regulatory framework -- No privative clause and right of appeal -- Appropriate standard of review *of Commission's decisions -- Whether standard properly applied -- Securities Act, S.B.C. 1985, c. 83, ss. 1(1) "material change", "material fact", 14(1), (2), 44(1), 45(2), 49(1), 50(1), 67, 68, 144(1)(a), (b), (c), (d), 149(a), (b), (c), 154.2.*

Securities -- Securities Commission -- Statutory duty on issuers of stock to disclose nature and substance of material change -- Prohibition against insider trading -- Series of transactions allegedly breaching duty to disclose -- Whether transactions breaching duty to disclose and/or prohibition against insider trading.

Respondents were, respectively, the chair of the board, the vice president responsible for internal administration and the president of Prime, a company holding several wholly owned subsidiaries and controlling or managing about 50 public junior resource companies. Respondents were also directors of Calpine, a company controlled and managed by Prime. Both companies were reporting issuers listed on the Vancouver Stock Exchange and subject to the VSE's rules and policies concerning public disclosure of information and pricing of options. Both were subject to the continuing and timely disclosure requirements under s. 67 of the Securities Act and to the insider trading provisions under s. 68. The British Columbia Securities Commission administers the Act and ensures compliance with its requirements. It also regulates the VSE.

In the spring of 1990, the Superintendent of Brokers (the Commission's chief administrative officer) instituted proceedings against the respondents in connection with various types of transactions which occurred between July and October, 1989. The Superintendent alleged that the respondents had violated the timely disclosure provisions and insider trading provisions in three categories of impugned transactions: the drilling results and share options transactions, the private placement, and the ALC withdrawal. Respondents were prevented from having information relative to assay results by a "Chinese Wall".

In the first category, Prime or Calpine allegedly failed to disclose all material changes in four transactions in that assay results were publicly disclosed after the company had granted or repriced options. The fifth option transaction, although made after a detailed news release of assay results, allegedly violated a pricing formula under the VSE options policy.

The second series of impugned transactions involved the private placement of Calpine units. Calpine allegedly failed to disclose, contrary to s. 67, that Prime was the purchaser and that the sale significantly increased Prime's interest in Calpine. It was also alleged that Calpine had misled the VSE as to the firm brokering the private placement.

The third impugned transaction occurred when a broker disputed its contractual obligation either to find a purchaser or to buy a set number of Prime units on offer following the withdrawal of a firm (ALC) from a deal to purchase them. Prime was alleged to have violated s. 67 by not making timely and adequate disclosure of the dispute following ALC's withdrawal.

The Commission concluded that the respondents contravened s. 67 of the Act by failing to disclose material changes in their affairs. No insider trading contrary to s. 68 of the Act was found, however. The respondents were found responsible for these breaches as senior managers of the companies, were suspended from trading in shares for one year and were required to pay part of the costs incurred by the Commission and Superintendent. Respondents' appeal was limited to whether the Commission had erred as a matter of law in its conclusions on s. 67 (disclosure of material change), s. 144 (power of Commission to make orders) and s. 154.2 (power of Commission to make orders regarding costs) of the Act. The Court of Appeal allowed the appeal and set aside the Commission's orders. The Superintendent and the Commission now appeal from that decision.

These appeals dealt mainly with the appropriate standard of review for an appellate court reviewing a decision of a securities commission which is not protected by a privative clause when there exists a statutory right of appeal and where the case turns on a question of statutory interpretation. The appeals also raised issues of compliance with the timely disclosure requirements under applicable securities legislation.

Held: The appeals should be allowed.

The Securities Act is part of a much larger framework which regulates the securities industry throughout Canada primarily for the protection of the investor but also for capital market efficiency and ensuring public confidence in the system.

The central question in ascertaining the standard of review is to determine the legislative intent in conferring jurisdiction on the administrative tribunal. The analysis must consider the tribunal's role or function, whether the agency's decisions are protected by a privative clause, and whether the question goes to the tribunal's jurisdiction. The courts have developed a spectrum that ranges from the standard of patent unreasonableness (where deference is at its highest, for example, where a tribunal is protected by a privative clause in deciding a matter within its jurisdiction) to that of correctness (where deference is at its lowest, for example, where there is a statutory right of appeal or where the issue concerns the interpretation of a provision limiting the tribunal's jurisdiction). The case at bar falls between these two extremes. On one hand lies a statutory right of appeal pursuant to s. 149 of the Securities Act. On the other lies an appeal from a highly specialized tribunal on an issue which arguably goes to the core of its regulatory mandate and expertise. Even where there is no privative clause and where there is a statutory right of appeal, the concept of the specialization of duties requires that deference be shown to decisions of specialized tribunals on matters which fall squarely within the tribunal's expertise.

The breadth of the Commission's expertise and specialisation is reflected in the provisions of the Securities Act. The Commission is responsible for the administration of the Act, has broad powers with respect to investigations, audits, hearings and orders, and any decision, when filed in the Supreme Court of British Columbia Registry, has the force and effect of a decision of that court.

The Commission has the power to revoke or vary any of its decisions. It also has a very broad discretion to determine what is in the public's interest. The definitions in the Act exist in a factual or regulatory context and must be analysed in context, not in isolation. This is yet another basis for curial deference. A higher degree of judicial deference is also warranted with respect to a tribunal's interpretation of the law where it plays a role in policy development. Here, the Commission's primary role is to administer and apply the Act. It also plays a policy development role but its policies are not to be treated as legal pronouncements absent statutory authority mandating such treatment. Thus, on precedent, principle and policy, those decisions of the Commission falling within its expertise generally warrant judicial deference.

Sections 67, 144 and 154.2 of Act were specifically considered with an eye to the tribunal's expertise and its need for deference. The decision to make an order and the precise nature of that order, under s. 144, as well as any decision obliging a person to pay the costs of a hearing necessitated by his or her conduct, pursuant to s. 154.2, are clearly within the jurisdiction and expertise of the Commission. The other provision at issue was s. 67 which involves an interpretation of the words "material change" and "as soon as practicable".

Both "material change" and "material fact" are defined in s. 1 of the Act. They are defined in terms of the significance of their impact on the market price or value of the securities of an issuer. The definition of "material fact" is broader than that of "material change"; it encompasses any fact that can "reasonably be expected to significantly affect" the market price or value of the securities of an issuer, and not only changes "in the business, operations, assets or ownership of the issuer" that would reasonably be expected to have such an effect.

This case turned partly on the definition of "material change". Three elements emerge from that definition: the change must be (a) "in relation to the affairs of an issuer", (b) "in the business, operations, assets or ownership of the issuer" and (c) material, i.e., would reasonably be expected to have a significant effect on the market price or value of the securities of the issuer. Not all changes are material changes; the latter are set in the context of making sure that issuers keep investors up to date. The determination of what information should be disclosed is an issue which goes to the heart of the regulatory expertise and mandate of the Commission, i.e., regulating the securities markets in the public's interest.

This case also turns on the meaning of the words "as soon as practicable", in s. 67 of the Act, as to when a material change should be disclosed to the public. The timeliness of disclosure also falls within the Commission's regulatory jurisdiction.

Given the nature of the securities industry, the Commission's specialization of duties and policy development role, and the nature of the problem before the court, considerable deference was warranted in the present case notwithstanding the facts that there was a statutory right of appeal and that there was no privative clause.

The determination of what constitutes a material change for the purposes of general disclosure under s. 67 of the Act falls squarely within the regulatory mandate and expertise of the Commission. New information relating to a mining property (which is an asset) bears significantly on the question of that property's value. A change in assay and drilling results can amount to a material change as was the case here.

The obligation to disclose "as soon as practicable" takes on a different meaning when an issuer is about to engage in a securities transaction. Although a duty to inquire is not expressly stated in s. 67, such an interpretation contextualizes the general obligation to disclose material changes and guarantees the fairness of the market, which is the underlying goal of the Act. The Commission had jurisdiction to interpret s. 67 in this manner and was entitled to the court's deference.

A duty to inquire under s. 67 is not incompatible with the Act's insider trading provision (s. 68). If an issuer wishes to engage in a securities transaction, its directors must inquire about all material changes in the issuer's affairs. Consequently, the directors will have, at one point in time, knowledge of undisclosed material facts and material changes which constitute inside information. As long as the material facts and material changes are adequately disclosed prior to the transaction, there will be no possibility of insider trading. The directors' duty to inquire about material changes is not erased by the erection of a Chinese Wall because the disclosure requirements under s. 67 are on the issuer.

Each of the Commission's findings were supported by overwhelming evidence and should not be disturbed. The Commission concluded that information contained in drilling results can constitute a material change in a reporting issuer's affairs and that s. 67 imposes a duty on senior management to inquire as to the existence of material changes before causing a reporting issuer to engage in a securities transaction. It found that the respondents breached s. 67 by failing to disclose various material changes in the affairs of Prime and Calpine before causing these two companies to engage in securities transactions. The Commission also concluded that the non-disclosure of information concerning the private placement issue and the withdrawal of ALC constituted a failure to disclose a material change. Although the material change arising from the controversy surrounding the withdrawal of ALC was self-evident, not all material changes are self-evident.

Section 144 of the Act gives the Commission a broad discretion to make orders that it considers to be in the public interest. Thus, a reviewing court should not disturb an order of the Commission unless the Commission has made some error in principle in exercising its discretion or has exercised its discretion in a capricious or vexatious manner.

The Commission exercised its discretion in a judicial manner. Further, it could make the orders it did with respect to the respondents even though the duty to make timely disclosure under s. 67 of the Act applies to a "reporting issuer". Although responsibility for timely disclosure is vested in the reporting issuer, effective responsibility rests with the senior officers and the directors of the reporting issuer. In addition, s. 144 of the Act not only gives the Commission a broad power to make orders it considers to be in the public interest but also confers upon the Commission the authority to make orders with respect to "a person". The Commission's order with respect to costs was well within its jurisdiction; considerable deference was in order.

Cases Cited

Referred to: Canadian Union of Public Employees, Local 963 v. New Brunswick Liquor Corp., [1979] 2 S.C.R. 227; U.E.S., Local 298 v. Bibeault, [1988] 2 S.C.R. 1048; Domtar Inc. v. Quebec (Commission d'appel en matière de lésions professionnelles), [1993] 2 S.C.R. 756; Zurich Insurance Co. v. Ontario (Human Rights Commission), [1992] 2 S.C.R. 321; Canada (Attorney General) v. Mossop, [1993] 1 S.C.R. 554; University of British Columbia v. Berg, [1993] 2 S.C.R. 353; Bell Canada v. Canada (Canadian Radio-Television and Telecommunications Commission), [1989] 1 S.C.R. 1722; United Brotherhood of Carpenters and Joiners of America, Local 579 v. Bradco Construction Ltd., [1993] 2 S.C.R. 316; Brosseau v. Alberta Securities Commission, [1989] 1 S.C.R. 301; National Corn Growers Assn. v. Canada (Import Tribunal), [1990] 2 S.C.R. 1324; Pacific Coast Coin Exchange v. Ontario Securities Commission, [1978] 2 S.C.R. 112; Four Star Mgmt. Ltd. v. B.C. Securities Comm. (1990), 46 B.C.L.R. (2d) 195, leave to appeal refused sub nom. Williams (Byron Leslie) v. British Columbia Securities Comm., [1991] 1 S.C.R. xv; Gordon Capital Corp. v. Ontario Securities Commission (1991), 14 O.S.C.B. 2713; Re the Securities Commission and Mitchell, [1957] O.W.N. 595; Bay Street West Securities (1983) Inc. v. Alberta Securities Commission (1984), 56 A.R. 19.

Statutes and Regulations Cited

Company Act, R.S.B.C. 1979, c. 59, ss. 1, 255, 267, 272.
Securities Act, S.B.C. 1985, c. 83, ss. 1(1) "material change", "material fact", 14(1), (2), 44(1) [am. 1989, c. 78, s. 16], 45(2) [am. 1989, c. 78, s. 16], 47(1), (2), 48(1) [am. 1989, c. 58, s. 12], 49(1) [am. 1989, c. 78, s. 20], 50(1), 67, 68 [rep. & sub. 1989, c. 78, s. 25], 144(1)(a) [rep. & sub. 1989, c. 78, s. 39], (b) [rep. & sub. 1989, c. 78, s. 39], (c) [rep. & sub. 1989, c. 78, s. 39, am. 1990, c. 25, s. 49], (d) [rep. & sub. 1989, c. 78, s. 39], 149(a) [rep. & sub. 1989, c. 78, s. 43, am. 1992, c. 52, s. 27], (b) [rep. & sub. 1989, c. 78, s. 43], (c) [ad. 1992, c. 52, s. 27], 154.2 [ad. 1988, c. 58, s. 25].

Authors Cited

Alboini, Victor P. Securities Law and Practice, 2nd ed., vol. 2 (loose-leaf). Toronto: Carswell, 1984.
Johnston, David L. Canadian Securities Regulation. Toronto: Butterworths, 1977.
Stevens, George C. and Stephen D. Wortley. "Murray Pezim in the Court of Appeal: Draining the Lifeblood from Securities Regulation" (1992), 26 U.B.C. L. Rev. 331.

APPEALS from a judgment of the British Columbia Court of Appeal (1992), 66 B.C.L.R. (2d) 257, 96 D.L.R. (4th) 137, 24 W.A.C. 1, allowing an appeal from an order of the British Columbia Securities Commission. Appeals allowed.

M.J. Gregory Walsh and Catharine M. Esson, for the appellant the Superintendent of Brokers. John L. Finlay and Susan E. Ross, for the appellant the British Columbia Securities Commission. Alan J. Lenczner, Q.C., and Winton K. Derby, Q.C., for the respondents. Deborah K. Lovett, for the intervener the Attorney General of British Columbia. Stephen T. Goudge, Q.C., and Sandra Forbes, for the intervener the Ontario Securities Commission. Frances L. Zinger and Glenda A. Campbell, for the intervener the Alberta Securities Commission. Bryan Finlay, Q.C., and Philip Anisman, for the intervener the Securities Dealers Society of Ontario.

Solicitors for the appellant the Superintendent of Brokers: Walsh & Company, Vancouver. Solicitors for the appellant the British Columbia Securities Commission: Arvay, Finlay, Victoria. Solicitors for the respondents: Lenczner, Slaght, Royce, Smith, Griffin, Toronto. Solicitor for the intervener the Attorney General of British Columbia: The Attorney General of British Columbia, Victoria. Solicitors for the intervener the Ontario Securities Commission: Davies, Ward & Beck, Toronto. Solicitor for the intervener the Alberta Securities Commission: The Alberta Justice, Edmonton. Solicitors for the intervener the Securities Dealers Society of Ontario: Weir & Foulds, Toronto.

The judgment of the Court was delivered by

1 **IACOBUCCI J.**:-- These appeals (hereinafter referred to in the singular) deal mainly with the appropriate standard of review for an appellate court reviewing a decision of a securities commission which is not protected by a privative clause when there exists a statutory right of appeal and where the case turns on a question of statutory interpretation. The appeal also raises issues of compliance with the timely disclosure requirements under applicable securities legislation.

I. Facts

2 At the relevant time, the respondents were directors and senior managers of Prime Resources Corporation ("Prime"), a company which headed a large corporate network which consisted of Prime, various wholly owned subsidiaries, and Prime's "managed companies", a group of about 50 public junior resource companies controlled and managed by Prime. Murray Pezim was the chairperson of Prime's board of directors and was responsible for promoting and arranging financing for Prime and the managed companies. Lawrence Page was Prime's vice president and was responsible for administration within Prime and for liaison with Prime's outside legal counsel. Finally, John Ivany was president and chief executive officer of Prime. He was also responsible for the overall direction of Prime and played a role in raising financing for the corporation.

3 One of Prime's managed companies was Calpine Resources Inc. ("Calpine"), which was

involved in mineral exploration and development in northern British Columbia. Prime held 23 percent of Calpine's common shares. The respondents were also directors of Calpine.

4 Both Prime and Calpine were incorporated under the Company Act, R.S.B.C. 1979, c. 59 (as amended), and were reporting issuers whose common shares were listed for trading on the Vancouver Stock Exchange ("VSE"). As such, they were subject to the VSE's rules and policies concerning such matters as public disclosure of information and pricing of options. They were also subject to the continuing and timely disclosure requirements under s. 67 of the Securities Act, S.B.C. 1985, c. 83 (as amended) (the "Act"), which required disclosure of "material changes" in the affairs of a reporting issuer as soon as practicable, as well as the insider trading provisions under s. 68 of the Act. The British Columbia Securities Commission ("the Commission"), which is established by the Act, is charged with administering the Act and ensuring compliance with the requirements of the Act, as well as regulating the VSE.

5 In the spring of 1990, the Superintendent of Brokers ("Superintendent"), the chief administrative officer of the Commission, instituted proceedings against the respondents in connection with various types of transactions which occurred between July and October, 1989. The Superintendent alleged that the respondents had violated the timely disclosure provisions found in s. 67 of the Act, as well as the insider trading provisions found in s. 68. As a matter of convenience, the impugned transactions have been divided into three categories: the drilling results and share options transactions, the private placement, and the so-called ALC withdrawal. Each of these will be discussed in turn.

A. The Drilling Results and Share Options Transactions

6 In September 1988, Calpine announced the commencement of drilling on a property known as "Eskay Creek". On May 18, 1989, Calpine announced another drilling program on the same property for the summer of 1989.

7 Prime Explorations Ltd., one of Prime's wholly owned subsidiaries, was engaged to provide consulting and management services for the project. David Mallo, a staff geologist employed by Prime Explorations, was appointed manager of the Eskay Creek project and prepared regular written reports on the progress of the project. These reports, which contained information on the activity at the camp, as well as visual descriptions and ratings of the holes drilled since the last report, were sent to the president of Prime Explorations, Chet Idziszek, an experienced geologist. Idziszek was responsible for implementing and carrying out a system to compile the drilling and assay results, to ensure the confidentiality of the results, and to determine the time when public disclosure of the results was required. Idziszek also erected a "Chinese Wall" to prevent the non-geological officers of Prime Explorations, including the respondents, from having actual knowledge of the drilling results before they were released to the public.

8 Early in the first program, that is in the fall of 1988, news releases had been issued to disclose the drilling results from a single hole or even a partial hole. However, by the summer of 1989, the

practice was to release results about every two weeks covering several holes.

9 During the summer program, the drilling concentrated on two zones of mineralization, known as the 21A zone and the 21B zone. Several holes were drilled including holes 71, 93, 101 and 109. During this period, share options were granted and news releases were issued.

10 The first disclosure on the summer program occurred in a news release, dated June 20, 1989, to announce the commencement of the drilling activity. Five subsequent news releases were issued on July 13, 19, August 2, 15 and 22. The first four of these five news releases were issued after, rather than before, Calpine and Prime granted new share options or reduced the price of previously issued options in favour of directors (including the respondents) and employees. The fifth news release was issued before the fifth impugned share options transaction. As a matter of convenience, I set out the following chronology of events which relate to the five share options transactions and news releases:

Date	Event
July 11/12, 1989	Idziszek and Mallo visit the drill camp and are very impressed with their visual observations. A new zone of mineralization is identified and Mallo states that there is a very good chance that the reserves are doubling.
July 12, 1989	Calpine grants options on 100,000 of its common shares to the Calpine Employee Plan at a price of $1.44 per share, the previous close being $1.63 per share.
July 13, 1989	A news release is issued describing the location of the drilling. The assay results for the first hole, hole 71, are ready but they are not disclosed in the news release.
July 19, 1989	Calpine issues a news release disclosing the first assay results from the summer drilling program.
July 26, 1989	While reviewing the daily fax sent from the drill camp, Mallo finds out that hole 109 is out of the ordinary. Mallo receives chip samples from hole 109 and has assays done on them. At least one of the samples shows very high gold and silver values.
July 28, 1989	While on vacation, Idziszek is advised that visible gold has been discovered in hole 109. He immediately phones the respondent Ivany to advise him of the discovery. He then calls Mallo who informs him of the results of the chip sample assays for hole 109.
July 31, 1989	In the morning, Calpine grants options on 100,000 of its common shares to

	Leslie MacConnell, a long-time associate of Pezim's, at a price of $2.32 per share, the previous close being $2.55. Idziszek and Mallo visit the drill camp, arriving about noon. After viewing the drill core and confirming the finding of visible gold, Idziszek phones Pezim at about 1:30 p.m. and informs him of the visible gold. In the late afternoon, Pezim signs and files a declaration in which he certifies that there are no undisclosed material changes in the affairs of Calpine.
August 1, 1989	Idziszek and Mallo begin to prepare a news release and correlate the assay results that are in the office.
August 2, 1989	At Pezim's request, trading in Calpine's shares is halted from 9:40 a.m. until 9:30 a.m. the following day. A news release is issued announcing the assay results for several more holes as well as the discovery of visible gold in hole 109.
August 14, 1989	The final gold and silver assays for holes 93 and 101 arrive. They included "very good numbers".
August 15, 1989	Prime reduces, to $2.13 per share, the exercise price of options on 3,351,383 of its common shares already granted, the previous close being $2.47. Most of these options are held by Senior Management of Prime, including the respondents. In the afternoon, Calpine issues a news release disclosing the assay results for holes 93 and 101.
August 16, 1989	The final total gold assays for hole 109 arrive at Prime Explorations in the afternoon.
August 17, 1989	Prime grants options on 125,000 of its common shares to Richard Warke and Murray Garrison, two Prime employees, at an exercise price of $2.28 per share, the previous close being $2.50. In the afternoon, Pezim signs and files a declaration in which he certifies that there are no undisclosed material changes in the affairs of Prime.
August 22, 1989	Calpine issues a news release (dated August 21) disclosing a detailed description of the assay results for hole 109, as well as information on visual observations of nearby holes that had been subsequently drilled.
August 24, 1989	Calpine grants options on 100,000 of its common shares to the Calpine Employee Plan and to Norman Pezim, Murray Pezim's brother, at an exercise price of $4.78 per share, the previous close being $6.

B. The Private Placement

11 On July 14, 1989, Calpine issued a news release announcing a private placement for two million units; each unit was to consist of one Calpine common share and one Calpine share purchase warrant, which entitles the holder to purchase one Calpine common share. The fact that the purchaser or placee was Prime was not disclosed in the news release even though the sale would increase Prime's interest in Calpine from 23 to 36 percent of the outstanding Calpine common shares.

12 On July 17, 1989, the respondent Ivany sent a notice letter to the VSE concerning the private placement. Prime Equities Inc., a wholly owned subsidiary of Prime, was named as agent for the private placement, but the notice did not indicate the name of the placee.

13 During the period from July 14 to August 10, 1989, the respondent Pezim told certain brokers and investors who asked him that it was Prime, directly or indirectly, that was purchasing the private placement.

14 On August 10, 1989, the VSE was advised that the private placement would be taken down by an entity related to Prime and that Prime Equities would not be involved in the transaction. Prime issued a news release on that same day identifying Prime as the placee and announcing that it would close the private placement by August 18, 1989.

15 On August 18, 1989, Calpine filed the required declaration with the VSE in which the respondent Page certified that there were no undisclosed material changes in Calpine's affairs.

16 Although the private placement purportedly closed on August 18, 1989, the money was not paid or the shares issued until December of that year. On December 11, 1989, Prime issued a news release announcing that it had completed, on December 7, 1989, the purchase of four million shares of Calpine by way of a private placement.

C. The ALC Withdrawal

17 In September 1989, Prime made a public offering of five million units, at $4.25 per unit, under a guaranteed agency agreement ("GAA") with three brokerage firms. Each unit was to consist of one Prime common share and one Prime share purchase warrant. Under the GAA, one of the brokerage firms, Canarim Investment Corporation Ltd. ("Canarim") guaranteed either to find purchasers or purchase itself four million units. An English company, Alexanders, Laing and Cruickshank Ltd. ("ALC"), entered into a deal with Canarim to buy one million Prime units. The deadline for payment under the GAA was September 29, 1989.

18 On September 25, 1989, Tim Hoare, a principal of ALC and a director of Prime, advised Canarim that ALC was withdrawing its purchase because it had not been adequately consulted on the price of the offering. Peter Brown, Canarim's chairperson and a director of Prime, called Pezim and told him there was a problem. Pezim told Brown to give ALC a delayed delivery contract and said he would talk to Hoare personally to convince him to take the units. Pezim also told Brown that Canarim would have to pay for the units, but indicated that Prime would try to help Canarim offset any loss through other business. On September 29, 1989, neither ALC nor Canarim paid for the unwanted one million units.

19 On October 16, 1989, Brown formally notified Prime that Canarim would not take down or pay for the one million Prime units. The withdrawal of Canarim was disclosed on October 19, 1989 in a planned news release intended to disclose a share swap between Prime and another company. Following this news release, Canarim came under pressure from the brokerage community to take down the units. Accordingly, Canarim agreed to honour its obligation and advised Prime. This was disclosed by Prime in a news release on October 23, 1989.

20 Following a rather lengthy hearing relating to the three groups of impugned transactions described above, the Commission concluded that the respondents had contravened s. 67 of the Act by failing to disclose material changes in their affairs. However, no contravention of s. 68 of the Act, relating to improper insider trading, was found. The respondents were responsible for these breaches as senior managers of the companies and were suspended from trading in shares for a period of one year through the removal of their trading exemptions under the Act. Further, they were ordered to pay two-thirds of the costs incurred by the Commission and the Superintendent.

21 Pursuant to s. 149 of the Act, the respondents appealed to the British Columbia Court of Appeal. The order granting leave to appeal limited the appeal to the question of whether the Commission had erred as a matter of law in its conclusions on s. 67 (disclosure of material change), s. 144 (power of Commission to make orders) and s. 154.2 (power of Commission to make orders regarding costs) of the Act. The Court of Appeal allowed their appeal and set aside the orders of the Commission, Locke J.A. dissenting. The respondents were ordered to pay one tenth of the costs incurred by the Commission and the Superintendent. The Superintendent and the Commission now appeal from that decision.

II. Relevant Statutory Provisions

Securities Act, S.B.C. 1985, c. 83 (am. S.B.C. 1988, c. 58, S.B.C. 1989, c. 78, S.B.C. 1990, c. 25 and S.B.C. 1992, c. 52):

1. (1) In this Act

. . .

"material change" means, where used in relation to the affairs of an issuer, a change in the business, operations, assets or ownership of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer and includes a decision to implement that change made by

(a) senior management of the issuer who believe that confirmation of the decision by the directors is probable, or
(b) the directors of the issuer;

"material fact" means, where used in relation to securities issued or proposed to be issued, a fact that significantly affects, or could reasonably be expected to significantly affect, the market price or value of those securities;

67. (1) Where a material change occurs in the affairs of a reporting issuer, the reporting issuer shall

(a) as soon as practicable issue and file a press release that is authorized by a senior officer and that discloses the nature and substance of the change, and

(b) file a required report, as soon as practicable, but in any event no later than 10 days after the date on which the change occurs.

(2) Subsection (1) does not apply to a reporting issuer which immediately files the report required under subsection (1) (b) marked "confidential" together with written reasons why there should not be a press release under subsection (1) (a) so long as

(a) in the opinion of the reporting issuer, the disclosure required by subsection (1) would be unduly detrimental to its interests, or

(b) the material change in the affairs of the reporting issuer

(i) consists of a decision to implement a change made by senior management of the issuer who believe that confirmation of the decision by the directors is probable, and

(ii) senior management of the issuer has no reason to believe that persons with knowledge of the material change have made use of that knowledge in purchasing or selling securities of the issuer.

(3) Where a report has been filed under subsection (2), the reporting issuer shall advise the commission in writing, within 10 days of the date of filing the

initial report and every 10 days after that, that it believes the report should continue to remain confidential until

(a) the material change is generally disclosed in the manner referred to in subsection (1) (a), or
(b) if the material change consists of a decision of the type referred to in subsection (2) (b), that decision has been rejected by the directors of the issuer.

68. (1) No person that

(a) is in a special relationship with a reporting issuer, and
(b) knows of a material fact or material change with respect to that reporting issuer, which material fact or material change has not been generally disclosed,

shall purchase or sell

(c) securities of that reporting issuer,
(d) a put, a call, an option or another right or obligation to purchase or sell securities of the reporting issuer, or
(e) a security, the market price of which varies materially with the market price of any securities of the reporting issuer.

(2) No reporting issuer and no person in a special relationship with a reporting issuer shall inform another person of a material fact or material change with respect to the reporting issuer before the material fact or material change has been generally disclosed, unless giving the information is necessary in the course of business of the reporting issuer or of the person in the special relationship with the reporting issuer.

(3) No person that proposes to

(a) make a take over bid, as defined in section 74, for the securities of a reporting issuer,

(b) become a party to a reorganization, amalgamation, merger, arrangement or similar business combination with a reporting issuer, or

(c) acquire a substantial portion of the property of a reporting issuer

shall inform another person of a material fact or material change with respect to the reporting issuer before the material fact or material change has been generally disclosed, unless giving the information is necessary to effect the take over bid, business combination or acquisition, as the case may be.

(4) A person does not contravene subsection (1), (2) or (3) if the person proves on the balance of probabilities that at the time of the purchase or sale referred to in subsection (1) or at the time of giving the information under subsection (2) or (3), as the case may be, the person reasonably believed that the material fact or material change had been generally disclosed.

144. (1) Where the commission or the superintendent considers it to be in the public interest, the commission or the superintendent, after a hearing, may order ...

(c) that any or all of the exemptions described in any of sections 30 to 32, 55, 58, 80 or 81 do not apply to a person,

(d) that a person

(i) resign any position that the person holds as a director or officer of an issuer, and

(ii) is prohibited from becoming or acting as a director or officer of any issuer,

. . .

149. (1) A person directly affected by a decision of the commission, other than

(a) a decision under section 33 or 59,

(b) a decision under section 147 in connection with the review of a

decision of the superintendent under section 33 or 59, or
(c) a decision by a person acting under authority delegated by the commission under section 6,

may appeal to the Court of Appeal with leave of a justice of that court.

154.2 The person presiding at a hearing required or permitted under this Act or the regulations may order a person whose affairs are the subject of the hearing to pay prescribed fees or charges for the costs of or related to the hearing that are incurred by or on behalf of the commission or the superintendent including, without limiting this,

(a) costs of matters preliminary to the hearing,
(b) costs for time spent by the commission or the superintendent or the staff of either of them,
(c) fees paid to an expert or witness, and
(d) costs of legal services.

III. Judgments Below

1. British Columbia Securities Commission

22 The Commission's reasons for judgment were handed down in two parts: the findings of the Commission and the decision of the Commission.

23 In its findings, released on November 16, 1990, the Commission began by commenting on its jurisdiction. It held that, because it was vested with the responsibility of regulating the financial markets, it had broad powers. More specifically, the Commission stated that its jurisdiction was not limited to breaches of the Act, but extended to "circumstances where no provision of any law has been violated...since, no matter how extensive the specific provisions are, there will be fertile and unscrupulous minds to invent schemes that will skirt the words of all published pronouncements". The Commission concluded its discussion of jurisdiction as follows:

> The Commission may from time to time judge the conduct of directors against a standard found in the Company Act. In other instances it may, through policy statements, impose a higher standard or one more specific in its terms. The Commission may exercise its jurisdiction even when there is no published policy. The focus of the Commission's inquiry remains constant: the conduct of market participants and its impact on the efficiency and fairness of the market. Where the public interest requires its intervention, the Commission's response is a

proper exercise of its jurisdiction and a fulfilment of its mandate.

24 Following these comments, the Commission examined the various impugned transactions in order to determine whether or not ss. 67 and 68 of the Act had been breached. It divided its findings according to the three types of transactions identified above in the recital of the facts.

A. The Drilling Results and Share Options Transactions

25 The Commission found that Prime or Calpine had, on four occasions in July and August 1989, contravened s. 67 of the Act in failing to disclose all material changes in their affairs prior to granting or repricing options. The Commission's key holding was that the "Chinese Wall", an internal company stratagem, did not relieve the senior managers from their obligations under s. 67 of the Act, which mandates disclosure of material change "as soon as practicable". The Commission stated:

> The accumulation of drilling results for release at periodic intervals is, in most circumstances, a reasonable approach to the disclosure of such information. Where an issuer proposes to engage in a securities transaction, however, it must ensure that any undisclosed material change is disclosed before proceeding with the transaction. The words "as soon as practicable" have a different meaning in this context than they might in the absence of the securities transaction.

In the view of the Commission, there was a positive obligation on the managers to make inquiries to determine whether there had been a material change prior to engaging in any securities transactions. The "Chinese Wall", though effective in shielding the managers from knowledge, did not release them from this obligation.

26 With respect to the fifth options transaction, the Commission found that Calpine had abused the ten day average pricing formula under the VSE's options policy, in failing to set the price of the options at a level reflecting the dissemination of recently disclosed material changes.

27 The Commission also found that, in two filings with the VSE for approval of options transactions, Pezim falsely certified that there were no material changes in the affairs of Calpine and Prime, respectively, that had not been publicly disclosed.

28 Finally, with respect to s. 68 of the Act, the Commission found, as noted above, that the "Chinese Wall" was effective in shielding the respondents from having knowledge of undisclosed material facts or material changes. Accordingly, the respondents had no knowledge of the drilling results when Prime and Calpine granted and repriced the options. Consequently, there was no breach of s. 68 of the Act.

B. The Private Placement

29 The Commission found that Calpine's disclosure of the private placement on July 14, 1989 was not in compliance with s. 67 of the Act because it failed to disclose that Prime was the placee and what effect the private placement would have on the control of Calpine. The Commission stated the following:

> The fact that Calpine's major shareholder would, through the private placement, raise its interest from 23 per cent to 36 per cent, assuming exercise of the warrants, represented a change in the ownership of Calpine that, by significantly reducing the possibility of a challenge for control, would reasonably be expected to cause a significant effect on the market price or value of Calpine's shares. It was therefore a material change in Calpine's affairs and was required to be disclosed, under section 67 of the Act.

30 The Commission also found that Calpine misled the VSE on July 17, 1989 by representing that the private placement was to be brokered by Prime Equities, and that Page falsely certified to the VSE on August 18, 1989 that there were no material changes in the affairs of Calpine that had not been publicly disclosed. With respect to the private placement, the Commission found no contravention of s. 68 of the Act.

C. The ALC Withdrawal

31 The Commission could not accept the respondents' argument that, with respect to the ALC withdrawal, there was nothing to disclose. In its view, the situation Prime found itself in on September 25, 1989 "would reasonably have been expected to have a significant effect on the market price of Prime's shares". Consequently, the Commission found that, in failing to make timely and adequate disclosure of the dispute with Canarim following ALC's withdrawal, Prime contravened s. 67 of the Act.

D. The Orders

32 In its findings, the Commission did not make any orders and preferred instead to hear submissions from the parties, following the release of its findings, with respect to the terms of the orders to be made under ss. 144 and 154.2 of the Act.

33 In its decision, released December 17, 1990, the Commission reviewed the parties submissions relating to orders and concluded that the respondents' improper conduct was related to distributions of securities under the exemptions in the Act. Consequently, in order to indicate the seriousness with which it viewed the contraventions, the Commission considered it to be in the public interest to remove the respondents' right to rely on the exemptions. Since the respondents were directors and senior management of Prime and Calpine, and had responsibility for ensuring compliance with securities regulatory requirements, the Commission decided not to differentiate among them in making its orders.

34 With respect to costs, the Commission rejected the respondents' argument that the length of the investigation and the hearing related mostly to the allegations of insider trading, which were not established. Rather, it found that most of the hearing related to evidence concerning those matters in respect of which it did find contravention. It held further that the suspicions which led to the other allegations were aroused by the respondents' own conduct in failing to make required disclosure and in filing misleading documents with the VSE.

35 The Commission concluded by making the following orders:

- under section 144(1)(c) of the Act, that the exemptions described in sections 30 to 32, 55, 58, 80 and 81 do not apply to Pezim, Page and Ivany for a period of one year, beginning January 1, 1991; and

- under section 154.2 of the Act, that Pezim, Page and Ivany pay prescribed fees or charges for two thirds of the costs of or related to the hearing that have been incurred by the Commission and the Superintendent, with the amount to be determined on further application to the Commission if the parties are unable to agree on the amount.

2. British Columbia Court of Appeal (1992), 66 B.C.L.R. (2d) 257

Lambert J.A., Carrothers J.A. concurring

36 The majority did not expressly consider the appropriate standard of review in the circumstances. Lambert J.A. merely stated the following at the outset of his reasons, at pp. 262-63:

> I think we may consider alleged errors of law in relation to both the interpretation and the application of those three specified sections of the Act. Alleged errors in interpretation are, of course, errors of law. Alleged errors of application may be errors of law or errors of fact or errors of mixed law and fact. We are required and permitted to consider only alleged errors of application that are errors of law.

37 The majority went on to examine the three types of impugned transactions in order to determine whether or not the Commission had erred in finding a breach of s. 67 of the Act and no breach of s. 68.

A. The Drilling Results and Share Options Transactions

38 Lambert J.A. determined that the Commission's findings were predicated on a finding that drilling results could be a "material change" within the meaning of s. 67 of the Act. He distinguished between s. 67, a reporting provision dealing with a material change and s. 68, a prohibitory provision dealing with material facts. Drilling reports, he said, are capable of being material facts. However, information obtained from those reports does not constitute a material change as that term is defined in the Act. Lambert J.A. explained this conclusion as follows, at p. 268:

> In my opinion, geological information of the nature obtained on a continuing basis as a result of a planned drilling program does not constitute a change in the business, the operations, the assets, or the ownership of the issuer, no matter what information is obtained from the drilling results. Such information may constitute a basis for a perception that there has been a change in the value of an asset. But that is a far different thing than a change in an asset.

39 Having determined that the Commission erred in its interpretation of "material change", the majority of the Court of Appeal held that all the conclusions of the Commission with respect to the drilling results and options transactions were flawed and could not stand.

40 Having made the distinction between material facts and material changes, the majority of the Court of Appeal further held that s. 67 does not impose a duty to inquire into material facts prior to engaging in securities transactions. Lambert J.A. stated the following at p. 279:

> There is a duty to disclose material facts that are known. There is a duty to disclose material changes in the business, operations, assets or ownership of the issuer, and perhaps to make enquiries about whether there are such material changes if it should happen that they are not known. But there is no duty to enquire about material facts, and to find them out, and not to engage in securities transactions if there are any material facts that could have been found out. Section 68(2) [since repealed] specifically contemplates that there is no such duty.

B. The Private Placement

41 For reasons of convenience, I reproduce below the Commission's two findings with respect to the private placement:

> [The Commission]... found that Calpine's disclosure of the private placement on July 14 was not in compliance with section 67 of the Act because it failed to disclose that Prime was the placee and what effect the private placement would have on the control of Calpine.

> [The Commission]... also found that Calpine misled the Exchange [VSE] on July 17 by representing that the private placement was to be brokered by Prime Equities, and that Page falsely certified to the Exchange on August 18 that there

> were no material changes in the affairs of Calpine that had not been publicly disclosed.

42 With respect to the first finding, the majority found no error of law on the part of the Commission, holding that the effect of the private placement constituted a material change in the affairs of Calpine in the form of a change of ownership which could reasonably be expected to have a significant effect on the market price or on the value of the common shares of Calpine.

43 The majority also held that the Commission did not err in law in its conclusion in the first part of the second finding that Calpine ought to have disclosed that Prime was to be the placee, although Lambert J.A. at p. 273 thought that to say that Calpine "misled the [VSE]" was a "somewhat harsh way of describing the filing".

44 The majority did, however, overturn the second part of the second finding. According to Lambert J.A., the Commission's conclusion was flawed by the error in law encompassed by regarding the undisclosed assays as constituting material changes in the affairs of Calpine.

C. The ALC Withdrawal

45 Once again, the majority held that the Commission's finding was flawed by the error of law in misinterpreting the definition of "material change". According to Lambert J.A., the oral statements by Brown, Canarim's chairperson, that his company did not consider itself bound to take four million units but only three million units, did not amount to a default of the GAA, and thus it could not be said that there was a change in the "business, operations, assets or ownership of the issuer" under s. 67 of the Act. He was also of the view that the telephone calls and meetings relating to the negotiations did not amount to a material change. Lambert J.A. stated that it may well have been counterproductive for the respondents to issue a press release during the difficult and delicate negotiations and thus may not have been in the public interest.

D. The Orders

46 With respect to s. 144 of the Act, the majority of the Court of Appeal held that the words "in the public interest" limit the range of orders that may be made by the Commission under that provision. It continued as follows at p. 281:

> If there is no rational link between the conduct of the person in question and the order made by the commission, or if that rational link is not a rational link for which the justification rests on the public interest, then such an order of the commission would be outside the commission's powers under s. 144(1).

47 Lambert J.A. then seemed to hold that there was no link between the order made in this case and the respondents' conduct since the order that was chosen was made in respect of personal trading. Lambert J.A. did not pursue this argument given his findings that the Commission had erred in law in finding a breach of the Act. Accordingly, the majority held that the Commission's orders under s. 144 could not stand.

48 On the issue of costs, the respondents argued that, because the Act requires the Commission to fund its own activities, there was a reasonable apprehension of bias with respect to the order that they pay two-thirds of the costs of the hearing. The majority rejected this argument stating that it was not the appropriate time in the proceedings to raise such an argument. The fact that the Commission was required to be self-funding did not impact on the legality of its order. Nevertheless, the majority ordered that the order of the Commission be set aside and that the respondents pay one tenth of the Commission's costs of the investigation. Disputes relating to costs were to be brought back to the Court of Appeal.

Locke J.A., dissenting

49 In most comprehensive reasons, Locke J.A. began by stating that the appeal was being heard under a general appellate provision and not as an application for judicial review under a particular statute. He then reviewed several cases dealing with the purpose and characteristics of securities commissions and concluded at p. 300 that "[i]n the case of appeals from specialized tribunals...an appellate court should be slow to interfere unless the tribunal is shown to be clearly wrong either on fact or law".

50 Locke J.A went on to examine the three types of impugned transactions as identified in the facts.

A. The Drilling Results and Share Options Transactions

51 In interpreting the disclosure requirements of s. 67 of the Act, Locke J.A. rejected the narrow approach advocated by the respondents. He held, at p. 308, that "information per se is capable of being an 'asset' within the meaning of the Act". This interpretation of the Act, according to Locke J.A. at p. 309, is consistent with its aims, which include "prevent[ing] high-pressure sales tactics, seeing that disclosure is complete, and ensuring that all individuals are informed before actually entering into a securities transaction". Locke J.A. then reviewed the drilling results as well as their potential effect. He held that the information found in these results could indeed be interpreted as a material change in the assets of the company within the meaning of the Act.

52 Noting that the Act is not penal legislation but rather is regulatory in scope, Locke J.A. would have interpreted its provisions as advocated by the appellants. He concluded at p. 315 that there was "overwhelming evidence to support each finding of the commission" and would not tamper with them.

B. The Private Placement

53 After reviewing the facts surrounding the private placement, Locke J.A again concluded that there was ample evidence to support the Commission's findings and that there was no basis for interfering with them.

C. The ALC Withdrawal

54 Locke J.A. reviewed the facts and the findings relating to the ALC matter, and concluded, at p. 329, that there was "no justifiable reason" for the respondents' delay in informing the public of the default. He added, at p. 329, that Ivany's natural reluctance to inform the public as well as his hopes to remedy the situation "constitute[d] no legal excuse for withholding the information".

D. The Orders

55 With respect to the orders handed down by the Commission, Locke J.A. stated, at p. 339, that the appropriateness of a penalty is a matter for a commission to decide and that a court should not interfere unless it is clear that "there is such an injustice as indicates a legal error". Locke J.A. found no such error.

56 On the issue of costs, Locke J.A. rejected the respondents' argument that there was an apprehension of bias. He also did not disturb the proportion of the costs (two thirds) which the respondents were ordered to pay. Locke J.A. did have concerns, however, regarding the compilation of the "expenses" charged as costs to the appellants under s. 154.2. However, as he pointed out at p. 344, his concerns relate to a matter "for legislators and not judges".

IV. Issues

57 Although the parties to this appeal have made specific allegations of error on the part of the Commission and of the Court of Appeal, the issues can be reduced to the following two questions:

1. What is the appropriate standard of review for an appellate court reviewing a decision of a securities commission not protected by a privative clause when there exists a statutory right of appeal and where the case turns on a question of interpretation?
2. In the case at bar, did the British Columbia Court of Appeal exercise the appropriate standard of review?

V. Analysis

1. What is the appropriate standard of review for an appellate court reviewing a decision of a securities commission not protected by a privative clause when there exists a statutory right of appeal and where the case turns on a question of interpretation?

58 In order to answer this first question, I should like to discuss a number of factors and principles which come into play.

A. The Nature of the Statute

59 It is important to note from the outset that the Act is regulatory in nature. In fact, it is part of a much larger framework which regulates the securities industry throughout Canada. Its primary goal is the protection of the investor but other goals include capital market efficiency and ensuring public confidence in the system: David L. Johnston, Canadian Securities Regulation (1977), at p. 1.

60 Within this large framework of securities regulation, there are various government administrative agencies which are responsible for the securities legislation within their respective jurisdictions. The Commission is one such agency. Also within this large framework are self-regulatory organizations which possess the power to admit and discipline members and issuers. The VSE falls under this head. Having regard to this rather elaborate framework, it is not surprising that securities regulation is a highly specialized activity which requires specific knowledge and expertise in what have become complex and essential capital and financial markets.

B. Principles of Judicial Review

61 From the outset, it is important to set forth certain principles of judicial review. There exist various standards of review with respect to the myriad of administrative agencies that exist in our country. The central question in ascertaining the standard of review is to determine the legislative intent in conferring jurisdiction on the administrative tribunal. In answering this question, the courts have looked at various factors. Included in the analysis is an examination of the tribunal's role or function. Also crucial is whether or not the agency's decisions are protected by a privative clause. Finally, of fundamental importance, is whether or not the question goes to the jurisdiction of the tribunal involved.

62 Having regard to the large number of factors relevant in determining the applicable standard of review, the courts have developed a spectrum that ranges from the standard of reasonableness to that of correctness. Courts have also enunciated a principle of deference that applies not just to the facts as found by the tribunal, but also to the legal questions before the tribunal in the light of its role and expertise. At the reasonableness end of the spectrum, where deference is at its highest, are those cases where a tribunal protected by a true privative clause, is deciding a matter within its jurisdiction and where there is no statutory right of appeal. See Canadian Union of Public Employees, Local 963 v. New Brunswick Liquor Corp., [1979] 2 S.C.R. 227; U.E.S., Local 298 v. Bibeault, [1988] 2 S.C.R. 1048, at p. 1089 (Bibeault), and Domtar Inc. v. Quebec (Commission d'appel en matière de lésions professionnelles), [1993] 2 S.C.R. 756.

63 At the correctness end of the spectrum, where deference in terms of legal questions is at its lowest, are those cases where the issues concern the interpretation of a provision limiting the tribunal's jurisdiction (jurisdictional error) or where there is a statutory right of appeal which allows

the reviewing court to substitute its opinion for that of the tribunal and where the tribunal has no greater expertise than the court on the issue in question, as for example in the area of human rights. See for example Zurich Insurance Co. v. Ontario (Human Rights Commission), [1992] 2 S.C.R. 321; Canada (Attorney General) v. Mossop, [1993] 1 S.C.R. 554, and University of British Columbia v. Berg, [1993] 2 S.C.R. 353.

64 The case at bar falls between these two extremes. On one hand, we are dealing with a statutory right of appeal pursuant to s. 149 of the Act. On the other hand, we are dealing with an appeal from a highly specialized tribunal on an issue which arguably goes to the core of its regulatory mandate and expertise.

65 This Court's decision in Bell Canada v. Canada (Canadian Radio-Television and Telecommunications Commission), [1989] 1 S.C.R. 1722 (Bell Canada), is particularly helpful in deciding the present case as it dealt with a statutory right of appeal rather than an application for judicial review. Gonthier J., writing for this Court, stated the following at pp. 1745-46:

> It is trite to say that the jurisdiction of a court on appeal is much broader than the jurisdiction of a court on judicial review. In principle, a court is entitled, on appeal, to disagree with the reasoning of the lower tribunal.
>
> However, within the context of a statutory appeal from an administrative tribunal, additional consideration must be given to the principle of specialization of duties. Although an appeal tribunal has the right to disagree with the lower tribunal on issues which fall within the scope of the statutory appeal, curial deference should be given to the opinion of the lower tribunal on issues which fall squarely within its area of expertise. [Emphasis added.]

66 Consequently, even where there is no privative clause and where there is a statutory right of appeal, the concept of the specialization of duties requires that deference be shown to decisions of specialized tribunals on matters which fall squarely within the tribunal's expertise. This point was reaffirmed in United Brotherhood of Carpenters and Joiners of America, Local 579 v. Bradco Construction Ltd., [1993] 2 S.C.R. 316 (Bradco), where Sopinka J., writing for the majority, stated the following at p. 335:

> . . . the expertise of the tribunal is of the utmost importance in determining the intention of the legislator with respect to the degree of deference to be shown to a tribunal's decision in the absence of a full privative clause. Even where the tribunal's enabling statute provides explicitly for appellate review, as was the case in Bell Canada, supra, it has been stressed that deference should be shown by the appellate tribunal to the opinions of the specialized lower tribunal on matters squarely within its jurisdiction.

> On the other side of the coin, a lack of relative expertise on the part of the tribunal vis-à-vis the particular issue before it as compared with the reviewing court is a ground for a refusal of deference.

67 In my view, the pragmatic or functional approach articulated in Bibeault is also helpful in determining the standard of review applicable in this case. At page 1088 of that decision, Beetz J., writing for the Court, stated the following:

> . . . the Court examines not only the wording of the enactment conferring jurisdiction on the administrative tribunal, but the purpose of the statute creating the tribunal, the reason for its existence, the area of expertise of its members and the nature of the problem before the tribunal.

68 As already mentioned, the primary goal of securities legislation is the protection of the investing public. The importance of that goal in assessing the decisions of securities commissions has been recognized by this Court in Brosseau v. Alberta Securities Commission, [1989] 1 S.C.R. 301 (Brosseau), where L'Heureux-Dubé J., writing for the Court, stated the following at p. 314:

> Securities acts in general can be said to be aimed at regulating the market and protecting the general public. This role was recognized by this Court in Gregory & Co. v. Quebec Securities Commission, [1961] S.C.R. 584, where Fauteux J. observed at p. 588:
>
> > The paramount object of the Act is to ensure that persons who, in the province, carry on the business of trading in securities or acting as investment counsel, shall be honest and of good repute and, in this way, to protect the public, in the province or elsewhere, from being defrauded as a result of certain activities initiated in the province by persons therein carrying on such a business.
>
> This protective role, common to all securities commissions, gives a special character to such bodies which must be recognized when assessing the way in which their functions are carried out under their Acts.

69 In National Corn Growers Assn. v. Canada (Import Tribunal), [1990] 2 S.C.R. 1324, Wilson J., in a concurring judgment, referred at p. 1336 to financial markets as a field where specialized tribunals have an important role to play:

> Canadian courts have struggled over time to move away from the picture that Dicey painted toward a more sophisticated understanding of the role of administrative tribunals in the modern Canadian state. Part of this process has

involved a growing recognition on the part of courts that they may simply not be as well equipped as administrative tribunals or agencies to deal with issues which Parliament has chosen to regulate through bodies exercising delegated power, e.g., labour relations, telecommunications, financial markets and international economic relations. Careful management of these sectors often requires the use of experts who have accumulated years of experience and a specialized understanding of the activities they supervise.

Courts have also come to accept that they may not be as well qualified as a given agency to provide interpretations of that agency's constitutive statute that make sense given the broad policy context within which that agency must work. [Emphasis added.]

70 The breadth of the Commission's expertise and specialisation is reflected in the provisions of the Act. Section 4 of the Act identifies the Commission as being responsible for the administration of the Act. The Commission also has broad powers with respect to investigations, audits, hearings and orders. Section 144.2 provides that any decision of the Commission filed in the Registry of the Supreme Court of British Columbia has the force and effect of a decision of that court. Finally, pursuant to s. 153 of the Act, the Commission has the power to revoke or vary any of its decisions. Sections 14 and 144 are of particular importance as they reveal the breadth of the Commission's public interest mandate:

14. (1) The commission may, where it considers it to be in the public interest, make any decision respecting

(a) a bylaw, rule or other regulatory instrument or policy, or a direction, decision, order or ruling made under a bylaw, rule or other regulatory instrument or policy, of a self regulatory body or stock exchange.

(b) the procedures or practices of a self regulatory body or stock exchange,

(c) the manner in which a stock exchange carries on business,

(d) the trading of securities on or through the facilities of a stock exchange,

(e) a security listed and posted for trading on a stock exchange, and

(f) issuers, whose securities are listed and posted for trading on a stock exchange, to ensure that they comply with this Act and the regulations.

(2) A person affected by a decision made by the commission under subsection (1) shall act in accordance with it.

144. (1) Where the commission or the superintendent considers it to be in the public interest, the commission or the superintendent, after a hearing, may order

(a) that a person comply with or cease contravening, and that the directors and senior officers of the person cause the person to comply with or cease contravening,

(i) a provision of this Act or the regulations,

(ii) a decision, whether or not the decision has been filed under section 144.2, or

(iii) a bylaw, rule, or other regulatory instrument or policy or a direction, decision, order or ruling made under a bylaw, rule or other regulatory instrument or policy of a self regulatory body or stock exchange, as the case may be, which has been recognized by the commission under section 11,

(b) that

(i) all persons

(ii) the person or persons named in the order, or

(iii) one or more classes of persons

cease trading in a specified security or in a class of security,

(c) that any or all of the exemptions described in any of sections 30 to 32, 55, 58, 80 or 81 do not apply to a person,

(d) that a person

(i) resign any position that the person holds as a director or officer of an issuer, and

(ii) is prohibited from becoming or acting as a director or officer of any issuer,

....

71 In reading these powerful provisions, it is clear that it was the legislature's intention to give the Commission a very broad discretion to determine what is in the public's interest. To me, this is an additional basis for judicial deference.

72 It must also be noted that the definitions in the Act exist in a factual or regulatory context. They are part of the larger regulatory framework discussed above. They are not to be analyzed in isolation but rather in their regulatory context. This is something that requires expertise and thus falls within the jurisdiction of the Commission. This is yet another basis for curial deference.

73 Finally, it is noteworthy that various courts, including this Court, have shown deference towards the decisions of securities commission: Pacific Coast Coin Exchange v. Ontario Securities Commission, [1978] 2 S.C.R. 112; Brosseau, supra; Four Star Mgmt. Ltd. v. B.C. Securities Comm. (1990), 46 B.C.L.R. (2d) 195 (C.A.), leave to appeal refused, sub nom. Williams (Byron Leslie) v. British Columbia Securities Comm., [1991] 1 S.C.R. xv; and Gordon Capital Corp. v. Ontario Securities Commission (1991), 14 O.S.C.B. 2713 (Div. Ct.).

C. The Role of the Commission

74 Where a tribunal plays a role in policy development, a higher degree of judicial deference is warranted with respect to its interpretation of the law. This was stated by the majority of this Court in Bradco at pp. 336-37:

> . . . a distinction can be drawn between arbitrators, appointed on an ad hoc basis to decide a particular dispute arising under a collective agreement, and labour relations boards responsible for overseeing the ongoing interpretation of legislation and development of labour relations policy and precedent within a given labour jurisdiction. To the latter, and other similar specialized tribunals responsible for the regulation of a specific industrial or technological sphere, a greater degree of deference is due their interpretation of the law notwithstanding the absence of a privative clause. [Emphasis added.]

75 In the case at bar, the Commission's primary role is to administer and apply the Act. It also plays a policy development role. Thus, this is an additional basis for deference. However, it is important to note that the Commission's policy-making role is limited. By that I mean that their policies cannot be elevated to the status of law; they are not to be treated as legal pronouncements absent legal authority mandating such treatment.

76 Thus on precedent, principle and policy, I conclude as a general proposition that the decisions of the Commission, falling within its expertise, warrant judicial deference.

D. The Questions of Law at Issue

77 As mentioned above, it is also necessary to focus on the specific question of law at issue to determine whether it falls within the tribunal's expertise and whether deference is warranted. The specific sections at issue in this case are ss. 67, 144 and 154.2 of the Act.

78 The decision to make an order and the precise nature of that order, under s. 144, as well as any decision obliging a person to pay the costs of a hearing necessitated by his or her conduct, pursuant to s. 154.2, are clearly within the jurisdiction and expertise of the Commission. The other provision at issue is s. 67 which involves an interpretation of the words "material change" and "as soon as practicable".

79 Both "material change" and "material fact" are defined in s. 1 of the Act. They are defined in terms of the significance of their impact on the market price or value of the securities of an issuer. The definition of "material fact" is broader than that of "material change"; it encompasses any fact that can "reasonably be expected to significantly affect" the market price or value of the securities of an issuer, and not only changes in the "business, operations, assets or ownership of the issuer" that would reasonably be expected to have such an effect.

80 The use of these two terms in the Act also reflects the differences in their scope. For example, a prospectus relating to a public distribution of securities must disclose all material facts relating to the issuer: ss. 44(1), 45(2), 49(1) and 50(1). However, the prospectus need be amended only when a material change occurs: ss. 47(1), (2) and 48(1).

81 Sections 67 and 68 of the Act also reflect the differences between a material change and a material fact. As Victor P. Alboini points out in Securities Law and Practice, 2nd ed., vol. 2 (1984), at p. 18-13, "[t]he concept of 'material change' should be distinguished from that of 'material fact'. Undisclosed material facts concerning a reporting issuer may not require timely disclosure...although they do restrict trading". Under the timely disclosure provision of the Act, s. 67, only material changes require that a press release be issued and that a report be filed. In contrast, under the insider trading provision, s. 68, a person who is in a special relationship with a reporting issuer is prohibited from buying or selling securities of the issuer when the person knows of either a material change or a material fact which has not been publicly disclosed.

82 As already mentioned, the present case turns partly on the definition of "material change". Three elements emerge from that definition: the change must be (a) "in relation to the affairs of an issuer", (b) "in the business, operations, assets or ownership of the issuer" and (c) material, i.e., would reasonably be expected to have a significant effect on the market price or value of the securities of the issuer. Thus, not all changes are material changes; the latter are set in the context of making sure that issuers keep investors up to date. Consequently, it would seem wholly uncontroversial that the determination of what information should be disclosed is an issue which goes to the heart of the regulatory expertise and mandate of the Commission, i.e, regulating the securities markets in the public's interest.

83 This case also turns on the meaning of the words "as soon as practicable" in s. 67 of the Act which reveal when a material change should be disclosed to the public. In my view, the timeliness of disclosure also falls within the Commission's regulatory jurisdiction.

84 In summary, having regard to the nature of the securities industry, the Commission's specialization of duties and policy development role as well as the nature of the problem before the court, considerable deference is warranted in the present case notwithstanding the fact that there is a statutory right of appeal and there is no privative clause.

2. In the case at bar, did the British Columbia Court of Appeal exercise the appropriate standard of review?

A. The Drilling Results and Share Options Transactions

85 The Commission's conclusion that s. 67 was violated in the context of the share options transactions can be subdivided into two parts. The first element of the conclusion is that undisclosed drilling results can constitute a material change in the affairs of a reporting issuer. Locke J.A. of the Court of Appeal agreed. Lambert J.A., however, writing for the majority of the Court of Appeal, was of a different view. He held at p. 268 that information obtained from assay results cannot constitute a material change:

> In my opinion, geological information obtained from observations of visible matter and geological information from drill cores in the form of assay results, or in the form of a properly plotted plan prepared from the results of a number of assays, are all capable of being material facts. Let us assume that the geological information relied upon by the commission constituted material facts in this case. That does not mean that the same geological information constituted material changes. In my opinion, geological information of the nature obtained on a continuing basis as a result of a planned drilling program does not constitute a change in the business, the operations, the assets or the ownership of the issuer, no matter what information is obtained from the drilling results. Such information may constitute a basis for a perception that there has been a change in the value of an asset. But that is a far different thing than a change in an asset. [Emphasis added.]

86 As already mentioned, the determination of what constitutes a material change for the purposes of general disclosure under s. 67 of the Act is a matter which falls squarely within the regulatory mandate and expertise of the Commission. Consequently, when the majority of the Court of Appeal rejected the Commission's findings on this matter, it fell into error. Furthermore, the majority's view on this point is, in my opinion, clearly wrong and is inconsistent with the economic and regulatory realities the Act sets out to address. Counsel for the respondents conceded this point, during the hearing of this appeal, and stated that "information from a drilling program can be tantamount to a material change".

87 In the mining industry, mineral properties are constantly being assessed to determine whether there is a change in the characterization of the property. Thus, from the point of view of investors, new information relating to a mining property (which is an asset) bears significantly on the question of that property's value. Accordingly, I agree with the approach taken by the Commission, namely that a change in assay and drilling results can amount to a material change depending on the circumstances.

88 George C. Stevens and Stephen D. Wortley, authors of "Murray Pezim in the Court of Appeal: Draining the Lifeblood from Securities Regulation" (1992), 26 U.B.C. L. Rev. 331, are of the same view. In commenting on the above quoted passage, they stated the following at pp. 336-37:

> To the geologist or the mining property valuator, Lambert J.A.'s statement is astonishing. Every mine starts from host rock. Every drill hole leads not merely to a change of perception of the asset: it is a piece in the puzzle that ultimately determines whether the asset is moose pasture or ore. Each new result may change the characterization of the asset from rock, to mineral deposit, to inferred ore, to probable ore and ultimately, with enough holes supported by a feasibility study, to proven ore.
>
> Even more astonishing was the Court's conclusion, without receipt of any evidence, that drilling results would never constitute a change in the operations or assets of an issuer.
>
> . . .
>
> Can the Court really suggest that there has not been a change in a company's assets when, following adequate sampling, a discovery is made on a portion of its property that had been previously categorized as having no known mineralization? Surely, given the basic aim of the Act - to protect the investing public through full, true and plain disclosure of all material facts relating to securities - one could conclude (as did Mr. Justice Locke, the dissenting judge) that the Commission did not make a "plain and vital mistake" in the application of the words in s. 67 of the Act to the facts before it....

89 Consequently, I am of the view, as found by the Commission and Locke J.A., that the assay results constituted a change with respect to or in the companies' assets and is "material" for the purposes of the Act.

90 The second element of the Commission's conclusion that s. 67 was violated in the context of the share options transactions is that the obligation to disclose "as soon as practicable" takes on a different meaning when an issuer is about to engage in a securities transaction:

> Where an issuer proposes to engage in a securities transaction...it must ensure that any undisclosed material change is disclosed before proceeding with the transaction. The words "as soon as practicable" have a different meaning in this context than they might in the absence of the securities transaction.
>
> Senior Management were responsible for managing the affairs of Prime and Calpine and for ensuring that they complied with their obligations under the Act. In carrying out this responsibility, Senior Management ought to have made reasonable inquiries, before causing Prime and Calpine to engage in securities transactions, to ensure that all material changes in their affairs had been disclosed.
>
> . . .
>
> Considering the importance of the principles involved here, any securities transactions by Prime or Calpine in their own securities warranted inquiries and any reasonable inquiries would have led to any undisclosed material changes that may have existed. [Emphasis added.]

91 By stating the following at p. 279, the majority of the Court of Appeal appeared to disagree:

> ...the commission erred in law by interpreting and applying the defined phrase "material change" in s. 67 as if it were equivalent to the phrase "material fact"....
>
> As a consequence of that error in law, the commission regarded Prime and Calpine and the senior officers of those issuers as having a duty, before Prime or Calpine engaged in any securities transaction, to make enquiries of the senior geologist who was responsible for releasing all geological information as soon as it was practicable to do so in comprehensible form, about whether there was any material geological information that had not been released.
>
> There are sound arguments both for and against the imposition of such a duty. But in balancing those arguments the legislature has chosen against imposing that duty.

92 However, in this next passage at p. 279, the majority seems to say that, although there is no duty to inquire about material facts, there may be a duty to inquire about material changes:

> There is a duty to disclose material facts that are known. <u>There is a duty to disclose material changes in the business, operations, assets or ownership of the</u>

> issuer, and perhaps to make inquiries about whether there are such material changes if it should happen that they are not known. But there is no duty to inquire about material facts, and to find them out, and not to engage in securities transactions if there [were] any material facts that could have been found out. Section 68(2) [since repealed] specifically contemplates that there is no such duty.

93 From this passage, it appears that the majority of the Court of Appeal is itself unclear as to whether or not there is a duty under s. 67 to inquire as to the existence of material changes before causing a reporting issuer to engage in securities transactions. In any event, I find that it was well within the Commission's jurisdiction to interpret s. 67 in the manner it did, and I fully agree with its position on this point. Although a duty to inquire is not expressly stated in s. 67, such an interpretation contextualizes the general obligation to disclose material changes and guarantees the fairness of the market, which is the underlying goal of the Act. Stevens and Wortley, supra, also support this position, at pp. 338-39:

> Now the duty to disclose all material facts arises when a company enters the public market. Its prospectus must contain full, true and plain disclosure of all material facts. Compliance with that fundamental rule does indeed put a duty of inquiry on those who sign the prospectus, Lambert J.A.'s statement notwithstanding. Thereafter, the duty to disclose material facts is really a duty to disclose *changes* from the basket of facts disclosed originally and from time to time afterwards. That is why the Act uses "material facts" and "material changes" in different contexts.
>
> Nowhere, however, in this underlying statutory scheme of continuous disclosure is there a principle that states the duty of inquiry imposed upon management when a company first enters the securities markets is in some way lessened thereafter. On this point the Court has made unhappy new law. [Emphasis in original.]

94 It must be noted that a duty to inquire under s. 67 is not incompatible with the insider trading provision of the Act, s. 68. If an issuer wishes to engage in a securities transaction, its directors must inquire about all material changes in the issuer's affairs. Consequently, the directors will have, at one point in time, knowledge of undisclosed material facts and material changes which constitute inside information. However, as long as the material facts and material changes are adequately disclosed prior to the transaction, there will be no possibility of insider trading. It must also be noted that the erecting of a Chinese Wall, which prevents directors of a company from having inside information, does not erase the duty imposed on directors to inquire about material changes, as the disclosure requirements under s. 67 are on the issuer.

95 Having concluded that information contained in drilling results can constitute a material change in the affairs of a reporting issuer and that s. 67 imposes on senior management a duty to inquire as to the existence of material changes before causing a reporting issuer to engage in a securities transaction, the Commission went on to review the circumstances surrounding the share options transactions of July 12 and 31, August 15 and 17, 1989. The Commission made the following findings: (1) The July 12 transaction was completed after a new zone of mineralization had been identified, as well as a possible doubling of the reserves, but before the news release of July 13 was issued. (2) The July 31 transaction was concluded after the discovery of visible gold and extensive other mineralization in hole 109, but before the news release of August 2. (3) The August 15 transaction was completed after Prime was in possession of the assay results for holes 93 and 101 but before the news release was issued that afternoon. (4) The August 17 transaction followed the arrival of the gold assays for hole 109; the news release relating to these assays was issued on August 22. Based on these findings, the Commission held that the respondents failed to disclose various material changes in the affairs of Prime and Calpine before causing these two companies to engage in securities transactions. Consequently, the respondents had contravened s. 67 of the Act.

96 Like Locke J.A., I find that there was overwhelming evidence to support each of the Commission's findings and I would not disturb any of them. Consequently, the majority of the Court of Appeal erred in interfering with the Commission's conclusion that, with respect to the share options transactions, the respondents breached their timely disclosure obligations under s. 67 of the Act.

97 As the majority of the Court of Appeal did not discuss the fifth impugned share options transaction, the Commission's finding with respect to this transaction will stand.

B. The Private Placement

98 The majority of the Court of Appeal agreed with the Commission that s. 67 of the Act was breached when Calpine failed to disclose the identity of the placee or the fact that Prime was to increase its control over Calpine from 23 to 36 percent, assuming exercise of the warrants. In this respect, it is worth noting that by obtaining a 36 percent holding in Calpine, Prime thereby could prevent the passing of a special resolution as defined in s. 1 of the Company Act, which in turn empowered Prime to prevent a number of important transactions for which a special resolution of shareholders is required under the Company Act (see, for example, ss. 255, 267 and 272).

99 The majority also agreed that Calpine misled the VSE on July 17, 1989 by representing that the private placement was to be brokered by Prime Equities. However, the majority overturned the Commission's finding that Page falsely certified to the VSE on August 18, 1989 that there were no material changes in the affairs of Calpine that had not been publicly disclosed. It predicated its conclusion on the fact that undisclosed assays cannot constitute a material change.

100 As already mentioned, the determination of what constitutes a material change goes to the heart of the expertise and mandate of the Commission. Furthermore, having regard to the realities of the mining industry, information from assay results can properly be characterized as a material change in the business, operations, assets or ownership of a reporting issuer. To conclude, I agree with Locke J.A. that the findings of the Commission on the private placement issue reveal no error.

C. The ALC Withdrawal

101 The majority of the Court of Appeal overturned the Commission's finding that s. 67 had been breached by not disclosing the ALC withdrawal. The majority viewed the ALC withdrawal in contractual terms and stated that it did not have to be disclosed until there was repudiation of the contract and such repudiation was accepted by Prime.

102 In my view, this narrow approach is wrong and is inconsistent with the purpose of the Act, i.e., to protect the investing public. Again, like Locke J.A., I find there is little basis for disagreeing with the Commission's conclusions. ALC's withdrawal represented a $4.25 million contractual dispute. It would seem wholly uncontroversial to consider such a dispute a change in the business, operations, ownership or affairs of a reporting issuer. As Stevens and Wortley point out, supra, at p. 338, "an account receivable that was to be transformed into cash on September 29 became instead nothing more than a disputed claim for breach of contract". Accordingly, non-disclosure of this dispute constituted a failure to disclose a material change. Thus, the majority of the Court of Appeal erred in rejecting the Commission's findings on this point.

103 In stating the above, I do not wish to imply that it is always self-evident as to what constitutes a material change. In this respect, it is interesting to note that the Chair of the Ontario Securities Commission has encouraged in that province an early warning system which allows informal disclosure to the Commission of a proposed transaction on a confidential basis. According to Alboini, supra, at pp. 18-14 and 18-15, such a system "allows for appropriate steps to be taken by the Commission to permit stock watches, while also creating an opportunity to discuss with Commission members or staff possible orders or applications that may be required in order to facilitate the transaction from a regulatory point of view".

D. The Orders

104 The respondents' argument that there must be a rational link between the conduct of the person in question and the order made by the Commission must be rejected. As we have seen, s. 144 of the Act gives the Commission a broad discretion to make orders that it considers to be in the public interest. Thus, a reviewing court should not disturb a Commission's order unless the Commission has made some error in principle in exercising its discretion or has exercised its discretion in a capricious or vexatious manner.

105 The discretion given to Securities Commissions to determine what is in the public interest was discussed by the Ontario Court of Appeal in Re the Securities Commission and Mitchell, [1957] O.W.N. 595, at p. 599:

> The Chairman and other members of the Commission are selected and appointed by the Lieutenant-Governor in Council for their high qualifications, ability and experience. It is the function and duty of the Commission under s. 8 of The Securities Act to form an opinion whether or not it is in the public interest to suspend or cancel the registration of any person. It is intended by the legislation that the Commission shall have extremely wide powers of discretion in forming its opinion.
>
> The opinion of the Commission should not be set aside or altered upon an appeal unless the Commission has erred in some principle of law or unless it appears clearly that the Commission has not proceeded to form its opinion in a judicial manner or unless it appears that the opinion of the Commission is so clearly wrong as to amount to an injustice requiring a remedy on appeal.

These words were adopted with approval in Bay Street West Securities (1983) Inc. v. Alberta Securities Commission (1984), 56 A.R. 19 (C.A.).

106 In the present case, the Commission exercised its discretion in a judicial manner. Following the release of its findings, it held a supplementary hearing to receive submissions from both parties as to the appropriate sanctions to impose on the respondents. In its final decision, the Commission held that the respondents were responsible for Prime and Calpine's contravention of the timely disclosure requirements of the Act. It further held that the respondents' conduct was related to distributions of securities under the exemptions in the Act. Consequently, the Commission removed the respondents' trading exemptions under the Act for a period of one year.

107 Some may argue that the Commission could not make the orders it did with respect to the respondents because the duty to make timely disclosure under s. 67 of the Act applies to a "reporting issuer". This argument must be rejected for two reasons. First, as Alboini points out, supra, at p. 18-26, "[a]lthough responsibility for timely disclosure is vested in the reporting issuer... effective responsibility rests with the senior officers and the directors of the reporting issuer". Second, not only does s. 144 of the Act give the Commission a broad public interest to make orders it considers to be in the public interest, it also confers upon the Commission the authority to make orders with respect to "a person".

108 In summary, it was clearly within the Commission's jurisdiction to order that the trading exemptions not apply to the respondents for a period of one year. Furthermore, the Commission's orders were not vexatious or erroneous in law. Consequently, the order under s. 144 of the Act must stand.

109 The Commission's order with respect to costs was also well within its jurisdiction. Consequently, considerable deference is in order. Moreover, although the respondents argued that the length of the investigation and the hearing related mostly to the allegations of insider trading, which were not proven, this was not the case. The Commission specifically stated so:

> The Respondents argued that we should make no order for payment of costs. They said that the length of the investigation and the hearing were made necessary only by the allegations related to insider trading and breach of directors' duties, which were not proven. However, most of the hearing related to evidence concerning those matters in respect of which we did find contraventions. Furthermore, the suspicions which led to the other allegations, about which the Respondents complained, were aroused, quite reasonably, by the Respondents' own conduct in failing to make required disclosure and in filing misleading documents with the [VSE]. [Emphasis added.]

110 Since no persuasive basis has been suggested for overturning the order relating to costs, I would not interfere with it.

VI. Conclusion and Disposition

111 The majority of the Court of Appeal erred in failing to appreciate the Commission's role in an area requiring special knowledge and sophistication. It also failed to recognize the Legislature's intent to confer a broad public interest mandate on the Commission to carry out its role. There was ample evidence to support each of the Commission's findings. There being no reviewable error of law, the majority of the Court of Appeal erred in interfering with the Commission's findings. Consequently, I would allow the appeal, set aside the judgment of the British Columbia Court of Appeal and substitute therefor the findings and orders of the Commission. The appellants shall have their costs here and in the court below.

Court File No. CV-10-883-00CL

SUPERIOR COURT OF JUSTICE

B E T W E E N: ONTARIO SECURITIES COMMISSION

Applicant

- AND -

PETER SBARAGLIA, MANDY SBARAGLIA, CO CAPITAL GROWTH INC. and 91 DAYS HYGIENE SERVICES INC.

Respondents

BEFORE THE HONOURABLE MR. JUSTICE MORAWETZ, held at the courthouse, 330 University Avenue, on December 23, 2010, commencing at 10:00 a.m.

REASONS FOR JUDGMENT

A P P E A R A N C E S:

PAMELA FOY	FOR THE APPLICANT
M.P. GOTTLIEB	FOR RSM RICHTER INC., RECEIVER AND ROBERT MANDER
MILTON DAVIS	FOR THE RESPONDENTS
KELLI PRESTON	FOR THE RESPONDENTS
PAUL ERIC VEEL	FOR CREDITOR, THE RESPONDENT CO CAPITAL GROWTH INC.

December 23, 2010
Mr. Justice Morawetz,

REASONS FOR JUDGMENT

The Ontario Securities Commission ("OSC") brings this application for an order appointing RSM Richter Inc. as receiver of the assets, undertakings and property of Dr. Peter Sbaraglia, Ms. Mandy Sbaraglia, CO Capital Growth Inc. and 91 Days Hygiene Services Inc.

This matter has a long history. In July 2008, staff of the OSC obtained an order from the Commission pursuant to s. 11(1) of the Securities Act to investigate and inquire into the business and affairs of Dr. Sbaraglia, Mr. Robert Mander, CO and Pero Assets Inc. with respect to trading in securities and potential breaches of Ontario securities law.

Based on the information that OSC staff received, it appeared that CO was obtaining funds from investors and investing those funds in securities.

The primary concern of the Commission was the use of investor funds by CO and Mr. Mander and Dr. Sbaraglia and whether funds and assets were available so as to ensure that the investors would be repaid.

During its investigation, the staff learned that a significant amount of funds obtained from investors had been transferred to Mr. Mander and his companies.

Mr. Mander operated and owned EMB Asset Group Inc. Through EMB, Mr. Mander operated a fraudulent Ponzi scheme involving in excess of $40 million of investors' funds. In certain instances, investors, such as CO Capital, invested money with

Mr. Mander or EMB which had been loaned to them from third-party investors.

CO was run by D. Sbaraglia and Mr. Mander. The record also establishes that Ms. Sbaraglia was integrally involved in the business of CO.

Throughout the period under review, CO was used by Dr. and Ms. Sbaraglia as an investment vehicle to solicit third-party investors to invest with Mr. Mander through CO.

Neither Dr. or Ms. Sbaraglia were registered with the OSC. CO raised approximately $21.2 million from investors, who Dr. Sbaraglia described as both friends and family. There were approximately 25 to 30 CO investors.

It has been determined that a significant portion of investor funds were not invested at all. Rather, the funds were used by Mr. Mander, and by CO to repay other investors.

The OSC takes the position that the Sbaraglias, through their role in CO and their close involvement with Mr. Mander, participated in the Ponzi scheme in a manner which they knew or ought reasonably to have known, perpetrated a fraud on investors contrary to s. 126(1)(e) of the Securities Act.

This is disputed by the Sbaraglias who take the position that they were victims of the fraud and not perpetrators of the fraud as they did not know about the fraud until the summer of 2009.

CO was incorporated on January 5, 2006. The first investor agreement is dated January 9, 2006 and CO continued to enter into loan agreements with investors until August 2009.

The OSC takes the position that CO's purported business model provided that CO would solicit investors to loan money; funds would then be loaned to CO for a fixed term, generally 1 to 3 years at a fixed high rate of interest ranging from 20% to 30%. CO would issue a loan agreement to each investor; funds from CO were transferred to Mr. Mander personally or through EMB or other Mander controlled companies for investment purposes and the profits generated from these investments above the fixed interest rate promised to investors were to be split equally between CO and Mr. Mander.

The record established that CO's actual business varied from the above model in a number of ways. First, CO did not transfer all of the funds of CO investors to Mr. Mander as approximately $6 - 7 million was not transferred directly to Mr. Mander or EMB. These funds were used in a number of ways by Dr. Sbaraglia, acting on behalf of CO, by making payments to CO investors with newly received funds from other CO investors, or in making investments in securities either directly in trading accounts in the names of other companies, which resulted in significant losses.

Further, it became clear that the funds that Mr. Mander did receive from CO were not invested, but were used to pay the returns to other investors that he was dealing with independently from CO.

RSM Richter as receiver of the EMB Asset Group, Mr. Mander and related entities obtained an order on July 14, 2010 in the receivership proceedings of EMB, which authorized the receiver to conduct investigations into the business and affairs of Dr. Sbaraglia and Ms. Sbaraglia and the CO group.

According to the receiver's reports, $15.4 million of the $21.2 million raised by CO from its investors was transferred to Mr. Mander/EMB.

The balance of what CO raised, estimated to be between $6 and 7 million can be accounted for as follows. $2.1 million was received personally by Dr. and Ms. Sbaraglia at the direction of Mr. Mander, purportedly for profits earned by them from the actions of Mr. Mander.

Approximately $2.4 million was lost through trading accounts. Approximately $985,000 in general expenses of CO were paid from the CO bank accounts. Approximately $585,000 was used by CO to purchase open ventures securities, which securities have very little value today. Approximately $213,000 in rent payments in respect of a property located at 239 Church Street, Oakville, Ontario were made by CO to 91 Days Hygiene, a company wholly owned by Ms. Sbaraglia. Approximately $383,000 in charges were incurred on a corporate visa in the name of CO, a significant number of which were not for the benefit of CO investors, but rather, were for the personal benefit of the Sbaraglias, including significant payments for restaurants, renovations of 239 Church Street and numerous other personal expenses.

Dr. Sbaraglia, on behalf of CO, opened bank accounts over which he had signing authority. The accounts were used to pool investor funds. At no time were the funds segregated in any manner.

Dr. Sbaraglia acknowledged that throughout the review period CO used funds raised from one investor to pay amounts owing to other investors. This issue was specifically referenced in cross-examination, the transcript of which reads, commencing at Question 954 as follows:

> Q. And Ms. Burton was an investor?
> A. Yes.
> Q. And this payment of $63,250 was paid to her in connection with her investment?
> A. Yes.
> Q. And that payment was made just using other investors' funds also? Correct?
> A. Yes.
> Q. And I can keep going through this book, but what we will see is throughout this entire piece payments are being made by CO Capital directly from funds paid into CO Capital from other investors?
> A. Right.
> Q. And you are aware of that?
> A. Yes.
> Q. And you were aware that this was going on throughout the piece?
> A. Yes.

The payments to investors from the CO bank accounts were made with cheques signed by Dr. Sbaraglia. Ms. Sbaraglia undertook the bank statement and loan reconciliations for the payments.

In July 20098, as part of its investigation, OSC staff conducted examinations of Mr. Mander and Dr. Sbaraglia. They were represented by the same legal counsel, who attended with each of them at their respective examinations.

Dr. Sbaraglia had retained legal counsel in or around June 2009 and it is apparent that Dr. Sbaraglia knew that the OSC's primary concern was whether investors' funds were at risk and whether CO could properly account for the funds. Dr. Sbaraglia understood that the OSC staff would be seeking verification from CO that the assets as between CO and Mr. Mander and EMB were in excess of what was owed to CO investors.

Dr. Sbaraglia specifically acknowledged that he was under oath and he swore to tell the truth at this OSC examination.

During the examination, OSC staff were advised by counsel to Dr. Sbaraglia of the following: CO investors consisted of only friends and family and that each of the investors had approached Dr. Sbaraglia about investing; CO had relied on legal advice obtained from another law firm with respect to CO's compliance with Ontario securities law in raising funds from third parties; CO investor funds were not at risk; the amount owing by CO to the CO investors was approximately $8.5 million, but the bulk of the value of CO investors' funds were invested in real estate assets purchased by Mr. Mander and Dr. Sbaraglia; Dr. Sbaraglia and Mr. Mander had a verbal arrangement whereby all assets held by the Sbaraglias were used by Mr. Mander for the benefit of CO investors and that the assets held by Dr. Sbaraglia and Mr. Mander were valued at approximately $12 million, and therefore well in excess of all amounts owing to CO investors.

At no time during the examination did Dr. Sbaraglia correct his legal counsel. Further, it is clear that Dr. Sbaraglia was aware that his legal counsel was speaking on his behalf during the examination.

OSC takes the position that the statements made by Dr. Sbaraglia were materially misleading and that among other things, Dr. Sbaraglia did not advise that CO had raised almost $1 million in 2006 prior to obtaining any legal advice as to whether CO was in compliance with Ontario securities law. Dr. Sbaraglia did not disclose a $6 million obligation to CO to Pero pursuant to a loan agreement dated March 1, 2009. Dr. Sbaraglia does take the position that the obligation is not one of CO and that it was transferred to Mr. Mander. Documentation was produced that evidences a transfer to EMB/Mander, but there is no documented release from Pero in favour of CO or Dr. Sbaraglia. Further, Dr. Sbaraglia now claims that he feels only morally obligated to CO investors. Dr. and Ms. Sbaraglia wish to use the proceeds from the sale of their assets to pay certain of the CO investors in priority to others based on their assessment of the relative needs of the CO investors. It is also apparent that all the assets of the Sbaraglias and Mr. Mander and CO were not, in fact, available to satisfy the amounts owing to CO investors as Mander had loans outstanding with many additional investors, other than the CO investors, all of which has been documented in the Mander receivership.

On August 7, 2009, following the examination, Dr. Sbaraglia's counsel provided OSC staff with a loan agreement between EMB and CO and an undertaking to the OSC in respect of loans made by CO investors to the real assets, which are being held for the benefit of those investors.

The undertaking provided that: (a) CO would not enter into any further loan agreements with third-party investors; (b) CO would cause outstanding loans to CO investors to be paid as they became due; (c) CO had used the loans from CO investors to acquire the assets listed in the schedule to the undertaking.

OSC takes the position that the undertaking constitutes an obligation and commitment in favour of OSC.

OSC also takes the position that immediately after entering into the undertaking, CO breached the terms of the undertaking by entering into a new loan agreement on August 21, 2009 in the amount of approximately $54,000. Dr. Sbaraglia takes the position that this was not a new loan agreement, but a rollover of an existing agreement.

OSC also takes the position that Dr. Sbaraglia failed to identify material obligations in its schedule of outstanding loans. The undertaking failed to list nine loan agreements for a total of approximately $9.4 million, which includes the Pero investment of $6 million. Even taking into account the position put forth by Dr. Sbaraglia that the $6 million Pero investment was an obligation transferred to Mr. Mander, there remains $3.4 million in loans which were not listed.

Counsel for Dr. Sbaraglia and Ms. Sbaraglia and the CO Group paints a very different picture of events. Counsel suggests that the proper narrative should be that a well-intentioned family was caught in the middle of a Ponzi scheme, that they were led into error by a career fraudster and ill-advising lawyers. Counsel portrays his clients as victims of Mr. Mander, a predator fraudster. Counsel puts forth that his clients are guilty of no wrong-doing and that no investor had sued or made any claim against them. In fact, all investors without exception, support them. Mr. Davis does acknowledge that Mr. Obradovich is one investor who raises the spectre of a claim against Dr. Sbaraglia through Pero, on the basis that notwithstanding the transfer of the obligation to Mr. Mander there is still no obligation from CO.

Counsel for the Sbaraglias takes the position that his clients are not to blame, but rather, others were involved. These include the lawyers who acted for both the Sbaraglias and also Mr. Mander. Mr. Davis also contends that these lawyers breached their fiduciary duty, hid information from the Sbaraglias in their representation before the OSC and despite a grave conflict of interest, counsel advised the Sbaraglias and misinformed the OSC.

Mr. Davis also puts forth that Dr. Sbaraglia and Ms. Sbaraglia have been and remain committed to helping repair the damage to repay those who invested with them and to co-operate with the OSC. The Sbaraglias are also suing their lawyers to pay for the repairs.

The Sbaraglias also take the position that the OSC has been deficient in its investigation insofar as it had in its possession evidence of Mr. Mander's fraud for the better part of the year before examining Dr. Sbaraglia. Further, it takes the position that the receivership is not necessary for a number of reasons including: (a) the creditors - who are also victims of Mr. Mander - oppose the receivership; (b) the receivership would strip the Sbaraglias of their assets without any action or proceeding having been commenced, in effect denying them due process; (c) the receivership would be destructive, and it would diminish the Sbaraglias' efforts to make the creditors whole; (d) it would punish the Sbaraglias for Mr. Mander's wrong-doing and would ignore their innocence; and (e) it would ignore the Sbaraglias' diligence in trying to avoid this current predicament as it would reduce the prospects of recovery in the litigation against the lawyers. In all respects the Sbaraglias remain transparent and wish to co-operate with the OSC.

The Sbaraglias also take the position that the receivership will benefit no one and will be costly and consequently the OSC's application, they take the position, should be dismissed, and they should be relieved of their undertaking and allowed to continue with their work.

From their standpoint, the matter began to unravel in the spring of 2009 when CO Capital stopped making money for new investments. As noted previously, the OSC served Dr. Sbaraglia and Ms. Sbaraglia with a summons under the Securities Act and they were required to attend examinations. The Sbaraglias had no reasons, they say, to have known about Mr. Mander's fraud at that point. There was also no reason to think that they were caught in a fraudulent scheme, as Mr. Mander had paid all investors to that date.

Dr. Sbaraglia acknowledges that his OSC examination and the participation of his counsel at this examination resulted in statements that may not have been accurate. Certain aspects were not true. He now says that he knew that some of the statements being made by his counsel were not true at the time, but he did not correct these statements. He now states that he was surprised by the disclosure. He also felt that he was under duress at the time. He acknowledges that he knew the information was inaccurate, but he did not speak up. Dr. Sbaraglia is of the view that he has paid dearly for his legal counsel's transgressions and having already been victimized by the fraud, he now find himself victimized by his own lawyer. He has sued that lawyer.

Dr. Sbaraglia also referenced the undertaking to the OSC. It is described in his counsel's factum as being an ill-advised undertaking. It is also referenced that the undertaking was a misrepresentation in certain respects. The undertaking states that the property had been bought with CO Capital's money; this was false. It was also false insofar as certain properties had been bought before CO Capital's incorporation.

Dr. Sbaraglia takes the position his legal counsel had prepared the statutory declaration which he had signed and swore that assets that he owned or controlled would be held in trust as security for the repayment of loans. He also took the position that it was his legal counsel who provided assurances to him which misled him into signing the undertaking. Dr. Sbaraglia also takes the position that he should be relieved of the undertaking as it was not freely given or independently given and that it was not accurate.

It is apparent that the Sbaraglias have also acknowledged that they have suffered financial and personal devastation at Mr. Mander's hands and that they are now working to repay investors fully, but they are struggling to meet their expenses. Their insolvency has been acknowledged.

Dr. Sbaraglia also takes the position that the OSC and the receiver are trying to access their personal assets, i.e., the proceeds or potential proceeds from the sale of their home or corporate assets, i.e. the proceeds through the sale of 239 Church Street to repay investors, most of whom are unrelated to the Sbaraglias.

The Sbaraglias also take the position that both the OSC and the receiver ignored the fact that the three properties in question were bought before the Sbaraglias met Mr. Mander and that there is no basis in law for stripping them of their personal assets.

The Sbaraglias also place certain responsibility on the OSC. The OSC was investigating Mr. Mander as early as 2008 and by August 2008 the OSC obtained bank records showing millions of dollars flowing to EMB, yet the Sbaraglias contend the OSC stood back and did nothing.

They do not accept the receiver's report as being accurate. They also stress that the receiver has not reviewed monies paid by CO Capital to its investors and, as a result, the accounting and subsequent allegations against Dr. Sbaraglia and Ms. Sbaraglia have been skewed.

Counsel for the Sbaraglias does acknowledge that mistakes were made and that misrepresentations were made. However, he submits that there is nothing to be gained from a receivership; there are no hidden assets, the investigations have been complete and the most viable assets that the Sbaraglias have, mainly litigation against former counsel, can only be optimized in the absence of a receivership.

He also stressed that s number of CO Capital investors are in dire straits, that they are losing homes or businesses and that his clients are trying to arrange for these investors to receive some monies now so as to avoid disaster. Further, counsel contends that the Sbaraglias themselves are in dire need and that while they seek to re-establish themselves professionally they need money for basic living expenses.

The two positions are diametrically opposed. The position put forward by the OSC is supported by the receiver and by counsel to Mr. Obradovich who claims he is a creditor for some $6 million. The position of Dr. Sbaraglia is supported by all of the remaining creditors, most of whom are family and friends.

Turning now to an analysis of the law. Section 129 of the Securities Act permits the commission to apply to the court for an order appointing a receiver for all the property, assets and undertakings of a person or company. Such an order can be made where the court is satisfied that such an appointment is in the best interest of the company's creditors or the security holders or if it is appropriate for the due administration of Ontario securities law.

A threshold question was raised by counsel on behalf of certain creditors of CO Capital, contending that the court has no jurisdiction to appoint a receiver under s. 120 of the Act because constitutional principles impose a limitation on the power of the court to appoint a receiver under a provincial statute in situations where the entity over whose assets the receiver is sought to be appointed is insolvent

This position is based on the Constitution Act 1867, which gives exclusive jurisdiction over bankruptcy and insolvency to the federal parliament. On this basis, counsel contends that the Supreme Court has repeatedly held that a provincial statute which purports to impact creditors' priorities or to otherwise substantially regulate the affairs of an insolvent person or company vis-à-vis its debtors is unconstitutional.

Counsel goes on to submit that in the present case, there is no challenge to the validity of s. 129 itself. It is not a necessary condition for the appointment of a receiver under s. 129 that the person or company over whose assets the receiver is being appointed be insolvent. Section 129, therefore, does not in pith and substance relate to bankruptcy and insolvency.

The constitutional challenge was raised on behalf of creditors of CO Capital and not by counsel on behalf of Dr. Sbaraglia and Ms. Sbaraglia of CO Capital, who declined to take a position.

No notice of a constitutional question was served on the Attorney General of Canada and the Attorney General of Ontario as provided for in s. 109 of the Courts of Justice Act. Counsel for the creditors who put forth this argument relies on his statement that there is no direct challenge to the validity of s. 129 itself.

Counsel to the receiver submits that this submission is belied by the statements contained at paragraph 25 of the factum of counsel for the CO Capital creditors, which takes direct aim on the constitutional validity or constitutional applicability of the Act in this context, and further, that the notice provision in s. 109 of the Courts of Justice is mandatory. In the absence of such notice, s. 109(2) of the Courts of Justice Act provides that the Act, Regulation and Bylaw, a rule of common law shall not be adjudged to be invalid or inapplicable.

In my view, the position put forth by the creditors of CO Capital calls into question the constitutional validity of the Securities Act in this context. No case law was put forward to support this position. This seems unusual because, as was pointed out to counsel in argument, if this position is correct with respect to the Securities Act, it would also call into question the thousands and thousands of receivership orders granted over the years under s. 101 of the Courts of Justice Act. Counsel was unable to reference any case law under which such a challenge had been successfully made to receiverships granted under the Courts of Justice Act.

I am satisfied that if counsel wished to raise this issue, the same should have been done after providing the required Notice of Constitutional Question.

A number of disputes have been raised by the Sbaraglias with respect to the factual background. However, putting their position at its highest, there are still a number of facts that are most troubling:

1. Neither Dr. Sbaraglia or Ms. Sbaraglia were registered with the Commission. CO raised approximately $21.2 million from CO investors.

2. CO did not transfer all the funds of CO investors to Mr. Mander and EMB. Approximately one-third of the funds raised, namely $6 - 7 million, were not transferred. These funds were used in part to make investments with newly received funds form other CO investors. This activity took place over a number of months. It cannot be characterized as a mistake.

3. $ 213,000 in payments were made in respect to property located at 239 Church Street. These payments were made by CO to 91 Days Hygiene Services Inc.

4. $383,000 in charges were incurred on a corporate visa in the name of CO with a significant number of payments being made not for the benefit of CO investors, but rather, for the personal benefit of the Sbaraglias.

5. It is also clear that the OSC was misled in its investigation. The Sbaraglias did not advise the OSC that they raised almost $ 1 million prior to receiving any legal advice as

> to whether they were in compliance with securities law. They did not disclose the $6 million obligation to Pero, regardless of whether the matter had been transferred to Mander. They did not fully disclose their remaining creditors.
>
> 6. With respect to the undertaking, it seems to me clear that the Sbaraglias knew counsel's strategy was to convince the OSC that there were sufficient assets to repay all CO investors and accordingly proceedings should not be taken against them. Through-out the investigation, the Sbaraglias sat by and let legal counsel make representations to the OSC that they knew were false. In this respect, the Sbaraglias did have options. They could have taken steps to ensure that the truth came out. They chose to remain silent.

The Sbaraglias take the position that the receivership will achieve nothing. They insist that the litigation can only be maximized under their direction. They insist that they are the ones who should be able to direct the payment of funds to creditors in dire straits.

Counsel to the Sbaraglias and also to the CO creditors submit that if there are any issues that require a resolution they can be brought forth to the court. In this respect, I take it from their submissions that there is a tacit acknowledgement that there are several loose ends in this matter that will require further direction.

The criteria for determining what is in the best interests of creditors, security holders or subscribers for the purposes of the appointment of a receiver pursuant to securities legislation is broader than the solvency test. The criteria should take into consideration all the circumstances and whether in the context of the circumstances it is in the best interests of creditors that a receiver be appointed. The criteria should also take into account the interest of all stakeholders (OSC v. Factorcorp 2007 OJ 4496; OSC v. Sextant 2009 OJ 3063.

Further, where there is a history of mismanagement, no evidence of a tangible alternative resolution, evidence that investors' interests will not be served by maintaining the status quo and evidence that the company is not in a better position than a receiver to protect investors' interests, it is appropriate to appoint a receiver.

Further, where there is evidence of regulatory breaches and evidence that the value and integrity of the assets purchased with investor funds has been compromised, it is in the investors' best interests that a receiver be appointed such that the investors are provided with an independent and verifiable review and analysis. Investors deserve treatment they can rely on (see Factorcorp., Sextant, and OSC v. ASL Direct).

The second part of the test, the alternate test, is that securities legislation has as its primary goal, the protection of the investing public and the protection of the integrity of the capital markets. Section 1.1 of the Act provides that the purposes of the Act are to provide protection to investors from unfair or improper or fraudulent practices and to foster fair and efficient capital markets and confidence in the capital markets.

It seems to me that an assessment of whether the appointment of a receiver is appropriate for the due administration of Ontario Securities law must therefore take into consideration the purposes of the Act to be undertaken with a view to determining whether such an appointment is consistent with the goals of protecting investors and protecting the integrity of the capital markets.

In this respect, it is noteworthy that, pursuant to s. 122 of the Act, it is an offence to mislead staff of the Commission during the course of an examination taken as part of an investigation.

The failure to advise staff of complete information about the flow of investor funds in the operation and business of the entity in question amounts to a contravention of s. 122 of the Act. The offence of misleading staff can occur by making affirmative statements and can equally occur by omission (Norshield Asset Management Canada Limited 2010, 33 OSCB 7171).

In addition, s. 126 of the Act prohibits conduct which perpetrates a fraud on investors. The use of investor funds to repay other investors and for personal benefit constitutes securities fraud pursuant to s. 126.1(b) of the Act.

Having considered the uncontradicted facts noted above, it is clear to me that this is a situation that cries out for the appointment of a receiver. I am satisfied that by using investor funds to repay other investors, by using investor funds for personal use, by being untruthful to the OSC, by not fully disclosing creditors of CO to the OSC, it cannot be in the best interests of creditors of CO Capital that the continued administration of creditors' affairs be administered by the Sbaraglias. This is a situation that requires an independent court officer to oversee.

I am making this finding notwithstanding the level of support provided by the family and friends who are creditors of the Sbaraglias. It could very well be that there are other creditors, most notably Mr. Obradovich. It is essential, in my view, that a claims process be established which can be verified as being accurate. I am not satisfied that this can be accomplished without an independent court officer overseeing the process.

In making this determination I cannot overlook that CO, Dr. Sbaraglia and Ms. Sbaraglia retained and had access to funds in excess of $6 million. I also cannot overlook that they improperly used some of these funds for personal use or for related corporate use. I also cannot overlook that some of the new money was used to pay interest payments to old investors. To use the words of counsel of the receiver, "This is the hallmark of a Ponzi scheme where you keep the dollars rolling."

I have no doubt that Mr. Mander contributed significantly to the problems that the Sbaraglias currently face. I also have to take into account that there may be issues with respect to deficiencies in the legal advice that can be pursued in due course. With respect to the litigation against former counsel, I have not been persuaded that the Sbaraglias are the best party to direct such litigation. Rather, it seems to me that the insertion of an independent court officer is essential to ensure the best outcome for creditors.

The Sbaraglias have also blamed the OSC for not taking more prompt action. It could very well be that the OSC could have acted more promptly. However, the timing of the OSC's involvement does not excuse or explain the activities of the Sbaraglias that led to the determination being made today.

The Sbaraglias also take the position that breaches of securities legislation have not been clearly proven. I do note that under s. 129 there is a broad discretion that the courts can make such an order which does not require evidence of a breach. Having said that, there are certain very serious concerns that have been raised by the OSC with respect to possible breaches of the statute.

With respect to the second part of the test which provides a receiver can be appointed if it is appropriate for the due administration of Ontario securities law, I am satisfied that this is the type of case that calls for such an appointment. The factors that have led to my decision to appoint a receiver as being in the best interests of the company's creditors and the potential Sbaraglia creditors is also applicable for the appointment under the second part of the test. This was a Ponzi scheme. Although Mr. Mander may have been the head of the Ponzi scheme, it is clearly apparent that by using investors' money to repay other investors, steps were taken by the Sbaraglias that were improper. The use of investors' money to pay personal and related company expenses is also improper. It also cannot be overlooked that the Sbaraglias misled the OSC in the course of its investigation. This type of activity cannot and should not be overlooked and I am satisfied that the appointment of the receiver is also justified under the second part of the test.

As Mr. Gottlieb summed up in his reply, the remedy of the appointment of a receiver goes beyond certain principles, it also takes into account the importance of a neutral court officer to oversee the claims process, the evaluation process and to provide appropriate recommendations as to the administration of the estate.

A considerable amount of investigation has already been done. Most assets have been identified. However, issues remain outstanding with respect to the identification of proper creditors, maximizing asset realization through litigation and the necessity to demonstrate that transparency exists in all respects in the resolution of all outstanding matters.

For the foregoing reasons, the application of the OSC is granted. I would be grateful if counsel could prepare an appropriate order for my review.

CERTIFIED

HELEN P. SINCLAIR
OFFICIAL COURT REPORTER
SUPERIOR COURT OF JUSTICE

Case Name:

Ontario (Securities Commission) v. Future Solar Developments Inc.

RE: Ontario Securities Commission, Applicant, and Future Solar Developments Inc., Cenith Energy Corporation, Cenith Air Inc., Angel Immigration Inc. and Xundong Qin also known Sam Qin, Respondents

[2015] O.J. No. 2258

2015 ONSC 2334

Court File No.: CV-15-10887-00CL

Ontario Superior Court of Justice
Commercial List

L.A. Pattillo J.

Heard: April 7, 2015.
Judgment: May 5, 2015.

(46 paras.)

Securities regulation -- Offences and enforcement -- Commission orders for interim preservation of property -- Application by the Ontario Securities Commission to continue freeze directions allowed -- The Commission issued the directions against the respondents' bank accounts and property and alleged that the respondents were trading in securities without being registered, illegally distributing securities and/or acting contrary to the public interest -- The Commission established a serious issue to be tried -- The monies raised by the respondents contrary to the provisions of the Securities Act either remained in the frozen bank accounts or were used to purchase the frozen property -- The freeze directions were necessary for the due administration of the Securities Act.

Statutes, Regulations and Rules Cited:

Securities Act, R.S.O. 1990, c. S.5, s. 25, s. 53, s. 126, s. 126(5), s. 126(5.1), s. 126(7)

Counsel:

Christie Johnson, for the Applicant.

Allan Rouben, for the Respondents.

ENDORSEMENT

1 L.A. PATTILLO J.:-- On February 16 and 17, 2015, the Ontario Securities Commission (the "Commission") issued 11 freeze directions (the "Freeze Directions") against the bank accounts and property of the Respondents Future Solar Developments Inc. ("Future Solar"), Cenith Energy Corporation ("Cenith Energy"), Cenith Air Inc. ("Cenith Air"), Angel Immigration Inc. ("Angel Immigration") (collectively the "Corporate Respondents") and Xundong Qin (also known as Sam Quin) ("Quin") pursuant to s. 126(1)(a) and (b) of the *Securities Act*, R.S.O. 1990, c. S.5, as amended (the Act).

2 There are two matters before the court:

1. The Commission's application for an order continuing the Freeze Directions pursuant to s. 126(5) of the Act; and

2. A motion by the Respondents to revoke the Freeze Directions or, in the alternative to have them varied to allow payment of expenses by the Corporate Respondents in the ordinary course of business and payment of legal fess.

3 The Commission's application for continuation of the Freeze Directions first came before the court on February 26, 2015. Because the Respondents wished to bring their motion and file material, the application was adjourned to April 7, 2015 and the Freeze Directions were continued until that date. On April 7, 2015, following argument, I reserved my decision and continued the Freeze Directions pending release of this decision.

4 For the reasons that follow, the Commission's application is allowed and the Freeze Directions are continued. The Respondents motion is dismissed.

Background

5 The Corporate Respondents are incorporated in Ontario and are engaged in solar energy (Future Solar) and the manufacture of air purifier systems (Cenith Energy and Cenith Air). Quin is an officer and director of the Corporate Respondents.

6 The Commission alleges that the Respondents are trading in securities without being registered, contrary to s. 25 of the Act, illegally distributing securities contrary to s. 53 of the Act and/or acting contrary to the public interest.

7 Future Solar was incorporated in May 2011 for the purpose of developing and managing solar energy projects in Ontario. In order to raise capital, Solar Energy, through a firm in Beijing, sought out individuals in the People's Republic of China ("China") who had monies available and who wished to immigrate to Ontario utilizing the Ontario Provincial Nominee Program ("OPNP").

8 OPNP is an immigration program offered through the Ontario Ministry of Citizenship, Immigration and International Trade ("MCII") whereby Ontario nominates individuals and their families' for permanent resident status based on certain criteria including amount of investment, number of jobs created and involvement in the business.

9 The Commission has been involved in an investigation of the respondents which is ongoing. To date, the Commission staff has observed approximately $5.9 million in payments from 11 OPNP investors deposited into Ontario-based bank accounts held by Future Solar and Cenith Energy between May 2012 and August 2014. In contrast, Qin advised the Commission staff that he had raised approximately $8.1 million from 13 OPNP investors.

10 The Ontario based bank accounts of the Corporate Respondents show a further $830,000 in funds received from eight investors which came from Canadian financial institutions and further deposits totaling approximately $3.6 million which originated primarily from mainland China but also from Hong Kong and Australia. None of these investors are associated with the OPNP.

11 Further, Commission staff has been able to locate $1.84 million of assets in Ontario made up of approximately $845,000 in bank accounts and $965,000, net, in real property held in Qin's name and in Cenith Energy's name. Based on its investigation to date, Commission Staff believes that the properties were purchased from funds in the Corporate Respondents' bank accounts after receipt of funds from investors.

12 Cenith Air is engaged in the manufacture and distribution of air purifier systems and related products. In October 2014, Cenith Air signed a memorandum of understanding with a Chinese company relating to the manufacture and sale of air purifiers in China. Cenith Air has other contracts for the sale of air purifier products.

13 None of the Corporate Respondents are reporting issuers in Ontario. Further, between January 1, 2011 and at least December 8, 2014, the Respondents were not registered with the Commission and no prospectus was filed on behalf of any of the Corporate Respondents.

14 The Respondents submit that they are legitimate businesses and, since the Freeze Directions, have been unable to carry on business. They have been unable to carry on projects or to pay their manufacturers, suppliers and employees.

15 The relevant provisions of s. 126 of the Act are:

> 126. (1) If the Commission considers it expedient for the due administration of Ontario securities law or the regulation of the capital markets in Ontario or expedient to assist in the due administration of the securities laws or the regulation of the capital markets in another jurisdiction, the Commission may,
>
> (a) direct a person or company having on deposit or under its control or for safekeeping any funds, securities or property of any person or company to retain those funds, securities or property;
>
> (b) direct a person or company to refrain from withdrawing any funds, securities or property from another person or company who has them on deposit, under control or for safekeeping;
>
> (1.1) A direction under subsection (1) applies until the Commission in writing revokes the direction or consents to release funds, securities or property from the direction, or until the Superior Court of Justice orders otherwise.
>
> (5) As soon as practicable, but not later than 10 days after a direction is issued under subsection (1), the Commission shall serve and file a notice of application in the Superior Court of Justice to continue the direction or for such other order as the court considers appropriate.
>
> (5.1) An order may be made under subsection (5) if the court is satisfied that the order would be reasonable and expedient in the circumstances, having due regard to the public interest and,
>
> (a) the due administration of Ontario securities law or the securities laws of another jurisdiction; or
>
> (b) the regulation of capital markets in Ontario or another jurisdiction.

(7) A person or company directly affected by a direction may apply to the Commission for clarification or to have the direction varied or revoked.

16 In *Ontario Securities Commission v. Sextant Capital Management Inc.* (2010), 100 O.R. (3d) 706 (CA), the Court of Appeal set out the test to be applied by the Superior Court when determining whether to continue freeze directions pursuant to s. 126(5) of the Act. That test, as first articulated by Farley J. in *Ontario (Securities Commission) v. RBC Dominion Securities Inc.* (2001), 54 O.R. (3d) 767 (SCJ), is similar to the test for a Mareva injunction and has three parts: a strong *prima facie* case or a serious issue to be tried, as to whether there has been a contravention of the Act; a close connection between the alleged misconduct and the frozen assets; and evidence of a potential dissipation of assets.

17 At the time of the *Sextant* decision, s. 126 (5.1) was not present in the Act. It was added by amendment in July 2014 (2014, c.7, Sched. 28, s.13(2)). At the same time, amendments were also made to the wording of s. 126 (1) (a), (b) (c) and (1.1).

Position of the Parties

18 The Commission submits that the test set out in *Sexton* no longer applies to the continuance of Commission freeze directions given the recent enactment by the legislature of s. 126(5.1). Further, and based on that section, it submits the court should continue the Freeze Directions because it is reasonable and expedient to do so, having regard to the public interest and the administration of the Act. In the alternative, and if the *Sexton* test still applies, it submits that the Commission's evidence before the court satisfies each of the three criteria.

19 The Respondents submit, notwithstanding the amendment, the *Sexton* test should continue to apply. The test continues to reflect the considerations set out in s. 126(5.1). They submit that the Commission has failed to meet the *Sexton* test. It has failed to establish a strong prima facie case that the Respondents breached either s. 25(1) or s.53(1) of the Act. Nor has it established a close connection between the alleged misconduct and the frozen assets or that there is any risk of dissipation of assets.

Discussion

20 Section 126 (5.1) of the Act requires that in order to continue the freeze directions, the court must be satisfied that the order would be "reasonable and expedient in the circumstances" have due regard to the public interest and the due administration of securities laws in Ontario and or other jurisdictions, or, the regulation of capital markets in Ontario or other jurisdictions.

21 Ultimately, based on the provisions of s. 126 (5.1), the question for the court to decide is whether it is in the public interest to continue the freeze direction.

22 I agree with the Commission that having regard to the wording of s. 126(5.1) of the Act, the

Sexton test is no longer applicable. As submitted by the Commission before me, the addition of s. 126(5.1) of the Act has lowered the threshold of the test required to continue a freeze direction from a test akin to a Mareva injunction. Nevertheless, in my view, the *Sexton* test remains a useful guide in formulating what is "reasonable and expedient" having regard to the public interest.

23 Further, and notwithstanding that the grounds considered by the Commission to issue a freeze order under s. 126(1) of the Act and the grounds for continuation set out in s. 126(5.1) are very similar, in my view, the addition of the word "reasonable" in s. 126(5.1) gives the court an oversight role which makes the task more than just a duplication of the Commission's role.

24 Section 126(5.1) requires that the court consider all the circumstances. This includes the stage of the investigation; the allegations of the Commission; the strength of the evidence; whether a proceeding has been initiated; any material filed in response by the company or individual who is the subject of the direction; the extent of the impact on private interests and any other circumstances unique to the particular case.

25 In considering the circumstances, the court must have regard to the public interest. The public interest in question is the public interest as reflected by the provisions of the Act. That is the proper administration and enforcement of the Act to protect investors and capital markets in Ontario. Included in that is ensuring that the Commission carries out its mandate in a proper manner, according to law. The Commission's interests are more specifically addressed in the later requirements concerning the due administration of securities law and regulation of capital markets.

26 With the above in mind, I consider that the following factors are relevant to the court's oversight role as set out in s. 126(5.1) of the Act.

27 First and foremost, the conduct in issue must provide a basis for the freeze order to have been issued. In that regard, the Commission must establish at a minimum that the conduct complained of contravenes the Act (or the securities laws of another jurisdiction).

28 Further, and while the use of the terms "reasonable" and "expedient" in my view provide for a lesser standard than the requirement to establish a strong *prima facie* case or even a *prima facie* case, I am of the view, given the draconian nature of the remedy and the fact that it originates *ex parte*, it is both reasonable and expedient that the Commission establish on the evidence that there is a serious issue to be tried in respect the alleged contravention of the Act or other securities law.

29 I am also of the view that it is reasonable, given the nature of the remedy, to require the Commission to establish a connection between the frozen assets and the conduct at issue. While the Commission need not prove a direct connection given that its investigation may be ongoing, it still must still establish some basis to suspect, suggest or prove that there is a connection between the assets sought to be frozen and the conduct complained of.

30 Finally, and while I do not consider that s. 126(5.1) requires the Commission must establish dissipation of assets, it must establish that the freeze order is necessary for the due administration of securities laws or the regulation of capital markets, in Ontario or elsewhere. This would include not only dissipation of assets but preservation of assets, inappropriate use of investor funds and other situations where the freeze direction is necessary to protect the investing public or capital markets.

31 In summary, in order for the court to continue the Freeze Directions pursuant to s. 126(5) of the Act, based on s. 126(5.1), the Commission must establish:

1. That there is a serious issue to be tried in respect of the Respondents' breaches of the Act or other securities laws in another jurisdiction;

2. That there is a basis to suspect, suggest or prove a connection between the frozen assets and the conduct at issue; and

3. That the Freeze Directions are necessary for the due administration of securities laws or the regulation of capital markets, in Ontario or elsewhere.

32 Turning to the evidence as presented by the Commission in this case, in my view the Commission has established that there is a serious issue to be tried in respect of the Respondents alleged breaches of ss. 25 and 53 of the Act.

33 Section 25(1) of the Act provides: "Unless a person or company is exempt under Ontario securities laws from the requirement to comply with this subsection, the person or company shall not engage in or hold himself, herself or itself out as engaging in the business of trading in securities unless the person or company, (a) is registered in accordance with Ontario securities laws as a dealer; or (b) is registered in accordance with Ontario securities laws as a dealing representative of a registered dealer and is acting on behalf of the registered dealer."

34 Section 53(1) of the Act provides: "No person or company shall trade in a security on his, her or its own account or on behalf of any other person or company if the trade would be a distribution of the security, unless a preliminary prospectus and a prospectus have been filed and receipts have been issued for them by the Director."

35 While the Commission's investigation is ongoing, the Commission has established that it appears the Respondents have raised between approximately $5.9 million and in excess of $10 million from investors resident in China, Ontario and elsewhere. The investments were solicited by the Respondents and others on their behalf, utilizing the OPNP and other means. For example, both Future Solar and Cenith Energy have active websites that contain links entitled "investors" which invite further contact with the companies. Further, during the relevant period of the Respondents were not registered with the Commission as required by s. 25(1) of the Act and did not file a preliminary prospectus or a prospectus with the Commission as required by s. 53(1) of the Act.

36 The Respondents submit that because they carry on legitimate businesses relating to solar energy and air purification that they are not in the business of trading in securities. The Respondents further submit, having regard to the provisions of Canadian Securities Administration Companion Policy 31-103CP, they do not meet any of the criteria set out therein for determining whether they are required to register.

37 I need not determine that issue on this application. In my view, having regard to all of the evidence, I am satisfied that the Commission has established there is a serious issue to be tried concerning its allegation that the Respondents have breached ss. 25(1) and 53(1) of the Act.

38 The Respondents further submit there is no close connection between the alleged misconduct and the frozen assets, given there is no allegation of misrepresentation. In my view, there is no requirement that there be an allegation of misrepresentation to establish close connection.

39 The Commission's evidence establishes that the monies raised by the Respondents from investors contrary to the provisions of the Act either remain in the bank accounts now frozen or were used to purchase the property which has been frozen.

40 Finally, in freezing the bank accounts and property of the Respondents, the Commission seeks to preserve both monies and property for the benefit of investors. In my view, the Freeze Directions are necessary for the due administration of the Act.

41 Based on the above therefore, the Commission's application is allowed. I conclude it is reasonable and expedient that the Freeze Directions be continued until the Commission or this court orders otherwise.

The Respondents' Motion

42 The Respondents have brought a separate motion to revoke the Freeze Directions or, in the alternative, to vary them to allow for the payment of expenses by the Corporate Respondents in the ordinary course of business and the payment of legal fees.

43 As noted, s. 126(7) of the Act provides that any person or company affected by a direction may apply to the Commission ... "to have the direction varied or revoked."

44 In my view, based on s. 126(7) of the Act, I have no jurisdiction to deal with the Respondents motion. It should be brought before the Commission. Having said that, I have reviewed and considered the Respondents' material in relation to the Commission's application to continue the Freeze Directions.

45 Accordingly, the Respondents' motion is dismissed without prejudice to them bringing it on before the Commission.

46 The Commission's application raised novel issues. The Respondent's motion was mainly a response to the application. In the circumstances, no costs.

L.A. PATTILLO J.

Case Name:

Ontario (Securities Commission) v. Sextant Capital Management Inc.

Between
Ontario Securities Commission, Applicant (Appellant), and Sextant Capital Management Inc., Sextant Capital GP Inc., and Sextant Strategic Opportunities Hedge Fund L.P., Respondents

[2010] O.J. No. 1221

2010 ONCA 228

317 D.L.R. (4th) 644

187 A.C.W.S. (3d) 875

262 O.A.C. 171

100 O.R. (3d) 706

2010 CarswellOnt 1752

Docket: C50136

Ontario Court of Appeal
Toronto, Ontario

K.N. Feldman, E.A. Cronk and E.E. Gillese JJ.A.

Heard: September 22, 2009.
Judgment: March 29, 2010.

(50 paras.)

Securities regulation -- Offences and enforcement -- Commission orders for interim preservation of property -- Direction to retain and hole assets -- Review by Court -- Appeal by Securities Commission from judge's decision not to continue freeze asset directions dismissed -- Mareva injunction was in place protecting assets in Ontario -- Commission failed to establish link between

Ontario assets and alleged wrongdoing by offshore companies -- Commission was not entitled to raise new grounds for directions in support of continuation order -- Securities Act, s. 126.

Appeal by the Securities Commission from a judge's decision not to continue directions by the Commission to freeze two offshore funds held in Toronto by Newedge. The funds had no Canadian investors. The Commission had directed the Canadian accounts of the funds be frozen and a court continued these directions. A receiver was appointed for the companies that owned the funds at the request of the Commission because of perceived fraud in the operation of the companies. The Commission's concern with the companies and their Canadian assets related to a class proceeding brought by non-Canadian investors in the offshore funds, in which a Mareva injunction was sought to protect the funds held in Ontario from dissipation pending the class action. The Mareva injunction was granted but the directions were not continued a second time. The judge found that the Commission was not entitled to raise a new ground for the directions, specifically, the alleged breaches of Cayman Islands law by the funds, which had not been raised earlier. The judge also found that the allegations were too vague to support a continuation of the directions. The Commission had alleged that the net asset values given for the shares of the funds were misleading, and that the offering memoranda for the funds did not disclose that 50 percent of their assets would be invested in two start-up companies. The judge found that the Commission failed to satisfy its onus to show at least one investor relied on these alleged misrepresentations.

HELD: Appeal dismissed. The judge applied the proper analysis in declining to continue the directions. The Commission failed to establish a link between the alleged wrongdoing of the offshore funds and the operations of the funds in Ontario. The judge's decision was practical because the Mareva injunction was there to protect the monies in Ontario.

Statutes, Regulations and Rules Cited:

Securities Act, R.S.O. 1990, c. S.5, s. 9(1), s. 111, s. 126, s. 126(1), s. 126(1)(a), s. 126(1)(b), s. 126(5), s. 126(6), s. 126(7), s. 126.2, s. 128(4)

Appeal From:

On appeal from the Order of Justice Herman Wilton-Siegel of the Superior Court of Justice, dated February 4, 2009, reasons released March 2, 2009, [2009] O.J. No. 881.

Counsel:

Philip Anisman, Susan Kushneryk and Matthew Britton, for the appellant.

Kevin Richard, for the respondents Otto Spork and Sextant Capital Management A Islandi EHF.

The judgment of the Court was delivered by

1 **K.N. FELDMAN J.A**:-- The Ontario Securities Commission (the "Commission") appeals from the decision of the application judge, Wilton-Siegel J., not to continue directions made by the Commission under s. 126 of the *Securities Act*, R.S.O. 1990, c. S.5, to freeze two offshore funds held in Toronto by a fund-holding agent, Newedge Canada Inc. (the "Offshore Directions"). The Commission asks this court to approve a new legal test to be applied by a court when deciding under s. 126(5) whether to continue freeze directions made by the Commission under s. 126(1).

Factual Background

2 The named respondent parties in this application are not the owners of the funds targeted by the Offshore Directions that the Commission seeks to have continued in the instant appeal. They are Canadian entities owned or controlled by the same man who owns or controls the targeted funds, Otto Spork (the "Sextant Canadian entities"). The targeted funds are the Sextant Strategic Hybrid2Hedge Resource Fund Offshore Ltd. (the "Sextant Hybrid Fund"), and the Sextant Strategic Global Water Fund Offshore Ltd. (the "Sextant Water Fund"), together referred to as the "Offshore Funds" or the "Funds". The Offshore Funds were incorporated under the laws of the Cayman Islands and have a stated net asset value of approximately U.S. $100 million. Importantly for this proceeding, according to the Notice of Application, they have no Canadian investors.

3 Accounts of the Sextant Canadian entities held in Ontario were also frozen by the Commission and those freeze directions were continued by order of the Superior Court under s. 126(5) of the *Securities Act*. Subsequently, at the request of the Commission, a Receiver of the Sextant Canadian entities was appointed because of perceived fraud in the operation of those entities and the fear that their funds would be removed from Ontario by Mr. Spork if they were not protected. The Receiver did not take part in this appeal, having determined, after examining the records of the entities under receivership, that it did not appear to have any interest in the Offshore Funds.

4 The Commission's concern with respect to all of the Spork entities arose out of a class proceeding brought by Squirrel Trust No. 1. on behalf of non-Canadian investors in the Offshore Funds, where a *Mareva* injunction, [1980] 1 All. E.R. 213, was sought to protect the monies held by the Offshore Funds in Ontario from dissipation, pending the class action.

5 Wilton-Siegel J. heard the two applications, one for the *Mareva* injunction in the class action and the other by the Commission for an order continuing the Offshore Directions, on two consecutive days. On February 27, 2009, he released his reasons granting the *Mareva* injunction. On March 2, 2009, he released his reasons declining to continue the Offshore Directions.

The *Mareva* Injunction Application para4

6 The basis of the class action claim was that while the Offshore Funds had exercised a forced redemption of the Class A and Class F shares held by the Squirrel Trust No. 1 as of September 30, 2008, they had not followed through with that redemption. The assets in Ontario were insufficient to satisfy any judgment in respect of the redemption of the shares. The basis for the *Mareva* injunction application was that the value of the Offshore Funds had been falsely inflated in a manner I will explain below, in order to allow another Spork entity to pay itself significant performance-based management fees. There was therefore a serious concern that the Offshore Funds would continue to be dissipated by Spork if they were not protected by a court-ordered injunction.

7 In applying the respective steps of the *Mareva* test, the application judge first concluded that the plaintiff class had made out a strong *prima facie* case that the Offshore Funds were legally required to redeem the shares in the Squirrel Trust No. 1. at the price and in accordance with the forced redemption action that they took on September 30, 2008.

8 Next, the application judge considered whether there was a genuine risk of dissipation of the assets of the Offshore Funds held in Ontario by Newedge. The evidence of the risk of dissipation took several forms and is important for understanding the Commission's concern regarding the operation of the Offshore Funds.

9 The first matter relied on was Spork's attempt to transfer U.S. $220,000 from the Sextant Hybrid Fund account at Newedge to another Sextant Hybrid Fund account at the Bank of Bermuda, also managed by the manager of the Offshore Funds, another Spork company called Sextant Capital Management a Islandi ehf (the "Manager"), an Icelandic corporation. This attempted transfer was made in the face of the class action proceeding and shortly after the funds in the accounts of the Sextant Canadian entities had been frozen by the Commission. The application judge found this sufficient, in the absence of a business explanation for the transfer, to establish a significant risk of dissipation of the assets in the Offshore Funds accounts.

10 The second matter was the calculation and payment of the performance fees based on the inflated values attributed by Spork to the Offshore Funds.

11 The following is the background to the values. Each of the Offshore Funds made a significant investment in two private Luxemburg entities founded by Spork: Iceland Glacier Products S.a.r.l. ("IGP"), and Iceland Global Water 2 Partners SCA ("IGW").[1] IGP had no revenue-producing business operations and no current assets other than an alleged 95-year exclusive lease to take water from a glacier in Iceland for commercial sale; nor was there evidence of any prospect for revenue-producing business operations in the future. Notwithstanding these facts, the Offshore Funds ascribed a market value of $226 million to IGP as of November 28, 2008. The application judge rejected the evidence tendered on behalf of the Offshore Funds that purported to be third-party valuations that supported the alleged value.

12 The offering memoranda of the Offshore Funds provided that the Manager was to be paid performance fees monthly in an amount equal to 20% of the increase in value of the "Class Net

Asset Values" of the Class A and Class F shares of the Offshore Funds since the previous month-end. From June 2007 to November 2008 the net asset values of the two Offshore Funds were alleged to have increased by 506% and 519.2% respectively, and performance fees were paid based on those increases. The increases were essentially attributable to the increase in market value of the IGP shares held by the two funds.

13 The application judge found that the market value of the IGP shares was not justifiable. To the contrary, he found that there was no evidence that the value of the IGP shares was anything other than the value of the investment by the Offshore Funds in IGP to purchase those shares. Therefore, there was no basis for the payment of the performance fees during 2007 and 2008. The application judge concluded that:

> The facts demonstrate a clear propensity on the part of these parties ... to appropriate assets of the Funds to the detriment of the shareholders of the Funds. The evidence indicates that the Manager and Spork have pursued a course of action that involved furthering the interests of IGP at the expense of honouring their fiduciary and contractual obligations to the shareholders of the Funds, including any judgment that may hereafter be obtained in this proceeding. These circumstances therefore establish a genuine risk that assets of the Funds will be dissipated in the absence of the requested relief.

14 Having concluded that he would grant the requested *Mareva* injunction, the application judge made two further observations about the operation of the Spork entities based on the evidence before him that further supported his conclusion. The first was that the Offshore Funds' investment in IGP and IGW was disproportionate relative to the total assets of the funds and could not be justified "as reasonable investments under recognized investment criteria on the record before the Court."

15 The second significant observation by the application judge was that the Offshore Funds, along with the Sextant Strategic Opportunities Hedge Fund L.P. (the "Canadian Hedge Fund") "have essentially become funding vehicles for IGP and IGW" and that those companies could not have conducted any business activities in 2007 and 2008 without the investments by the Offshore Funds and the Canadian Hedge Fund. Finally, as the benefit of these investments accrued to Spork as the only other substantial shareholder of IGP and IGW,

> [t]he evidence therefore suggests a serious likelihood that Spork would cause the Funds to direct any remaining monies in the Funds' accounts to IGP to attempt to preserve the value of his investment in IGP.

The Commission Application for an Extension of the Offshore Directions

16 The second application before the application judge was for an order pursuant to s. 126(5) of the *Securities Act* to continue directions issued by the Commission on December 17, 2008 to freeze the Offshore Funds. To understand properly the process that the *Securities Act* provides for the Commission to issue directions to freeze certain assets and for the Superior Court to continue those directions by order, I find it convenient to recite the relevant provisions of s. 126:

> 126.(1) If the Commission considers it expedient,
>
> (a) for the due administration of Ontario securities law or the regulation of the capital markets in Ontario; or
> (b) to assist in the due administration of the securities laws or the regulation of the capital markets in another jurisdiction,
>
> the Commission may direct a person or company having on deposit or under its control or for safekeeping any funds, securities or property of any person or company to retain those funds, securities or property and to hold them until the Commission in writing revokes the direction or consents to release a particular fund, security or property from the direction, or until the Superior Court of Justice orders otherwise.
>
> ...
>
> (5) As soon as practicable and not later than seven days after a direction is issued under subsection (1), the Commission shall apply to the Superior Court of Justice to continue the direction or for such other order as the court considers appropriate.
> (6) A direction under subsection (1) may be made without notice but, in that event, copies of the direction shall be sent forthwith by such means as the Commission may determine to all persons and companies named in the direction.
> (7) A person or company directly affected by a direction may apply to the Commission for clarification or to have the direction varied or revoked.

17 The Offshore Directions of concern were originally issued by the Commission on December 17, 2008. They followed similar directions issued by the Commission on December 8, 2008, that froze the accounts of the Sextant Canadian entities. Those directions were continued by the Superior Court on December 17, 2008.

18 The application judge used the test first established by Farley J. in *Ontario Securities Commission v. RBC Dominion Securities Inc.* (2001), 54 O.R. (3d) 767 (S.C.), to be applied by the Superior Court when determining whether to continue directions of the Commission to freeze funds. It is a three-part test similar to the test for a *Mareva* injunction:

> 1) a strong *prima facie* case or a serious issue to be tried, as to whether there

has been a contravention of the *Securities Act*;

2) a close connection between the alleged misconduct and the frozen assets; and

3) evidence of potential dissipation of assets.

19 The first issue was whether the Commission could point to any breach of the *Securities Act* by or in relation to the Offshore Funds. The Commission was initially relying on alleged breaches of s. 111 of the *Act* by the Canadian Hedge Fund but by the time of the application, it could not link any such alleged breaches to the Offshore Funds. Similarly, the Commission was also initially relying on questions regarding the propriety of certain payments by the Canadian Hedge Fund into the Sextant Water Fund, but again, the Commission could not identify any breach of the *Act* relating to the payments. Accordingly, on the hearing of the application, the Commission was relying on only two grounds that it submitted could satisfy the first part of the *RBC* test and justify continuation of the Offshore Directions.

20 The first ground was based on a January 2009 e-mail request received from the Cayman Islands Monetary Authority, stating that there may be some breaches of the Cayman Islands laws by the Offshore Funds and requesting continuation of the Offshore Directions on that basis under s. 126(1)(b). The application judge rejected the extension order on this ground. First, he found that as the original Offshore Directions had been made under s. 126(1)(a), they could not be continued on a totally new ground under s. 126(1)(b). Second, the vague, non-specific allegations of breach made by the Cayman Islands Monetary Authority were not sufficient to meet the first or second prongs of the *RBC* test and to ground an order.

21 The second ground was based on two alleged misrepresentations or untrue statements concerning the Offshore Funds, which were said to constitute breaches of s. 126.2 of the *Securities Act*. That provision states:

> 126.2 A person or company shall not make a statement that the person or company knows or reasonably ought to know,
>
> (a) in a material respect and at the time and in the light of the circumstances under which it is made, is misleading or untrue or does not state a fact that is required to be stated or that is necessary to make the statement not misleading; and
>
> (b) would reasonably be expected to have a significant effect on the market price or value of a security.

22 The first allegation was that the net asset values of the shares of the Offshore Funds that were set out in Internet-posted performance charts for the Funds to September, 2008 were misleading. The application judge agreed that the net asset values could indeed be misleading, based on his findings in the Squirrel Trust No. 1 application relating to the underlying value of IGP. However, the Commission conceded that no Canadian residents owned shares in the Funds, and therefore there was a serious issue whether any breach of the *Act* had occurred. Furthermore, regarding the second branch of the test, the Commission had not established any connection between the alleged misrepresentations and any monies in the accounts or that any investor had acquired shares based on the performance charts. In that regard, the evidence was that a password was required to access these charts on the Manager's website.

23 The second allegation of misrepresentation or untrue statements was that the offering memoranda of the Offshore Funds did not disclose that 50% of the assets of each of the Funds would be invested in IGP and IGW, two start-up companies in the water business associated with Spork, the founder of the Offshore Funds. The application judge concluded that this ground as well did not meet the *RBC* test. First, he found that there was no clear misrepresentation based on the wording of the offering memoranda, which did state that the investments would be in the water business, nor did they identify ratios of proposed public versus private investments. Second, even if the disclosure was untrue at the date of the application, there was no evidence that the statements in the offering memoranda were untrue when they were made.

24 The application judge was also of the view that to succeed on the second branch of the *RBC* test, a sufficiently close connection between the alleged breaches and the Funds must be established by showing that one or more investors relied on specific misrepresentations in the offering memoranda when they made the decision to buy shares in the Funds and that the subscription proceeds were deposited into the frozen accounts. The Commission asked the court to draw the inference that some investors were misled and that their subscription monies were paid into the frozen accounts.

25 The application judge rejected this submission because it did not meet the standard of proof required by the *RBC* test. Given that a s. 126 freeze order is an extraordinary remedy involving the seizure of assets prior to the completion of an investigation by the Commission, the standard of proof requires at least a serious issue to be tried regarding a specific breach. In this case, drawing the inference that an unspecified investor was misled at some unspecified time could not amount to such a serious issue.

Issues

26 The appellant raises four issues:

(1) Whether this court should approve the *RBC* standard for a court to apply on a s. 126(5) application or accept the submission of the Commission that the standard should be "contextual reasonableness" and, if so, whether the application judge erred by failing to apply that standard.

(2) In the alternative, whether the application judge erred in his application of the *RBC* test.

(3) In the further alternative, whether the application judge erred in failing to

find misleading or untrue statements capable of constituting a breach of s. 126.2 of the *Act.*

(4) Whether the Offshore Directions should be continued.

Analysis

(1) The standard to be applied for continuing a direction to freeze accounts

27 The legislative mandate under consideration is contained in ss. 126(1) and (5) of the *Securities Act*, which I recite again for ease of reference:

> 126.(1) If the Commission considers it expedient,
>
> (a) for the due administration of Ontario securities law or the regulation of the capital markets in Ontario; or
>
> (b) to assist in the due administration of the securities laws or the regulation of the capital markets in another jurisdiction,
>
> the Commission may direct a person or company having on deposit or under its control or for safekeeping any funds, securities or property of any person or company to retain those funds, securities or property and to hold them until the Commission in writing revokes the direction or consents to release a particular fund, security or property from the direction, or until the Superior Court of Justice orders otherwise.
>
> ...
>
> (5) As soon as practicable and not later than seven days after a direction is issued under subsection (1), the Commission shall apply to the Superior Court of Justice to continue the direction or for such other order as the court considers appropriate.

28 The intent of s. 126(1)(a) is to give the Commission the power to act quickly to preserve property as soon as it has concerns about the possible dissipation of that property out of Ontario, and to do so based on a standard of expediency "for the due administration of Ontario securities law or the regulation of the capital markets in Ontario". Clearly the standard of proof for the Commission to issue freeze directions is very low, as it is anticipated that the Commission staff may only be commencing an investigation when they believe a direction is necessary. However, having acted with expedience, the Commission must then seek a court order within seven days, to continue the freeze and to be able to complete the investigation.

29 Subsection (5) does not use the term "expedient". In fact, the wording of the section gives little guidance as to the standard the court is to apply when determining whether to continue the freeze. The Commission has explained in its factum that the purpose of inserting a court continuance process into the legislative scheme in the 1994 amendments was to ensure that a continuing order is made in accordance with *Charter* rights.

The Commission's Position

30 The appellant argues that when s. 126 is read as a whole, including the ability of an affected person to apply to the Commission under s. 126(7) for clarification or to vary or revoke its directions, and that that decision can be appealed to the Divisional Court under s. 9(1), "it is apparent that s. 126(5) was not intended to substitute the court for the Commission, but only to ensure a mechanism for court consideration of the issuance of the direction." The appellant proposes that the proper role for the court is to also apply the expediency standard when deciding whether to continue a freeze order under s. 126(5) by considering whether it is reasonable on the evidence for the court to conclude that it is expedient to continue the Commission's direction.

31 The appellant submits that applying such a "contextual reasonableness standard" would allow the court to consider all relevant factors, including the stage of the Commission's investigation, the strength of the evidence, whether a proceeding has been initiated and any other circumstances.

Analysis

32 The Commission is seeking to displace the three-part test propounded in 2001 in *Ontario Securities Commission v. RBC Dominion Securities*. I will set out the test again here for ease of reference:

1) a strong *prima facie* case or a serious issue to be tried, as to whether there has been a contravention of the *Securities Act*;
2) a close connection between the alleged misconduct and the frozen assets; and
3) evidence of potential dissipation of assets.

33 Importantly, the courts that have discussed or applied the test have not insisted on a rigid application of the test but have imported a measure of flexibility. In *RBC* itself, where Farley J. was faced with interpreting and applying s. 126(5) for the first time, he stated, at para. 13, that the test for a *Mareva* injunction was a useful guide but "with some adjustments." For example, the strength of the *prima facie* case of breach of the *Act* required to continue a freeze of funds may depend on whether the freeze would interfere with the operation of the account in question -- if the account could continue to operate, then a lesser case based on circumstantial evidence could suffice.

34 The flexibility of the test was remarked on by Pepall J. in *Ontario Securities Commission v. von Anhalt*, [2005] O.J. No. 247, a cease-trading order case under s. 128(4) of the *Act*. In rejecting the need for a strong *prima facie* case for an order under s. 128(4), Pepall J. commented, at para. 16, that the freeze order under s. 126 is a more onerous order than the cease trade order, but that even under s. 126(5), Farley J. in *RBC* had made it clear that a strong *prima facie* case of breach of the *Act* would not be required in every case depending on the circumstances.

35 The last case before this one to consider the test under s. 126(5) was *Ontario Securities Commission v. De Freitas & Associates*, [2008] O.J. No. 2020, another decision of Wilton-Siegel J. In that case, the court noted again that in *RBC*, Farley J. had anticipated the ability to apply a flexible standard regarding the strength of the *prima facie* case required. However, in *De Freitas*, the court decided that a strong *prima facie* case of breach was required: *De Freitas* at paras. 28-31.

36 In my view, although the jurisprudence under this section is limited, the *RBC* test that has been articulated and applied is cogent, fair and effective. It sets out a standard against which a court may test the evidence presented to it and based on which the court is asked to impose a very onerous order that freezes assets of a corporation operating in the financial markets in Ontario.

37 Contrary to the submission of the Commission, the court is not being asked to approve the Commission's Offshore Directions or to review them to determine whether it was expedient for the Commission to make them in the first instance. Instead, the court is asked to make an order to continue the temporary Offshore Directions into the future, based on the record before it. Clearly a court needs criteria to apply in order to determine whether to make any order, and the affected parties also need to know the factors that will affect their position. This is quite different from the original directions of the Commission that can be made without notice and served on the affected parties thereafter: s. 126(6).

38 In my view, the *RBC* three-part test provides appropriate criteria for a court to consider when determining whether to continue freeze directions under s. 126(5). I am also of the view that the test is to be applied in a flexible manner with the required strength of proof of each component of the test dependent on the circumstances of the particular case. This would include not only the *prima facie* case or serious issue to be tried of breach of the Act, but also the link between the wrongdoing and the targeted fund. This is also the approach taken under the British Columbia and Alberta legislation, which provide a different procedure but seek to accomplish the same objective: see, for example, *Klytie's Development Inc. (Re),* 2006 ABASC 1763; *Workum (Re)*, 2005 ABASC 425.[2]

(2) Error by the application judge in applying the test

39 The application judge found that the evidence relied on by the Commission in this case did not establish a *prima facie* case of breach of the *Act* or a sufficient connection between the alleged wrongdoing and the Funds. The Commission argues on this appeal that a breach of the *Act* is not a necessary requirement for a freeze order, and that the order should be issued where there is evidence of wrongful misappropriation of funds after they are invested, in order to protect investors generally.

40 Although at first blush this argument may appear attractive, on closer consideration, it does not bear scrutiny. The purpose of a freeze direction is to give the Commission time to investigate alleged wrongdoing under the *Securities Act* with a view to the Commission instituting proceedings under the *Act* in respect of that wrongdoing. The Commission's jurisdiction flows from the *Act*. If the alleged wrongdoing cannot lead to any proceeding under the *Act*, then the freeze order would amount to a remedy in itself, and not a mechanism to preserve assets pending a proper proceeding under the *Act* with prescribed remedies upon proof of breach of the *Act*.

41 No case presented, including cases from other provinces, suggests that an apparent breach of the *Act* is not required as a first criterion for a freeze order. The application judge correctly required at least a *prima facie* case of breach of the *Act*. I also note that on the application hearing, the Commission itself recognized that it had to show evidence of a breach of the *Act*, and narrowed its arguments once it became apparent that some of its alleged breaches could not be established.

42 I also observe that in its evidence, the Commission's representative stated that Commission staff intended to amend a Statement of Allegations originally issued on December 8, 2008, in support of a temporary cease trade order that the Commission issued against the respondents. He swore in an affidavit on January 12, 2009, that staff intended to amend the statement "to include allegations with respect to the wrongful activity undertaken in Ontario in connection with the Sextant Offshore Funds." However, the record does not contain any amended statement or indicate that such amendments have, in fact, been made.

43 Another reason for the application judge's refusal to continue the Offshore Directions was because the evidence did not establish a link from the alleged misrepresentations in the performance charts and the offering memoranda to the Offshore Funds. He required the Commission to prove that an identifiable investor made his or her investment based on one of the alleged misrepresentations and that the invested funds were in the frozen accounts.

44 In my view, the application judge may well have been too stringent in his approach to the requirements of the second branch of the test. For example, had there been sufficient evidence of a breach of the *Act*, it may have been sufficient for the Commission to have been able to show that identifiable investors who had access to the impugned misrepresentations, whether or not they relied on them, invested in the Funds thereafter and that their investment monies were at some point in the frozen accounts. Arguably, such an investor should be protected pending the Commission investigation, even if the actual monies he or she invested had already been wrongfully removed.

45 Having said that, I see no error in the result reached by the application judge in this case. He was well aware of the serious wrongdoing that appeared to be the *modus operandi* of Spork in the operation of all of his related Sextant entities, and he was prepared to give an appropriate interim remedy in the Squirrel Trust No. 1 action. He was, however, not satisfied that the evidence presented by the Commission amounted to anything more than general concern about the operation of funds held in Ontario, which was not sufficiently linked to the enforcement jurisdiction of the

Commission to allow the court to continue the Offshore Directions under s. 126(5) of the *Act*. The Commission argues on the appeal that because the Funds are operated from Ontario, that should be a sufficient link. I agree with the application judge's reason for rejecting this assertion.

(3) Error by the application judge in his findings on the evidence

46 I also see no palpable and overriding error by the application judge in his conclusion that he was not prepared to interpret the offering memoranda as misleading at the time they were issued.[3] This was a conclusion that was open to him on the record. The Commission also argues that that conclusion was not consistent with the judge's observation in the *Mareva* injunction ruling that the offering memoranda did not state that the Offshore Funds would invest disproportionately in IPG and IPW. I do not see any inconsistency. The application judge did not go so far as to say that the failure of the offering memoranda to state that monies would be disproportionately invested amounted to a misrepresentation. Rather, his conclusion was focused on the fact that such an investment could not be justified as reasonable based on recognized investment criteria.

47 The decision reached by the application judge not to continue the Offshore Directions also made practical sense in the circumstances, where the only known investors whose monies were in the Offshore Funds held in Ontario were already protected by the *Mareva* injunction in the Squirrel Trust No. 1 action.

(4) Should the Offshore Directions be continued

48 At the conclusion of the argument in this matter, counsel for the appellant confirmed that as long as the *Mareva* injunction in the Squirrel Trust No. 1 action continued in place, that order had the same effect in this case as a freeze order under s. 126 of the *Act*. He further confirmed that an arrangement had been made for the Commission to receive notice if the *Mareva* injunction were to be lifted and in that event, the Commission would seek new freeze directions under s. 126(1) based on the state of its investigation at that time.

Conclusion

49 In my view, the application judge made no error in his application of the *RBC* test in this case, and I would not interfere with his conclusion not to continue the Offshore Directions under s. 126(5).

50 I would therefore dismiss the appeal, in the circumstances, without costs.

K.N. FELDMAN J.A.
E.A. CRONK J.A.:-- I agree.
E.E. GILLESE J.A.:-- I agree.

1 55% of the Sextant Hybrid Fund and 80% of the Sextant Water Fund.

2 The British Columbia and Alberta legislation allow the Securities Commissions of those jurisdictions to make the freeze orders without any further court order. Although the Alberta Commission has rejected the application of the *RBC* test based on the strength of the evidence that may be required, it is clear that a breach of the applicable securities legislation and some link to the frozen funds will be required: see *Workum (Re)* at paras. 19-22; *Klytie* at para. 21.

3 This ground does not apply to the performance charts as the application judge had found that although they could be misleading, the application failed with respect to them because other aspects of the RBC test were not met.

2016 CarswellOnt 14615
Ontario Superior Court of Justice

Ontario (Securities Commission) v. Jordan

2016 CarswellOnt 14615, 270 A.C.W.S. (3d) 657

Ontario Securities Commission, Applicant and Haiyan (Helen) Gao Jordan, Respondent

Conway J.

Judgment: September 16, 2016
Docket: Toronto CV-16-11361-00CL

Counsel: Jennifer Lynch, for Applicant, Ontario Securities Commission
J. Naster, for Ms Jordan

Subject: Corporate and Commercial; Securities
Related Abridgment Classifications
Securities
II Commissions and exchanges
II.4 Orders
II.4.a Freeze orders
Table of Authorities
Cases considered by *Conway J.*:

Ontario (Securities Commission) v. Future Solar Developments Inc. (2015), 2015 ONSC 2334, 2015 CarswellOnt 6487 (Ont. S.C.J. [Commercial List]) — considered

***Conway J.*:**

1 The OSC seeks an order to continue the freeze direction issued by the OSC on April 18/16 against Ms Jordan's mat home (that She co-owns with her husband). The test for an order to continue Under s.126(s.1) of the Act is the "Reasonable and expedient" test, and has been articulated by Pattillo J. in *Ontario (Securities Commission) v. Future Solar Developments Inc.*, 2015 ONSC 2334 (Ont. S.C.J. [Commercial List]) as being a 3 part one (1) serious issue to be tried re the respondent's breach of the Act; (2) a basis to suspect, suggest or prove a connection between the frozen assets & the conduct as issue; and (3) that the freeze directions are necessary for the due administration or securities laws on the regulation of capital markets, in Ontario or elsewhere.

2 As a preliminary comment, I note that this is *not* a judicial review of the OSC's original direction. I also note that in considering the application, I am looking to the evidentiary record that is before me and applying the test set out in s. 126 (s.1). I afford no deference or weight to the OSC's decision.

3 The OSC alleges that Ms Jordan raised $12 million from 40 investors in 4 companies over a 4 year period without being registered. The evidence is that Ms Jordan received $330,000 for her activities that was deposited into her bank account at RBC. There were other funds in that account and considerable activity in that account over the period in question. The evidence is that $230,000 in mortgage payments were made out on that account on Ms Jordan's home.

4 Ms Jordan acknowledges and concedes that there is a serious issue to be tried with respect to the alleged illegal activity. Her main focus & argument is on the connection between the frozen asset (her house) and the alleged illegal conduct. She argues that the OSC has not proven that the $230,000 in mortgage payments from the account came from

the $330,000 placed into that account. In other words, she argues that the OSC must prove that the mortgage payments came from investor funds, such that a freeze order is required to protect those funds. I accept Ms Jordan's argument that a freeze order is not merely to secure assets that may be available to satisfy a future judgment.

5 However, I am satisfied that the evidence gives rise to a basis to suspect, suggest or prove a connection between the house & the investor funds. It is clear that the $330,000 went into the account from which the mortgage payments were made. At this stage of the proceeding I do not agree that the OSC must demonstrate with certainty precisely which of those co-mingled funds actually were used to pay the mortgage. There is a sufficient connection between the inflow to that account from the investor funds and outflow to the mortgage on that house that the protective device of the freeze direction is to be continued. I also consider the freeze direction to be necessary having regard to the public interest. The issue of whether investor funds made their way into Ms s residence raises & engages issues of public confidence in the administration of securities laws & the regulation of capital markets.

6 The reasonable & expedient test is met & the order to continue is granted. The OSC does not seek any costs of that application.

End of Document

ONTARIO SECURITIES COMMISSION
Applicant

- AND -

MONEY GATE MORTGAGE INVESTMENT CORPORATION
Respondent

Court File No. CV-18-00608086-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

BOOK OF AUTHORITIES OF THE ONTARIO SECURITIES COMMISSION
(Application under Sections 126 and 129 of the *Securities Act*)

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