ONTARIO SECURITIES COMMISSION

IN THE MATTER OF:

THE RULES OF THE INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

AND

BRIAN MICHAEL SUTTON

AMENDED APPLICATION FOR HEARING AND REVIEW

THE APPLICANT (Respondent in the IIROC Proceeding below), Brian Sutton, seeks a hearing and review before the Commission of the Decision the Investment Industry Regulatory Organization of Canada ("IIROC") Tribunal in this matter, dated July 5, 2017 (the "IIROC Decision").

THE APPLICANT ASKS that the IIROC Decision and the associated decision of the IIROC Tribunal regarding Penalty, dated January 21, 2018 and released February 5, 2018, be set aside and that an Order issue dismissing the proceedings against the Applicant.

THE GROUNDS FOR THE HEARING AND REVIEW are as follows:

1. Brian Sutton was the part-time external Chief Financial Officer ("CFO") of investment dealer, First Leaside Securities Inc. ("FLSI"), which was one member of a large group of companies known in the industry as the First Leaside Group. Mr. Sutton's role as CFO for FLSI primarily involved: (1) monitoring whether FLSI had adequate risk-adjusted capital; and (2)

monitoring whether FLSI had reasonably priced on its client account statements a small number of Funds offered by FLSI affiliates that had been purchased by FLSI clients.

2. On the second of these tasks, Mr. Sutton was obliged by the relevant legal principles and the prevailing internal and external accounting and IIROC standards for the pricing of unlisted securities to act reasonably in verifying the pricing shown on FLSI client statements for the FL Funds (as defined below).

3. The investments at issue in the IIROC proceeding below were as follows:

(a) **The First Leaside Fund:** This fund was sold beginning in 2005 as an exempt product only to accredited investors who met criteria relating to their income or assets that suggested they could assume the risk of loss of their money. The only assets of the First Leaside Fund were 9% promissory notes issued by FL Master Texas Ltd. ("Master Texas") – which was a member of the FL Group and a subsidiary of WALP. Each $1.00 unit of the First Leaside Fund corresponded to $1.00 owing under the promissory notes held by the fund. All interest received on the Master Texas Promissory Notes was immediately distributed to investors and, as with the other FL Funds, throughout the relevant period leading, no payments to investors were ever missed. At all times, units in the FL Fund sold at a price of $1.00 per unit and it is not in dispute that at any time any investors in the First Leaside Fund were able to sell their units upon request at $1.00 within, at most, one or two days.

(b) **The First Leaside Properties Fund (the "Properties Fund"):** This fund was offered to the public by Prospectus dated March 19, 2009. Because it was offered

by Prospectus, it could be sold to non-accredited investors. The Prospectus included significant warnings to investors about the risks associated with the Properties Fund, including the risk that it might be unable to either pay distributions or return the principle invested when it was due – which was 10 years after the Fund units were issued, which was March 2019 or later.

The only assets of the Properties Fund were promissory notes due from Master Sherman Ltd. ("Master Sherman"), a member of the FL Group of Companies. Each $1.00 unit of the FL Properties Fund corresponded to $1.00 owing under the Master Sherman promissory notes. The notes paid 9% interest which was, in turn, paid out to the unitholders except for one class for which payment was in additional units. While there was no guarantee that Master Sherman would continue paying its obligations throughout the life of the Notes (as disclosed in the Properties Fund Prospectus at page (iii)), no payments to investors in the Properties Fund were ever missed during the relevant period.

As with the other FL Funds, it is not in dispute that at any time during the relevant period if an investor wanted to sell his/her Properties Fund units, he/she could always sell them at $1.00 per unit within 1 – 2 days;

(c) **The Wimberly Fund:** Units of this fund were issued pursuant to two Offering Memoranda, dated May 2010 and November 3, 2010. The primary assets held by the Wimberley Fund were unsecured promissory notes issued by Master Texas paying either 8% per annum (for the May 2010 offering) or 7% per annum (for the November 2010 offering). As with the Properties Fund, each $1.00 unit

corresponded to $1.00 owing under the Master Texas Promissory Notes. All interest received on the Master Texas Promissory Notes was immediately distributed to investors and, as with the other FL Funds, throughout the relevant period leading, no payments were ever missed and at any time during the relevant period if an investor wanted to sell his/her Wimberly Fund units, he/she could always sell them at $1.00 per unit within 1 – 2 days.

Both Offering Memoranda set out a number of risks inherent in investing in the Wimberly Fund, including the fact that the investors' investments were locked in for at least a decade (until 2020) and the risk that the investors would not receive distributions or their principal investments back due to a lack of cash on the part of the fund or the inability of Master Texas to pay the amounts owing on its notes to the Fund.

The Wimberly Fund was still in its primary offering to investors as late as August 2011 – just 2 - 3 months before the end of the period at issue.

The First Leaside Fund, the Properties Fund and the Wimberly Fund are hereinafter collectively referred to as the **"FL Funds"**.

4. In the IIROC proceeding below, it was alleged by IIROC staff that Mr. Sutton breached IIROC Dealer Member Rule 38.6(c) in relation to the pricing of the FL Funds on FLSI client account statements. IIROC Dealer Member Rule 38.6(c) provides as follows:

> "The Chief Financial Officer must monitor adherence to the Dealer Member's policies and procedures **as necessary to provide reasonable assurance that the Dealer Member complies with the financial rules of the Corporation** [IIROC]." [Emphasis added]

5. At all material times, Mr. Sutton took significant steps to comply with the above IIROC Rule in relation to the pricing of the FL Funds, including the following:

(a) He monitored the trading in the FL Funds on at least a monthly basis by reviewing trading records maintained and produced by the independent carrying broker charged with maintaining the records and issuing account statements for FLSI, Penson Financial Services ("Penson") and satisfied himself that there was a sufficiently active market to support the price shown on FLSI client account statements;

(b) He requested and reviewed a September 25, 2009 appraisal by Marcus & Millichap Ltd. valuing the real estate owned by members of the FL Group - which showed that the relevant entities had net assets, after deduction of liabilities, that were worth more than the amounts owing to the FL Funds. While none of the FL Funds owned real estate – this appraisal provided comfort that, in a worst case scenario, there was likely to be sufficient value in the real estate to pay off the promissory notes given to the FL Funds;

(c) He reviewed two independent expert reports on the pricing of the First Leaside Properties Fund (the "Properties Fund"), one report prepared by a firm of chartered accountants, Sloan Partners LLP, and one prepared by Stephen D. Warden, then of Parker Simone LLP, who had approximately 30 years of accounting experience, and specialized in and trained panel auditors for IIROC itself;

(d) He reviewed the 2009 and 2010 audited annual financial statements for the Properties Fund in which KPMG gave a clean audit opinion on Properties Fund financial statements that valued the assets of the Properties Fund at their full value and showed Properties Fund unit holders' equity as, if anything, higher than the $1.00 per unit shown on FLSI client statements;

(e) He considered the high yield of the FL Funds (either 7%, 8% or 9% per annum) and what impact those yields had on the value of the FL Funds when compared with similar debt-based securities and further considered and took into account the fact that no payments of this yield to unit holders were ever missed by any of the FL Funds; and

(f) He considered the initial offering price of the FL Funds and in particular the Properties Fund and the Wimberly Fund, the fact that both of those Funds were still in their initial offerings during portions of the relevant period, and the fact that arm's length individuals were still buying units of those Funds on the initial offerings at the same price that was shown on their FLSI Account Statements.

6. It was not in dispute in the IIROC proceeding below that at all times all units in the FL Funds were always issued at $1.00 per unit in their primary offerings, they always traded at a price of $1.00 per unit in secondary trading, that the majority of the primary and secondary trades were between parties trading at arm's length from each other and under no compulsion to buy or sell, and that during the entire period when those funds were shown on FLSI client statements at $1.00 per unit the FL Funds did in fact trade at $1.00 per unit and unit holders in the Funds were always able sell their units when they wanted to sell them.

7. It was also not in dispute that during the Material Period, the rules and requirements for accounting within IIROC Dealer Members, including those applicable to the pricing of unlisted securities, were in transition and lacked significant detail or guidance on the pricing of unlisted securities and, in any event, prescribed that a high level of professional judgment needed to be applied to the determination of the price of unlisted securities.

8. In a decision released on July 5, 2017, the IIROC Tribunal in the proceeding below issued a decision (the "IIROC Decision") finding that Mr. Sutton had breached IIROC Dealer Member Rule 38.6(c) in relation to the pricing of the FL Funds – primarily on the basis of the Tribunal's view that Mr. Sutton erred in determining that there was a sufficiently active market in the FL Funds to support the prices shown on FLSI client account statements.

9. In rendering the IIROC Decision, the IIROC Tribunal below erred, breached the rules of natural justice and fairness and caused irreparable prejudice to Mr. Sutton by relying upon materials that were not in evidence before it and doing so without any prior notice to Mr. Sutton. In particular:

(a) The IIROC Tribunal improperly reviewed and relied upon for the truth of their contents the following documents and other materials that were not adduced or admitted as evidence before them on the IIROC hearing below:

(i) Portions of the transcript from the compelled Ontario Securities Commission ("OSC") interview of Leon Efraim that were not read into evidence, admitted as evidence during the IIROC hearing or otherwise referred to by any party to the hearing;

(ii) A series of emails sent during 2010 and 2011 among and between IIROC staff and OSC staff relating to FLSI and other members of the First Leaside Group of Companies that were not adduced as evidence or otherwise referred to during the hearing by any party;

(iii) The contents of an independent report prepared in 2011 by Grant Thornton Limited in relation to the overall FL Group (the "GTL Report"). The GTL Report was identified during the IIROC hearing but its contents were not referenced and its authors were not called as witnesses or otherwise made available for cross-examination. IIROC staff did not seek to rely upon the the GTL Report for the truth of its contents, nor did either IIROC Staff or the IIROC Tribunal notify Mr. Sutton of any intention to do so; and

(iv) Other materials that came into the possession and were relied upon by the IIROC Tribunal without prior notice to Mr. Sutton but not specifically identified in the IIROC Tribunal's Decision and Reasons.

(b) The IIROC Tribunal improperly reviewed and relied upon the materials identified in paragraph 9(a) hereof (hereinafter, the "Extraneous Materials") without being asked to do so by IIROC Staff or any party and without giving Mr. Sutton any opportunity to challenge the admissibility and reliability of the Extraneous Materials or to call evidence to respond to the hearsay assertions contained in the Extraneous Materials;

(c) The IIROC Tribunal reviewed and relied upon the Extraneous Materials in direct contravention of its own express assurances to counsel for the parties during the

hearing that the members of the IIROC Tribunal would not review or rely upon any documents or portions of transcripts that were not expressly referenced and admitted as evidence during the oral testimony given at the hearing;

(d) The IIROC Tribunal erred in reviewing and relying upon the Extraneous Materials despite most or all of those materials being unsworn hearsay evidence contrary to Rule 13 of IIROC's Rules of Practice and Procedure and it further erred in doing so without giving Mr. Sutton an opportunity to challenge the admissibility of such hearsay as evidence under Rule 13 and the rules of natural justice; and

(e) The IIROC Tribunal erred in preferring the contents of the Extraneous Materials over the direct, sworn testimony of Mr. Sutton and Mr. Boyce on behalf of the Respondent - despite the Extraneous Materials not being evidence and despite not making any adverse findings regarding the credibility of either Mr. Sutton or Mr. Boyce.

10. In addition to breaching the basic rules of fairness and natural justice, reliance upon the Extraneous Materials by the IIROC Tribunal and the other errors identified in paragraph 9 hereof led to palpable and overriding errors in the conclusions reached by the IIROC Tribunal, including those reached regarding whether there was an active secondary market in relation to the FL Funds, to what extent members of FLSI management exercised control over the trading in the FL Funds, and whether Mr. Sutton complied with IIROC Dealer Member Rule 38.6(c) in verifying the pricing of the FL Funds as shown on FLSI client account statements.

11. The IIROC Tribunal erred in finding that Mr. Sutton had failed to meet the required standard of care for a CFO under IIROC Dealer Member Rule 38.6(c) in relation to the pricing of

the FL Funds in the absence of any admissible expert evidence being adduced by IIROC Staff on the standard of care that was required to be met by a reasonable CFO for an IIROC Dealer in the circumstances.

12. The IIROC Tribunal erred in reversing the burden of proof and requiring that Mr. Sutton, and not IIROC staff, bear the primary onus of proving the applicable standard of care that he was required to meet by adducing expert evidence to that effect. The IIROC Tribunal further erred in making an adverse inference based upon Mr. Sutton's failure to call an expert witness on the standard of care he was required to meet as CFO of FLSI – despite no such evidence being called by IIROC staff.

13. The IIROC Tribunal erred in finding that there was not a sufficiently active market for the FL Funds to support Mr. Sutton's conclusions on pricing in the absence of any definition of "active market" under the IIROC rules and in the absence of any qualified expert evidence on what, for a CFO working with an IIROC Dealer, amounts to an active market sufficient to support pricing of unlisted securities on client statements.

14. In deciding that there was no active market for the FL Funds, the IIROC Tribunal further erred in finding that the carrying broker, Penson, was not an independent source of pricing information for the FL Funds despite the uncontradicted evidence that Penson was a completely separate and unrelated corporation from FLSI and the other members of the FL Group and, as a registrant with IIROC and the OSC, was jointly and severally liable to regulatory sanctions for any errors in the pricing information it showed on FLSI client statements.

15. The IIROC Tribunal erred in finding that the prices shown on FLSI client account statements for the FL Funds were set by FLSI President, David Phillips, in determining that the

prices on client account statements misled investors, and in determining that the prices on client statements were intended to mislead investors in the complete absence of any evidence that could possibly support such findings.

16. The IIROC Tribunal erred in applying the wrong standard to whether there has been a breach of IIROC Dealer Member Rule 38.6. The IIROC Tribunal erroneously found a breach based upon a simple error or honest disagreement with IIROC staff rather than holding Mr. Sutton to a standard of providing *reasonable* assurance that IIROC rules were being complied with regarding the pricing of the FL Funds. In doing so, the IIROC Tribunal erroneously applied a standard of perfection or strict liability to compliance staff, contrary to both IIROC Dealer Member Rule 38.6(c) and IDA Member Regulation Notice MR0435**.**

17. The IIROC Tribunal erred in finding a breach of IIROC Dealer Member Rule 38.6 based solely upon its own interpretation of the internal FLSI Policies and Procedures Manual provisions regarding pricing of unlisted securities rather than a clear breach of the relevant IIROC Rules and guidelines, including IIROC Dealer Member Rule 38.6(c). The IIROC Tribunal further erred in refusing to accept the uncontradicted evidence regarding the application and interpretation of the FLSI Policies and Procedures Manual from Mr. Sutton and Larry Boyce – who were the persons who drafted the Manual and could amend it, where necessary, to more accurately reflect the changing and developing IIROC rules and accounting standards regarding pricing.

18. In determining whether there was a breach of IIROC Dealer Member Rule 38.6(c), the IIROC Tribunal erred in failing to adequately consider the steps that Mr. Sutton took in addition to verifying pricing based on an active market for the FL Funds – as set out in paragraph 5 hereof –

and in failing to find that all of the steps undertaken by Mr. Sutton, taken together, were sufficient to comply with IIROC Rule 38.6(c).

19. Given the finding that Mr. Sutton's breaches were without any fault or *mens rea*, the IIROC Tribunal erred in finding that a monetary penalty or indeed any sanctions were appropriate in the case of the alleged breach by Mr. Sutton. In any event, the Penalty Decision, dated January 31, 2018, should be set aside upon a reversal of the IIROC Tribunal's decision on liability.

20. Such other and further grounds as counsel may advise and the OSC Tribunal may permit.

July 31, 2017

Amended: March 5, 2018

AFFLECK GREENE MCMURTRY LLP
Barristers and Solicitors
200 - 365 Bay St.
Toronto, ON M5H 2V1

Kenneth A. Dekker LSUC# 40419P
kdekker@agmlawyers.com
Tel: (416) 360-6902

Tel/Fax: (416) 360-2800

Lawyers for the Applicant, Brian Sutton

TO: **THE OFFICE OF THE SECRETARY TO THE COMMISSION**
ONTARIO SECURITIES COMMISSION
20 Queen Street West, Suite 2000
Toronto, ON M5H 3S8
Fax: (416) 593-2318

AND TO: **INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA**
121 King Street West, Suite 2000
Toronto, Ontario, Canada M5H 3T9

Rob DelFrate
Senior Enforcement Counsel
Tel: (416) 943-6909
Fax: (416) 364-2998
Email: rdelfrate@iiroc.ca

Charles Corlett
Senior Enforcement Counsel
Tel: (416) 646-7253
Fax: (416) 364-2998
Email: ccorlett@iiroc.ca

ONTARIO SECURITIES COMMISSION

IN THE MATTER OF:

THE RULES OF THE INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA
AND
BRIAN MICHAEL SUTTON

NOTICE OF APPLICATION FOR HEARING AND REVIEW OF THE DECISION OF THE IIROC TRIBUNAL DATED JULY 5, 2017

AFFLECK GREENE MCMURTRY LLP
Barristers and Solicitors
200 - 365 Bay St.
Toronto, ON M5H 2V1

Kenneth A. Dekker LSUC# 40419P
kdekker@agmlawyers.com
Tel: (416) 360-6902

Tel: (416) 360-2800
Fax: (416) 360-5960

Lawyers for the Applicant, Brian Sutton