Re Sutton

IN THE MATTER OF:

The Rules of the Investment Industry Regulatory Organization of Canada

and

Brian Michael Sutton

2017 IIROC 35

Investment Industry Regulatory Organization of Canada
Hearing Panel (Ontario District)

Heard: January 16 - 24, 2017
Decision: July 5, 2017

Hearing Panel:
John Lorn McDougall QC, Chair, Richard E. Austin and Peter Gribbin
Appearances:
Rob DelFrate, IIROC Enforcement Counsel
Charles Corlett, IIROC Enforcement Counsel
Kenneth Dekker, For the Respondent
Brian Michael Sutton, In Person

DECISION AND REASONS

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I. INTRODUCTION

¶ 1 This is a singular case. It involves the Respondent, Brian Michael Sutton ("Mr. Sutton"), who is a highly regarded specialist in the field of securities industry regulation. He is a true expert in the field and his services have been utilized many times by companies wishing to enter the securities industry in Canada and elsewhere. He has had particular experience working with companies regulated by the Investment Industry Regulatory Organization of Canada ("IIROC"), which is opposed to him in this proceeding.

¶ 2 To further distinguish the case from the usual, at issue is a superficially simple difference about what

constitutes an "active market" for securities. Mr. Sutton was of one view, the regulator of another, opposing view, and the dispute tumbled into these unfortunate proceedings. There was no *mens rea* or intent to do wrong, and none is alleged. However, in the regulatory scheme, that is not a required element. Adherence to IIROC's rules is mandatory and the only question for the Panel is to determine whether there has been compliance with them. IIROC says there has not been, Mr. Sutton disagrees.

II. BACKGROUND

¶ 3 Mr. Sutton has spent almost his whole career in the regulation of financial institutions. He is a chartered accountant who has specialized for more than thirty five years in providing financial, operational, and business consulting services to participants in the securities industry in respect of their dealings with the securities regulators, both throughout Canada and elsewhere. He has described himself, with apparent good reason, as "a senior executive versed in the utilization of strategic, financial, operational and innovative organizational skills on the domestic as well as international fronts, in both the public and private sectors".

¶ 4 Mr. Sutton had been approved as the Chief Financial Officer ("CFO") and as a Non-Trading Officer with First Leaside Securities Inc. ("FLSI") from March 2003 until July 2012 and was employed as the CFO on a part time basis. At the time, in addition to his duties at FLSI, Mr. Sutton was also engaged by other IIROC Dealer Members. The Respondent is not currently approved with an IIROC Dealer Member.

¶ 5 By Notice of Hearing dated April 12, 2016, staff of IIROC ("Staff") alleged that Mr. Sutton had committed the following contraventions:

> That between September 2009 and October 2011, the Respondent, as Chief Financial Officer ("CFO") of First Leaside Securities Inc. ("FLSI"), failed to ensure that proprietary fund products recommended and sold by FLSI were properly priced, contrary to IIROC Dealer Member Rule 38.6(c).

¶ 6 The Dealer Member Rule 38.6 provides as follows:

> 38.6 Chief Financial Officer
>
> (a) Each Dealer Member must, subject to the approval of the Corporation, appoint one Executive as Chief Financial Officer who, in addition to the requirements under Rule 7.4(a), must have met the proficiency requirements of Rule 2900, Part I, section A.2A. The Chief Financial Officer need not be engaged full time in the business of the Dealer Member.
>
> …
>
> (c) 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.

¶ 7 The "financial rules of the Corporation [IIROC]" referred to in the preceding paragraph were incorporated in the FLSI Policies and Procedures Manual ("PPM") which, in relevant part, was as follows:

> **3.8 PRICING OF SECURITIES[1]**
>
> **3.8.1 Control objectives**
>
> To ensure that:
>
> 1. There is independent and timely verification of security prices designed to detect errors or omissions in the pricing of securities;
>
> 2. Security pricing discrepancies are identified and corrected on a timely basis and reviewed and approved by senior management;

[1] The underlined portions of the text are amendments made by Mr. Sutton in the latter part of 2011.

3. There is consistency of procedures in the pricing of all types of securities; and

4. There is accuracy and completeness of the pricing of securities and to ensure the reliability of prices.

3.8.2 Pricing of securities with readily available market prices

First Leaside will use prices obtained and used by Penson for:

1. Securities listed on TMX markets and major foreign markets;

2. All mutual funds settled through FundServ; and

3. Fixed income securities from reliable sources including CanPX, CanDeal, Reuters and Bloomberg.

3.8.3 Pricing of other unlisted securities

1. The CFO may obtain prices for unlisted securities from traders of Penson only if accompanied by a record showing an independent source for the pricing, such as a bid or offer from an arm's length dealer or institution, subject to the following:

    - The CFO will obtain at least independent pricing as of each month-end for any securities held in inventory; and

    - The CFO will obtain daily prices from an independent source for any securities held in inventory whose value represents in excess of 20% of risk adjusted capital as of the previous month-end.

2. The CFO will maintain a list of all restricted securities, OTC securities that do not trade and any other holdings for which there is no publicly available source of price information.

3. For each security, the CFO will establish a review period based on the likelihood of significant volatility in the asset value of the issuer.

4. The CFO will establish a reasonable price for each security based on the issuer's net asset value or shareholder's equity in its most recently audited or published financial statements <u>if the assets are of a nature that financial statements alone will provide an accurate reflection of value and the financial statements</u> were audited or published recently enough, in the opinion of the CFO, that it is unlikely that there has been a significant change in the value.

5. Where information on the issuer's financial statement is not available, <u>or the assets are of a type that the value of the assets cannot be accurately determined solely on the basis of the audited or published financial statements (i.e. real estate),</u> the CFO will contact the issuer or its auditor to obtain up-to-date valuations as frequently as is necessary to ensure that the asset value of the issuer has not changed significantly. In determining that values are reasonable, the CFO may rely on:

    - Third party valuations or appraisals of the assets of the issuer, for example, in the case of real estate, current valuations of the real estate owned by the issuer which have been performed by qualified third parties

    - Current draft financial statements from the issuer if those are reasonably consistent with previous audited or published financial statements, or

    - Internal valuations conducted by the issuer, so long as the internal valuation is based on the same third party valuation and draft valuation statements noted above provided that such sources are recent enough to support a reasonable

determination of the current value of the securities.

6. The CFO will obtain sufficient records from his or her enquiries to ensure that values given are reasonable and retain such records in support of the value given.

7. Where the CFO is unable to obtain sufficient information to reasonably support a price, the security will be shown as "Price not available" in the price column for security positions shown on client monthly statements, and carried as "0" for any calculation purposes.

¶ 8 Policy 3.8 was originally prepared, in large part, by Mr. Sutton who followed the guidance issued by IIROC Internal Control Policy Statement 7 – Pricing of Securities ("IC Policy 7"). Mr. Sutton confirmed that he followed those requirements. The control objectives in IC Policy 7 include ensuring that there is "independent and timely verification of security prices", that there is "consistency of procedures in the pricing of all types of securities" and that there is "accuracy and completeness of the pricing of securities to ensure the reliability of prices".

¶ 9 IC Policy 7, with respect to pricing of unlisted securities, is substantially incorporated in the requirements of Policy 3.8.3 of the PPM of FLSI, and highlights the fundamental objective of the regulations pertaining to the establishment of prices for such securities. The investor is to be provided with the best information available on the worth of his or her security on a regular basis, which in this case was monthly or quarterly depending on activity in a FLSI client's account. This information is required, and the investor is entitled to it, so that informed decisions can be made with respect to the retention or disposition of the investment. That objective underpins the whole of the pricing regime.

¶ 10 To assist in the application of Policy 3.8.3, FLSI employed and utilized a document entitled Process, Considerations and Methodologies Employed to Support Policy 3.8.3. A copy of that Policy is attached as Appendix A hereto. Mr. Sutton was the primary author of this document.

¶ 11 FLSI was an IIROC Dealer Member firm. In this instance it acted as introducing broker; Penson Financial Services ("Penson") was the carrying broker, meaning it provided FLSI with back office functions such as clearing, settlement and custodial services. FLSI became a Dealer Member of IIROC effective March 1, 2004. FLSI's head (and only) office was located in Uxbridge, Ontario.

¶ 12 FLSI was a relatively small part of a much larger and highly complex group of companies, First Leaside Group of Companies ("FL Group"). The principal of FL Group was David Phillips ("Mr. Phillips") who was also the president and ultimate designated person ("UDP") of FLSI. It is common ground that Mr. Phillips directed the affairs of FL Group and was very much in direct and complete control of its various businesses. FL Group was essentially a real estate group. It owned, primarily, residential apartment buildings in Canada and the United States which were held through various entities and financed by still other members of the FL Group. The financing was done by either equity financing through limited partnerships or by debt financing.

¶ 13 This case concerns only the debt-financed part of the FL Group's business. Such financing was done by fund units (collectively the "Fund Units") issued by one of three funds, First Leaside Properties Fund, First Leaside Fund and the Wimberly Fund (collectively, "WALP Funds"). These Fund Units were issued at $1.00 each and the funds raised were then lent by the funds to other members of the FL Group by means of unsecured notes. The Fund Units paid a handsome distribution to the unit holders with interest rates ranging from 7% to 9% depending on the fund that issued the unit and the date of issuance.

¶ 14 The Fund Units purchased by investors were processed through FLSI and Penson and remained on the records of both. FLSI's and Penson's records of the purchases and sales of Fund Units and month-end holdings were the basis of both regulatory and client reporting. It is the propriety of the $1.00 amount for Fund Units which appeared on the statements of FLSI clients for the time period from their issuance up to November 2011,that creates the single issue in this case.

¶ 15 Units of the First Leaside Fund were issued to investors beginning in or around October 2005. Units of the First Leaside Fund were not issued pursuant to a prospectus or an offering memorandum. Units of the First

Leaside Properties Fund were issued pursuant to a prospectus dated March 19, 2009. Units of the Wimberly Fund were issued pursuant to an offering memorandum dated November 3, 2010.

¶ 16 The primary assets held by both the First Leaside Fund and the Wimberly Fund were unsecured promissory notes issued by FL Master Texas Ltd. ("Master Texas"). The primary assets held by the First Leaside Properties Fund were unsecured promissory notes issued by FL Master Sherman Ltd ("Master Sherman"). Both Master Texas and Master Sherman were subsidiaries of Wimberly Apartments Limited Partnership ("WALP"), another entity within the FL Group.

¶ 17 The interest payments on the unsecured promissory notes issued by Master Texas and Master Sherman to the three WALP Funds equalled the distributions that were payable to unitholders of the WALP Funds.

¶ 18 On December 7, 2012, a judge of the Ontario Superior Court of Justice granted an Order appointing a Receiver over all of the assets, undertakings and remaining property of certain of the FL Group entities (including FLSI).

¶ 19 Mr. Sutton gave evidence at length in his own defence and was extensively cross-examined by Staff. He was entirely forthright in answering all questions put to him and the Hearing Panel was left in no doubt about his credibility and relied on his evidence in reaching our decision

¶ 20 The only other witness, besides Mr. Sutton, called by the defence was Larry Boyce ("Mr. Boyce"). He is a partner with Mr. Sutton in Sutton Boyce Gilkes Regulatory Consulting Group Inc. which provides advice to participants in the Canadian capital markets regarding compliance with all applicable laws and regulations. Mr. Boyce spent his whole career ensuring compliance with financial rules and regulations. He was, until retirement in 2009, Vice President, Business Conduct Compliance of IIROC and occupied a similar position with its predecessor, the Investment Dealers Association.

¶ 21 IIROC called two witnesses, Edward Varela ("Mr. Varela"), Manager of Investigations at IIROC and Robert Low ("Mr. Low"), a business valuator.

¶ 22 Mr. Varela was the manager of the investigation into the conduct of Mr. Sutton, having been assigned to that task in November 2011, following a referral to IIROC Enforcement by the Financial Operational Compliance section of IIROC ("FinOps") which had been responsible for the compliance reviews of FLSI which were conducted annually. Mr. Varela was not involved with FinOps work in relation to FLSI and had no personal knowledge in respect of it or in respect of any of the issues between the parties prior to his appointment.

¶ 23 The FinOps personnel most involved with FLSI were Louis Piergeti ("Mr. Piergeti"), William Dines ("Mr. Dines") and Maureen Jensen ("Ms. Jensen"). Mr. Piergeti was Vice President, Financial and Operational Compliance, Ms. Jensen was Senior Vice President, Surveillance and Compliance, and Mr. Dines was Manager, Financial and Operational Compliance. He was the prime contact with Mr. Sutton although Ms. Jensen and Mr. Piergeti had frequent interaction with FLSI as well. None of them were called to give evidence although the Hearing Panel was told they were available. No explanation for this was given to the Hearing Panel. It is the decision of counsel as to what witnesses to call.

¶ 24 Counsel for Mr. Sutton invited the Hearing Panel to draw an adverse inference from the failure to call the IIROC witnesses, particularly Mr. Dines, who had personal knowledge of, and involvement with, the controversy which led to the charges against Mr. Sutton. The Hearing Panel, for reasons which will be explained in what follows, has declined to do so.

¶ 25 Robert Low was called by IIROC to give expert evidence with respect to the valuation evidence which had been proffered by FLSI in support of the $1 price of the Fund Units. His evidence will be discussed later in these Reasons.

¶ 26 In his closing submission Mr. DelFrate, on behalf of Staff, correctly characterized the issue:

> "…this case is about the Respondent's conduct, what he did, what he didn't do, and what he should have done. And ultimately, you have to determine what he did or didn't do constitutes a

breach of 38.6(c)."

¶ 27 Staff's fundamental submission is that Mr. Sutton failed to "monitor adherence to the Dealer Member's policies and procedures" in respect to the pricing of the unlisted securities in question, being the Fund Units.

III. STANDARD OF PROOF

¶ 28 The Hearing Panel accepts the submission that the standard of proof that Staff's case must meet is the civil standard; proof on a balance of probabilities. The fact, as is the case in this instance, that the allegations and the consequences that flow from a finding that the Respondent breached the IIROC Dealer Member Rules are both serious does not serve to raise the standard of proof above a balance of probabilities. As was stated in *Re Quadrexx Hedge Capital Management Ltd.,* an OSC decision dated February 6, 2017 at paragraph 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.

IV. PRICING

¶ 29 The Fund Units were all issued at the price of $1.00. That is the same price that appeared for each of them on all the monthly and quarterly statements sent to FLSI clients who purchased, sold or held Fund Units during the period covered by the charge, September 2009 to October 2011. In that period FLSI clients received at a minimum quarterly statements, and in many cases monthly statements, and in each case the price of the Fund Units was shown to be $1.00. In fact the price of $1.00 never changed until the last financial report which was issued in November 2011, in which it was shown as "N.A.", i.e. price not available as required by Policy 3.8.3(7).

¶ 30 Policy 3.8.3, Pricing of Other Unlisted Securities, operates in what Mr. Sutton called a "hierarchy". By that he meant that one could determine the appropriate price of a security by various other means when the first choice, the price established by an active market, wasn't available. In short, the hierarchy was as follows and the CFO could rely on any or a combination of the following to price unlisted securities:

- Prices from independent sources showing arm's length bids and offers;
- Information from the issuer's financial statements;
- Third party valuations or appraisals of the assets;
- Current draft financial statements; and
- Internal valuations conducted by the issuer.

¶ 31 In that regard Mr. Sutton gave the following evidence:

1. <u>January 19, 2017: Page 159, Line 9 – Page 160, Line 18</u>

A. …My job – I had two jobs at IIROC. One was to maintain and monitor the risk-adjusted capital of the firm. The second was to be sure the funds were priced properly.

Q. Mm-hmm.

A. And I determined that under the hierarchy based on the active trading market.

MR. DEKKER: I'm going to move on to a different area. It's 3:30. I don't know if it's a good time for the afternoon break.

CHAIR: We can take the break

--- Recess at 3:23 p.m

--- Upon resuming at 3:39 p.m.

BY MR. DEKKER:

Q. Mr. Sutton, before we broke, you – we were talking about the Wimberly Apartments Limited Partnership financial statements for 2007, 2008.

A. Yes, sir.

Q. Do you recall when you received those?

A. I did receive them, but to the best of my recollection, it was subsequent to this file being closed for – First Leaside being shut down or cease trading, so it was subsequent to that.

Q. Did you have a view on whether they were relevant to your job?

A. As I said earlier, in the hierarchy, the first thing for me to determine is whether there is an active trading market, and once I've determined that there is an active trading market with the information provided to me from an independent source, and the active trading market was made up of people who were not ordered or forced to comply, no compulsion, then it stopped there. I have my answer.

2. January 20, 2017: Page 90, Line 25 – Page 91, Line 25

A. …As I explained yesterday, pricing is on a matrix of a hierarchy. And as you went down the hierarchy – and this is how IIROC had it, and the CSA and everybody else – if you couldn't satisfy yourself from the top of the hierarchy, you had to go to the next item. The top of the hiring act – the …

Q. Hierarchy?

A. Hierarchy – sorry – was trading. Was it active? Was it consistent? Was there a track record? And was it obtained from independent sources? If you couldn't satisfy yourself at that point, then you went to the number two item, down to the number three item – I think number three was net asset, which he's referring to here. Then four, I believe, was appraisals, going down to yield.

But, the point being, if you couldn't satisfy yourself at the top of the chain, you had to go to the next item, and the next item, and the next item. So you had seven different ways. If, at the end of the seven different ways, you couldn't value it, you had to say price not available. And under IFRS, you could say zero. But it was a hierarchy, so you had to go down. So they are cherry-picking here. They are simply saying the CFO will do this. Well, they're looking at two of the items to look at.

¶ 32 Mr. Sutton's view was consistent throughout his tenure as CFO of FLSI that there was an active market which produced a price of $1.00 for all three of the Fund Units every month and he therefore didn't have to look to the other alternatives to establish prices. His evidence in that regard was as follows:

3. January 20, 2017: Page 34, Line 2 – Page 37, Line 7

Q. What you've just talked about in terms of what you did every month, did that apply throughout the period at issue from September 2009 through to the end of October 2011?

A. The entire time. The entire time. Never – it applied from the day they became a member.

Q. In addition to the trading, did you have any understanding during this period as to whether people were able to sell the three funds at issue in this action when they wanted to?

A. To the best of my knowledge, every single time a client wished to sell, they were allowed to sell. I said yesterday I never saw anything filed on the ComSet report, but more importantly, as well, I would go to – every month, I would talk to the CCO and say, "Has there been any issues with somebody selling?" But First Leaside, as I said, had – there were many, many millions of dollars, so there was never an issue. But to the best of my knowledge – and there was never a complaint ever filed. No one was kept from selling. And based on my review of the trading blotters, you could see clients selling.

Q. Mr. Low, in his expert report, he refers to your interview evidence, and I don't – I've committed it to memory, but – where you say that David Phillips maintained the market for the three First Leaside funds at issue. What did you mean by that?

A. What I mean by that is – and it really comes back to what the question was you just asked before. If a client wanted to sell and wanted to sell at the stated dollar value, First Leaside always stood behind it. So analogous to a market-maker on the TSE, if a client wanted to sell and there was a market maker in that security and nobody else wanted to be on the buy side, the market maker – and he wasn't a market maker, but he played like one – had to stand behind the trade. So that's –

Q. What does that mean?

A. That's what I meant. When I say "stand behind the trade" – if a client wants to sell, a client gets to sell at that price.

Q. You've talked earlier about cross-trades. What are those?

A. Cross-trade is when an individual client – and this is very common on the street – an individual client sells and the purchaser is not the firm, but the purchaser is another client. And that goes on all the time. As a matter of fact, the efficient – the good firms – and I would argue that the more efficient firms are the big independents – do more of that than the banks do.

Q. How would that work here? How would a cross-trade happen in the three funds?

A. The sales department, as I understood it, maintained a list of clients who wanted to buy. And if there was nothing available in a particular security, a primary, then they had this list. So when a client came in who wanted to sell, they always had a purchaser.

Q. Okay.

A. And if they didn't have a purchaser, it may take a day or two, maybe a week, but they would generally – an affiliated company would buy that position, and they would facilitate the client trade. But across is – to answer your question, client A sells to client B; no involvement of the firm.

¶ 33 Policy 3.8.3(1) permits the following with respect to pricing derived from information from Penson:

3.8.3 Pricing of other unlisted securities

1. The CFO may obtain prices for unlisted securities from traders of Penson only if accompanied by a record showing an independent source for the pricing, such as a bid or offer from an arm's length dealer or institution, subject to the following:

    - The CFO will obtain at least independent pricing as of each month-end for any securities held in inventory; and
    - The CFO will obtain daily prices from an independent source for any securities held in inventory whose value represents in excess of 20% of risk adjusted capital as of the previous month-end.

¶ 34 Mr. Sutton's evidence as to how he applied this requirement is as follows:

Q. Okay. And what do you mean by "going down the list"?

A. Well, as I said, as you look at this, how do you price this? You're going to look at is there a public market? If there's not a public market, okay, you've got to find how you're going to price this. So then you go – and remember, IIROC rule book is written for historical cost financial statements, and historical cost financial statements – sorry, you don't want me to go there?

Q. I want you to talk about this list. I want you to talk about how this list works. I mean, if you – what if you get a price from number 1?

A. Which number 1, sir?

Q. Under 3.8.3, relating to "Pricing of other unlisted securities."

A. Well, then you would say – it says, "The CFO will obtain … independent pricing … [at] each month-end …", if it exists.

Q. Okay.

A. Didn't exist here, right? "… daily prices from an independent source." Well, there wasn't an independent source.

Q. There wasn't.

A. There wasn't. Well, hold it. You get – when you say an independent – you, of course, have the Penson reports that come out.

Q. Okay.

A. That – and the Penson report comes out and says they're worth a dollar, or you trade on – that's from – it's from the trade ticket which feeds the system. So if a trade is done June 29th and June 30th and September or July 1st, that's a holiday if it is, and it's done at a dollar, that's what's going to be, and that comes from Penson. That doesn't come from First Leaside. As I said, it's the trade ticket that gives you your cost of – and it's Penson comes back.

So if he – if First Leaside ever was to sell at 90 cents, and that was the last trade, the Penson system will report it, the value, as 90 cents, whereas – not the value, the price as 90 cents, and that's the same, that's the basis for the entire industry. It's what does it trade at, and that number is provided by Penson.

Q. Okay. And how does that fit into number 1 here, under 3.8.3?

A. It's exactly what it says. Get the prices from traders or Penson, and the source that's coming in is what Penson gives us.

CHAIR: So just to be simple about it, the independent source is the ticket. The independent source –

THE WITNESS: De facto, it's the ticket because it's the ticket that feeds –

CHAIR: I understand that, but it's – the ticket is at the bottom of this, your difference with IIROC.

THE WITNESS: Yes, sir.

CHAIR: Okay. Thank you.

BY MR. DEKKER:

Q. And the independent source for the pricing, what's the independent source for the pricing here?

A. It's coming to me from Penson.

Q. Okay. And what happens if you get a price under number 1? What happens to the other items here?

A. They go away.

Q. And why is that?

A. Well, if they come back and say this is – oh, well, I have to do the other items to make sure that that's reasonable, and the other items, and it's specifically talked about in your, you know, the CFO exam and the CSA pronouncement. They have said it's a dollar. It's a dollar because that's what

the trade ticket, what the transaction was done at, whether it was sold out of primary or whether it's secondary.

They give me that record. Now I'm charged with the responsibility: It that price correct? What do I look at? And so then the hierarchy becomes, and it's in the Parker Simone report which you've already covered, everything going, active trading market, going down the list.

Q. And why is there a hierarchy there? What if you have an active trading market? Do you need –

A. Then it's closed. That's the price.

Q. Okay.

A. It can't be anything else for the simple reason that if someone buys on, using this, Jun 29th and June 30th, and somebody buys on July 2nd, or they sell on July 2nd, doesn't matter if it's a buy or sell, doesn't matter, if the price is a dollar, you could – the system will automatically make it a dollar, but more importantly, when the reports come out on the 3rd or 4th or 5th of the month or whenever they come out, how can you change it?

I mean, the Securities Act says it's sold at a dollar unless I have independent evidence that that price isn't right, and it's price we're talking about, and that independent evidence could be an active trading market. The independent evidence could be the fact that historical cost financial statement have to be – really don't bear any reality in the real estate world. You have to also in – there's a whole host of items. There's the – I know you'll ask me, but there's the variable equity interest. There's the financial statements as produced.

Q. Well –

A. Am I talking too much?

Q. I want to find out, like, where, where did the three First Leaside funds at issue in this proceeding fall within this hierarchy in determining pricing?

A. At the end? When you go down to 5, 6 and – well, not –

Q. What about number 1? Did any of them fall under number 1?

A. No.

Q. No?

A. Well, I'm getting independent pricing and I'm getting that from Penson. So you're right, it falls under that.

¶ 35 While there was no direct evidence in the record before the Hearing Panel of a concern on the part of FinOps about FLSI's pricing of the Fund Units until the latter part of 2010, in an email dated September 17, 2010 from Mr. Dines to his FinOps superiors, there is an indication that FinOps had had concerns earlier. In the email Mr. Dines refers to a study he prepared relating to "First Leaside" which indicates that IIROC must have had doubts about the $1.00 price before September 2010. However that study is not in the record. The email string, in chronological order, is as follows:

From: Bill Dines

Sent: Friday, September 17, 2010 4:20 PM

To: Maureen Jensen; Louis Piergeti; Paul Riccardi

Subject: First Leaside/OSC

I spoke on the telephone with Stephanie Collins of OSC. I believe she is in Enforcement as she has been conducting interviews of Mr. Phillips.

She said the situation stinks and something is wrong. Unfortunately, she is struggling to find an offence perpetrated by Mr. Phillips to take before a hearing.

She is not sure if she would call it a Ponzi scheme as there are some real estate assets. I agreed there were real estate assets (KPMG audited statements) but these assets are dwarfed by liabilities and liabilities are growing as more funds borrowed to cover huge operating losses. She has accepted at face value the Marcus Millchap valuation of the real estate assets and which I discredited in Appendix Q of my paper. Phillips is going to provide her with old valuations (2003 and 2007) performed when mortgages were taken out. She acknowledged that the real estate market in Texas MAY have moved since then. They haven't made a decision as to obtaining their (OSC's) own independent valuation.

I have arranged to meet with her on September 30 to go over my thoughts and calculations set out in appendix Q.

Her take it that the units are a "tax fiddle" and buyers know what they are getting into.

I'd be interested in Jeff Kehoe's take on the situation and whether he could find an offence (assuming enough of new investors paying old investors was given to him).

William R. Dines C. A.

Manager, Financial & Operational Compliance

Investment Industry Regulatory Organization of Canada

121 King St. West, Suite 1600

Toronto, ON M5H 3T9

From: Maureen Jensen

Sent: September 17, 2010 4:22 PM

To: Bill Dines; Louis Piergeti; Paul Riccardi

Subject: RE: First Leaside/OSC

I am glad that you have connected. They need help to know where to look.

Thanks for the diligence Bill.

Maureen

From: Bill Dines

Sent: 9/17/2010 8:51:30 PM

To: Maureen Jensen; Louis Piergeti; Paul Ricardi; Jeffrey Kehoe

Subject: RE: First Leaside/OSC

Attachments: OSC – Norshield.pdf

Please read attached article.

If the OSC is "Struggling to find an offence", they should choose the litigator who was successful before the Norshield hearing panel.

The OSC argued that the defendant did not inform investors about true value of investments. The hearing panel ruled that the defendant's calculations of the value of investments were artificially

inflated and gave a false impression… They found that the defendant was fully aware.

The $1 per unit is clearly inflated and I would love to see how First Leaside could justify $1 across the board to a hearing panel.

Any comments before I show them "where to look"?

Bill

V. THE APPRAISALS

¶ 36 Mr. Sutton's position, which is evident from the evidence which is quoted above at paragraph 33, was that there was an active market for the Fund Units and that the $1.00 amount was the result of the action of that active market. Consequently, he was of the view that he did not have to go any further than the first step in Policy 3.8.3. While he acknowledged that he, in fact, made some efforts to obtain appraisals and audited financial statements which were items that Policy 3.8.3 contemplated might be used in lieu of an active market price if such was not available, he said that he did so simply for confirmation of the $1.00 price. He went on to say that he was under no obligation to have done so, standing by his view that there was an active market and it had established the price and that was all that was required. However, in our view, none of the evidence gathered by Mr. Sutton provided the sought after confirmation.

¶ 37 Staff called Robert B. Low CPA CBV, a highly experienced business valuator whose evidence on valuation matters related to business have been given and accepted by courts and tribunals throughout Canada for more than 30 years. Counsel for Mr. Sutton objected to Mr. Low's evidence on the grounds that somebody with experience in the investment industry and experience as a CFO was needed in order to express an expert opinion about the standard to be expected of a person occupying the CFO role at FLSI.

¶ 38 The Hearing Panel, after due consideration, agreed to hear Mr. Low's evidence and indicated that they would thereafter determine what weight to attach to it. We found Mr. Low's evidence useful in understanding the appraisals and their limitations as well as other opinions of value which he reviewed. However, to the extent he expressed an opinion regarding the adequacy of Mr. Sutton's performance as a CFO, we did not rely upon it. In any event, such evidence was negligible in its extent.

¶ 39 Mr. Low reviewed the reports described below which became available in the period between 2009 and June 2011. It is worth noting that there is no evidence that Mr. Sutton relied on any of these reports in the establishment of the $1.00 fund unit price. Indeed such evidence as there is on the subject is completely to the contrary; as the above quoted evidence shows, he relied on what he regarded as an "active market". Further and in any event, the bulk of the reports and related material were not available until the last few months of 2011 and could not have been relevant for the earlier years.

¶ 40 The reports that Mr. Low reviewed:

1. A 2009 appraisal of the value of the properties owned by Master Sherman and Master Texas which showed that the relevant entities in which the FL funds had invested had assets as much or more than the amounts owing to the three funds;
2. Two independent expert reports on the price of First Leaside fund being the Parker Simone LLP Report dated August 25, 2011 and the review engagement report dated June 11, 2011 prepared by Sloan Partners LLP (the "Sloan Report"); and
3. The 2009 and 2010 audited financial statements for the Property's Fund in which KPMG gave a clean opinion on the First Leaside funds financial statements that valued the assets of the properties fund at their full value and showed unitholder's equity as higher than the $1.00 per unit. These audited financial statements were not available until late 2011.

¶ 41 The 2009 appraisal referred to was in fact simply a Broker Opinion of Value which was obtained from Marcus & Millichap Capital Corporation ("M & M BOV"). This report was four pages in length and did not provide a current value opinion. Instead it purported to opine on prospective values to be achieved upon the

completion of capital improvement rehabilitation programs on the properties. For that and other reasons identified by Mr. Low to the same effect, the M & M BOV Report could not have provided any support for the $1.00 price.

¶ 42 With respect to the Parker Simone Report, the difficulty in employing it in the context of establishing a price for the Fund Units is that it proceeds on the assumption that there was an active market for the units because the buyers and sellers were acting as arms' length and under no compulsion to act. This is an assumption, which was based on information from management, that was not in accordance with the facts, particularly that there were relatively few trades and the trades were all through FLSI or a related company at a fixed price.

¶ 43 According to Mr. Low, an active market is defined for IFRS purposes as a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. That was not the case for the Fund Units purchased and sold through FLSI following initial distribution.

¶ 44 Finally, there was the Sloan Report. It purports to report on the book value of the promissory notes receivable as disclosed in the relevant financial statements as at December 31, 2010 as follows:

> "Based on our review, nothing has come to our attention that causes us to believe that the promissory notes receivable is not, in all material respect, less than the book value disclosed in the audited financial statements."

¶ 45 The report does not provide detail as to what information was supplied, nor what inquiry, analytical procedures and discussions were undertaken by the reviewer. The Hearing Panel agrees with Mr. Low's view that the Sloan Report contributes nothing to the analysis of the value of the promissory notes receivable, much less to the validity of the $1.00 price for the Fund Units.

¶ 46 Grant Thornton Limited ("GTL") was retained by FL Group's solicitors to review, report and make recommendations on the business assets, affairs and operations of the FL Group. GTL produced a report ("the GTL Report") as instructed which was dated August 19, 2011. In it, among other things, GTL described the FLWM reporting system in the following terms:

> **FLWM reporting system**
>
> - We have been advised by Management that once an investor investswith the FL Group they are provided an account number and private access to the FLWM reporting system online. The system tracks each investor's individual investments, including their calculated return, the tax benefits/deductions and monthly distributions they have received.
> - The system also tracks the value of their investment. In assessing the unit value of each LP/Fund, the system uses the most recent transaction for each unit but it is not a perpetual recalculation of the actual unit value.
> - There is a limited secondary market for the LP units and the majority of transactions are between investors looking to sell and FLWM.
> - To date, the transactions are generally smaller in size and FLWM has, in many cases, purchased the units at their original price (typically $1/unit) regardless of where the LP is in its investment cycle.
> - FLWM`s repurchase of units at the original price may be higher than the underlying value of the investment (especially if the property is still within the early stages of its investment cycle). Management explained to us that they perform their own assessment of value in each instance to support the repurchase prices of investments.

¶ 47 It is to be noted that there is no mention of Mr. Sutton in the Report and it would appear that he was not

interviewed by GTL. If he had been, it is doubtful that GTL would have made the errors that appear in the description of the pricing process. Mr. Sutton gave evidence that he was not given a copy of the GTL Report and did not see it until after these proceedings commenced.

¶ 48 In summary, the various reports and financial statements were of marginal relevance, and of no utility to the determination of the central issue, the appropriateness of using $1.00 as the price under Policy 3.8.3. This was so for two reasons. First, most of the information wasn`t timely in the sense that it dealt with past events and prices and some of it either had never been seen by Mr. Sutton or was only available to him long after the events. Second, several of the reports are based on assumptions that are not in accordance with the facts. The best example is the Sloan Report`s reliance on assumed facts which renders it useless.

¶ 49 However, primarily the appraisals and financial statements are irrelevant to the determination of the main issue simply because Mr. Sutton didn`t employ them to set the price in the financial reports sent to investors. Mr. Sutton`s evidence, both in chief and under cross-examination, is clear and consistent and firmly establishes what his methodology for setting prices was.

VI. THE STANDOFF BETWEEN MR. SUTTON AND FINOPS

¶ 50 Were it not for the seriousness of the matter, particularly for the Fund Unit holders, what transpired during 2011 would be slightly farcical. On one hand, Mr. Dines and FinOps knew that the $1.00 price could not be supported as a current market value and knew that Mr. Sutton was highly unlikely to be able to come up with an appraisal that concluded $1.00 was correct, given the state of the real estate market in Texas and elsewhere, and the fact that a number of properties were in the rehabilitation stage of the cycle. That the values of the assets would decline in the rehabilitation phase was an acknowledged fact and was known to all participants, including IIROC.

¶ 51 Grant Thornton described in the GTL Report how the business plan of the FL Group worked as follows:

> **Property Investment Cycle**
>
> - As a result of buying a property (and the fees associated thereto) and going through a rehab program, the assets generally decline in value (lower occupancy) in the first few years and increase in value once the rehab is complete. Therefore, it is often common for the calculated equity value in a property to be less than the total equity raised.
> - The following table uses the Investment Model illustration and calculates the annual equity surplus/deficiency as follows:

In thousands of $	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Property Valuation	$8,500	$9,650	$11,156	$12,134	$12,762
Working Capital	747	256	(27)	(34)	(0)
Mortgage	(7,918)	(7,832)	(7,741)	(7,645)	(7,544)
Calculated Equity value	$1,329	$2,074	$3,388	$4,455	$5,218
Equity Raised	(4,287)	(4,287)	(4,287)	(4,287)	(4,287)
	$(2,959)	$(2,213)	$(899)	$168	$930

> - As shown in this table, in the first few years of the investment cycle, there is negative equity because of the following:
>
> i. The asset is undergoing renovations, therefore a lower operating income which results in a lower valuation; and
>
> ii. They raised surplus equity to cover 5 years of short funded distributions, principal payments and fees.

¶ 52 Discussions and correspondence between Mr. Dines and Mr. Sutton continued over the latter part of 2010 and early 2011 with IIROC pressing for appraisals or other evidence supporting the $1.00 price. FLSI responded by promising various appraisals would be produced. However, as discussed above, such appraisals as were produced were inadequate, incomplete and late. The upshot of these discussions was a meeting at IIROC's office in Toronto at which, in addition to Mr. Dines and Mr. Sutton, Mr. Phillips, Mr. Efraim, Joanna Hampton and Mr. Boyce were in attendance along with counsel.

¶ 53 It is not an exaggeration to say that this was a distinctly troubled meeting. The only direct evidence of what transpired at it was given by Mr. Sutton and Mr. Boyce. It is of little use to describe it in detail save to say that the evidence indicates that Mr. Dines was rude and dismissive of FLSI's attempts to satisfy his demands and in particular of the Sloan Report which was presented by FLSI. The meeting ended in disarray, causing Mr. Boyce to write a few days later to Mr. Piergeti voicing his objection to Mr. Dines' conduct and asking for removal of Mr. Dines from the FLSI file. No response was apparently made to that request, but Mr. Dines' reaction can be discerned in the following email, written to Mr. Piergeti and others following receipt of Mr. Boyce's letter:

> **From:** Bill Dines
>
> **Sent:** 6/29/2011 5:30:48 PM
>
> **To:** Louis Piergeti
>
> **CC:** Ciro Mirabella
>
> **Subject:** RE: Bill Dines and First Leaside
>
> Thank you.
>
> This will add to my list of 2011 achievements.
>
> Bill
>
> ---
>
> **From:** Louis Piergeti
>
> **Sent:** Wednesday, June 29, 2011 12:39 PM
>
> **To:** Bill Dines
>
> **Subject:** FW: Bill Dines and First Leaside
>
> FYI.
>
> Regards,
>
> Louis P. Piergeti, CA
>
> VP, Financial and Operations Compliance
>
> IIROC
>
> T: 416.865.3026
>
> E: lpiergeti@iiroc.ca

¶ 54 Following the premature end of the meeting, Messrs. Dines and Sutton had a lengthy meeting alone, the result of which, according to Mr. Sutton, was Mr. Dines told him that if Penson concurred in accepting the Sloan Report, the file would be closed.

¶ 55 We earlier indicated we would not draw the adverse inference that counsel for Mr. Sutton asked for and would explain why in due course. That explanation is quite simple. It is that we regard it as unnecessary because, even assuming the promise was made as Mr. Sutton asserts it was, it was far beyond Mr. Dines' authority to terminate proceedings, which at that stage involved both IIROC Enforcement and the Ontario

Securities Commission on his own initiative. In that regard, it is worthy of note that there is no written reference in the written record before us of such a promise. If it was made, the promise was unenforceable and Mr. Sutton would have been well aware of that fact.

VII. ANALYSIS AND DISCUSSION

¶ 56 It should be apparent from the foregoing that we are of the view that the subject of alternatives to the active market as a means to establish prices which is contemplated by 3.8.3 is a red herring in this case. No true alternatives in Mr. Sutton's hierarchy were identified during the course of the interactions between IIROC and the FL Group and FLSI. And perhaps more to the point, nothing was forthcoming that purported to validate the $1.00 price other than the explanation offered by Mr. Sutton as to why it was appropriate to use his choice.

¶ 57 While it is not entirely clear on the record, it seems highly likely that the selection of $1.00 was made by Mr. Phillips. By offering the original purchase price to investors who "wished to liquidate" their investments as one witness put it, Mr. Phillips offered them the security of believing they would be able to recover their investment should they choose to do so, but without making any firm or binding promises. It was all verbal and subject to Mr. Phillips' discretion to terminate the program unilaterally.

¶ 58 Mr. Efraim, the COO, when he was examined in the course of the investigation, gave evidence of the precarious nature of the promise and the consequences should the investors sense problems with the FL Group:

> So that they then turn to their clients and say, You know what? We just figured out these properties can't afford your 9 percent interest". And then everyone says, "Give me back my money". And, boom, we would be where we are today. At least we stopped selling it.

¶ 59 The security provided by the implied unwritten promise to repurchase at $1.00, coupled with a multiyear history having done so, provided the much needed security that FL Group needed to bridge the gaps when the net equity in the enterprises which had provided the promissory notes to the WALP Funds was down during the investment cycle. Unfortunately the negative periods were apparently much longer and deeper than had been envisaged, due primarily to then existing global and domestic financial issues.

¶ 60 In 2010 and perhaps earlier, it was apparent that the FL Group faced financial difficulties which would become overwhelming if it couldn't maintain the confidence of its investors. Mr. Sutton must have known that was the case, just as Mr. Dines knew that the $1.00 was not a true indicator and that anybody who relied on it was being misled. The question was who was going to act first. Clearly Mr. Dines wanted FLSI to go first and abandon the $1.00 price. Mr. Sutton stuck bravely, if somewhat irrationally, to the idea that $1.00 was a market derived price. He did this despite knowing that it was a weak proxy and originated from Mr. Phillips and not from any market activity whatsoever.

¶ 61 The Hearing Panel is entirely unpersuaded that there was an active secondary market for the Fund Units. The evidence demonstrated that there were not sufficient regular sales to constitute a market, much less an active market. Infrequent transactions at a fixed price, offered by the issuer of the Fund Units, for the ultimate purpose of maintaining the price and utilizing funds which were obtained from other investors for such purchases has none of the hallmarks of an active market. The fixed price was establishing not by the intrinsic value of the security or by the operations of buyers and sellers at arms-length but by Mr. Phillip's desire to preserve the FL Group[2].

¶ 62 Most importantly, the position Mr. Sutton espoused that it was an active market undercuts the very purpose underlying the regulatory objective of making sure that the investors had the information necessary to make informed investment decisions. Not only did they not have true information as to the current value of their

[2] Further, even if there were an active market, IC Policy 7 makes it clear that it is inappropriate to rely on security price information supplied by FLSI itself due to its market share or trading as a market maker in a specific security. This concept is acknowledged in Policy 3.8.3 paragraph 1 which requires "an independent source for pricing". Penson's pricing of units was simply mirroring what FLSI said, and therefore cannot be seen as independent.

investment, including that such information wasn't available, they actually had information that was intended to mislead them into believing that their investment was worth more than it actually was.

¶ 63 Thus, the decision we have reached is both obvious and difficult. Mr. Sutton made an aggressive, but we think honourable, attempt to persuade the regulator and ultimately this Hearing Panel that his interpretation of an active market was sufficiently arguable that it did not constitute a breach of IIROC Dealer Member Rule 38.6(c) as alleged. In that we have concluded he failed and a finding that Mr. Sutton breached Dealer Member Rule 38.6(c) must be registered.

¶ 64 We feel obliged to address a point made in Mr. Dekker's final argument, which was that individuals with regulatory functions in the securities industry should enjoy a certain degree of immunity for errors where they acted in good faith and with reasonable diligence. The submission was as follows:

> 196. Especially on the issue of pricing of securities – an area in which during the relevant period IIROC and the CSA expressly recognised the need to exercise judgment based upon reasonable belief – it must be the case that the regulatory standard is reasonableness and whether that judgment was exercised in good faith and with reasonable diligence.
>
> ***Carbonelli (Re),* 2012 IIROC 56 at paras. 115 – 121 – Respondent's Book of Authorities, TAB 2**
>
> ***YBM Magnex International Inc. (Re),* 2003, 26 OSCB 5285 at paras. 164 – 186 – Respondent's Book of Authorities, TAB 19**

¶ 65 The issue in this case, as has been stated many times, is simply whether Mr. Sutton failed in his duty as CFO by failing to ensure that the Fund Units were properly priced between September 2009 and October 2011. The determination of that issue requires consideration of whether the Respondent followed the financial rules of IIROC applicable to the pricing of securities. In turn, the Hearing Panel was required to hear from Mr. Sutton what he did in that regard. We accept Mr. Sutton's evidence and, based on that evidence, we have concluded that he did not follow the applicable financial rules.

¶ 66 Counsel for Mr. Sutton decries the fact that no expert evidence was called with respect to the pricing by CFOs of securities. We don't agree. We had no trouble understanding Mr. Sutton's evidence and his description of what he did.

¶ 67 Mr. Dekker relies on the *Carbonelli* case for the submission that expert evidence should have been called in this case. However, that case is the reverse of the present case as it was the Carbonelli panel who excused the Respondent because, in part, it hadn't been given any expert evidence as to what alternate steps the Respondent should have taken. Here it is Mr. Sutton who is asserting the course he followed was acceptable. However, he called no expert evidence to support his position. It was his burden to do so. The *Carbonelli* case is of no assistance to the Respondent.

¶ 68 Mr. Dekker also relies on experience in the United States, particularly in Securities and Exchange Commission ("SEC") proceedings, in support of his submission that compliance personnel, which he submits includes CFOs under the IIROC regulatory regime, "should not have to fear enforcement proceedings if they perform their responsibilities diligently, in good faith and in compliance with the law".

¶ 69 In support of that submission, the Respondent relies on the following 2015 public statement by the SEC Director of Enforcement, Andrew Ceresny:

> She said that compliance officers should not fear enforcement action if they perform their responsibilities diligently, in good faith, and in compliance with the law. That is still true today. You should know that both we in Enforcement and the Commission take the question of whether to charge a CCO very seriously and consider it carefully. We think very hard about when to bring these cases. When we do, it is because the facts demonstrate the CCO's conduct crossed a clear line. As I have said before, when we do bring actions against CCOs, they generally fall into three categories.

> In the first category are cases against CCOs who are affirmatively involved in misconduct that is unrelated to their compliance function….
>
> We also charge CCOs who engage in efforts to obstruct or mislead the Commission staff….
>
> The third category of cases where we have charged CCOs are where the CCO has exhibited a wholesale failure to carry out his or her responsibilities…."
>
> **2015 National Society of Compliance Professionals, National Conference: Keynote Address by Andrew Ceresny, Director, Division of Enforcement, dated November 4, 2015 – Respondent's Book of Authorities, TAB 20**

¶ 70 The Hearing Panel agrees in principle with the SEC statement and the sentiments that underlie it. However, it is not apposite to the case before us. The process that Mr. Sutton was directed to follow is clearly set out in Dealer Member Rule 38.6(c) and Policy 3.8.3. He did not do so and failed to price the securities as "price not available", thereby depriving the investors of information they were entitled to and any protection such information would have given them. In such circumstances, it would be contrary to the purpose of having a CFO supervise pricing of securities to afford him immunity.

VIII. DECISION

¶ 71 The Hearing Panel has concluded that Mr. Sutton failed to ensure that the prices of the Fund Units were properly priced, and consequently the contravention alleged by Staff, that:

> Between September 2009 and October 2011, the Respondent, as Chief Financial Officer ("CFO") of First Leaside Securities Inc. ("FLSI"), failed to ensure that proprietary fund products recommended and sold by FLSI were properly priced, contrary to IIROC Dealer member Rule 38.6(c)

has been established. There will therefore be a finding that Mr. Sutton breached IIROC Dealer Member Rule 38.6(c).

¶ 72 If required, a Sanction Hearing will take place at a date and place to be determined.

¶ 73 The members of the Hearing Panel wish to thank all counsel for their efforts in this matter. The work product and oral submissions were of great assistance.

DATED this 5th day of July, 2017.

John Lorn McDougall

Chair

Richard E. Austin

Panel Member

Peter Gribbin

Panel Member

APPENDIX A

PROCESS, CONSIDERATIONS AND METHODOLOGIES EMPLOYED TO SUPPORT POLICY 3.8.3 PRICING OF OTHER UNLISTED SECURITIES FOR FIRST LEASIDE SECURITIES INC.

The purpose of this document is to describe the processes, considerations and methodologies employed by First Leaside Securities Inc. **("FLSI")** to price the trust units (the **"Trust Units"**) of First Leaside Properties Inc. **("Properties Fund").**

BACKGROUND ON PROPERTIES FUND'S ACQUISITION OF MASTER SHERMAN NOTES

Properties Fund completed its initial public offering in 2009 and with the net proceeds acquired various classes and series of promissory notes (collectively, the **"Notes")** issued by FL Master Sherman, Ltd. (the **"Master Sherman"),** another reporting issuer. The classes and series of Trust Units issued by Properties Fund correspond to the class and series of Notes issued by Master Sherman effective as of the same date the applicable Trust Units were issued. Master Sherman used the funds it received from Properties Fund in exchange for issuing the Notes to acquire various income producing real estate properties in Texas. It is the income from these real estate properties which allows Master Sherman to make the requisite payments under the Notes to Properties Fund which in turn distributes the proceeds to holders of its Trust Units.

PRICING METHODOLOGY

The Chief Financial Officer of FLSI (the **"CFO"),** in consultation with senior management of FLSI ("Senior Management"), shall initially determine the price of a Trust Unit based on the trading price of the Trust Units in an active market. If such a determination is not possible, the CFO, in consultation with Senior Management, shall determine whether the fair value of the assets of Master Sherman are sufficient to support the principal amount of the Notes, and, based on such determination, ascribe a price per Trust Unit based on the considerations and manner set forth herein.

UNLISTED SECURITIES

Since the Trust Units are not listed on any stock exchange or quoted on any quotation system, FLSI has determined that the Trust Units are subject to Policy 3.8.3 of FLSI's Policies and Procedures Manual (the **"PPM").**

REVIEW PERIOD

In accordance with paragraph 3 of Policy 3.8.3 of the PPM, the CFO, in consultation with Senior Management, has determined that the appropriate review period for the Trust Units is quarterly, unless circumstances require a shorter period.

RELIANCE ON FINANCIAL STATEMENTS

In accordance with paragraph 4 of Policy 3.8.3 of the PPM, the CFO, in consultation with Senior Management, has determined that it is inappropriate to solely establish a price for a Trust Unit based on the net asset value of Properties Fund in its most recently audited financial statements. The CFO, in consultation with Senior Management, has determined that: (a) the assets of Properties Fund are not of a nature that the financial statements alone will provide an accurate reflection of value; and (b) the financial statement of Properties Fund (whether audited or unaudited), should be a consideration, but not the sole consideration, in establishing a price for the Trust Units.

RELIANCE AND NEED FOR VALUATION AND/OR APPRAISALS

As part of the process and methodology involved in establishing the price of a Trust Unit, the CFO, in consultation with Senior Management, may also consider valuations and/or appraisals of the property investments made by Master Sherman in the manner set forth in paragraph 5 of Policy 3.8.3 of the PPM.

The independent valuators are experienced and nationally recognized and qualified in the professional valuation of multi-family residential real estate in the geographic areas of the properties owned by Master Sherman. As required by IFRS, judgment is applied in determining the extent and frequency of independent appraisals.

PRICING FACTORS TO BE CONSIDERED BY THE CFO

Paragraph 6 of Section 3.8.3 of the PPM states the following: *"The CFO will obtain sufficient records from his or her enquiries to ensure that values given are reasonable and retain such records in support of the value given."*

The CFO, in consultation with Senior Management, has determined that paragraph 6 of Section 3.8.3 of the **PPM,** provides the CFO with the requisite authority to obtain and consider such other documents, records and information as, in the opinion of the CFO, acting reasonably, may be necessary to establish a price per Trust Unit. The CFO, in consultation with Senior Management, shall be responsible for ascribing the relative weight to be given to each of the considerations below, acting reasonably.

(a) Secondary Market Trades

Initially, the CFO, in consultation with Senior Management, will review the volume and price of secondary market trades of Trust Units made between arm's length third parties and those Trust Units acquired by a member of the First Leaside Group in order to determine if an active market exists for the Trust Units. Such a determination shall be made by the CFO, in consultation with Senior Management, acting reasonably. If a determination is made that an active market exists for the trading of the Trust Units, the CFO, in consultation with Senior Management, shall ascribe a price per Trust Unit accordingly.

(b) Subsequent Pricing Considerations

If the CFO, in consultation with Senior Management, is not able to determine that an active market exists for the trading of the Trust Units, then the CFO, in consultation with Senior Management, may, acting reasonably, consider, among other things, the following documents, records and information in order to determine the price per Trust Unit:

(i) Cash Flow Analysis

The CFO, in consultation with Senior Management, may also consider the cash flow analysis approach in determining the price per Trust Unit. In such circumstances, the Master Sherman assets should be measured at fair value, determined based on available market evidence, at the review date. The fair value of each Master Sherman property is based upon, among other things, rental income from current leases and assumptions about rental income from future leases reflecting market conditions at the review date, less future estimated cash outflows in respect of such properties. To determine fair value, the CFO, in consultation with Senior Management, obtains information as to whether the CFO can use current prices in an active market for similar property in the same location and condition, and subject to similar leases and other contracts.

Such information is obtained through documents, records and information including, but not limited to, those relating to: (a) ongoing discussions with Leaders Property Management Services, Inc. **("Leaders"),** the property management firm engaged by Master Sherman in connection with its investment properties, about the daily management and operations of the properties; (b) the cash receipts and disbursements for all properties; (c) the cash flows for each property (excess or disbursements as needed); (d) the forecasted and planned capital expenditure requirements for the properties (and funds required if any); (e) the revenues and occupancy rates of the properties; (f) the leasing activity reports prepared by Leaders.

Such reports may include the number of new leases in a week, move out notices received and effective occupancy and leasing percentages; (g) the printed materials regarding rental rates and the economic circumstances in the Sherman and Dallas areas of Texas; and (h) the forecasts prepared by management involving the operations of the Master Sherman properties, and information regarding the status of the various capital projects of Master Sherman. Such considerations may include any updates on unit rehabilitations involving the Master Sherman real estate properties including the number of units in progress, expected date of completion, the leasing status of the rehabilitated units including the amount of gross rent, lease differential (if any), and any concessions such as move-in specials (if applicable).

(ii) The Income Approach

The CFO, in consultation with Senior Management, may also consider the income approach in determining the price per Trust Unit.

The income approach is one in which the fair value is estimated by capitalizing the net rental income that the property can reasonably be expected to produce over its remaining economic life. The income approach is based on the overall capitalization rate method whereby the net operating income is capitalized at the requisite overall capitalization rate.

Such information is obtained through documents, records and information including, but not limited to, those relating to: (a) prevailing capitalization rates for equivalent properties in the Sherman, Texas region; and (b) net rental income of the Master Sherman properties.

(iii) Market Analysis Reports

In determining the price of a Trust Unit, the CFO may consider any updates provided by Senior Management regarding its ongoing analysis of the Texas real estate markets. Such analysis includes offers and sales of comparable properties as an indicator of the strengths/weaknesses of the Texas real estate market relative to the value of Master Sherman's real estate properties and comparisons and trends as to economic circumstances that might impact Master Sherman's real estate assets in the near and long term.

(iv) General Market Conditions and Yields of Comparable Securities

The CFO, in consultation with Senior Management, may also consider general market conditions and the yields of comparable securities in determining whether a premium or discount should be attributed to the price of a Trust Unit.

CRITICAL ASSUMPTIONS RELATING TO PRICING OF THE TRUST UNITS

The CFO and Senior Management's critical assumptions relating to the estimates of fair values of investment properties include the dollar volume and number of secondary market trades to assess whether an active market exists for the Trust Units, the counterparties to the trades, the settlement of the secondary market trades for cash, the receipt of contractual rents, expected future market rents, renewal rates, maintenance requirements, capital expenditure requirements, interest rates, capitalization rates and current and recent property investment prices. If there are significant changes in these assumptions or regional, national or international economic conditions, the fair value of property investments may change materially. These assumptions may also be considered by the CFO, in consultation with Senior Management, in its pricing methodology involving the Trust Units.

PRICING DETERMINATION

Based on the foregoing considerations, if the CFO, in consultation with Senior Management, is able to determine that at an active market exists for the trading of Trust Units, then the Trust Units shall be priced accordingly. If not, the CFO, in consultation with Senior Management, shall determine whether the fair value of the assets of Master Sherman are sufficient to support the principal amount of the Notes, and if so, the CFO shall ascribe a price per Trust Unit of not less than the book value of the Notes as shown on the most current unaudited interim financial statements and audited annual financial statements of Properties Fund. If the CFO is not able to determine that the fair value of the assets of Master Sherman is sufficient to support the principal amount of the Notes, then the CFO shall adjust the value of a Trust Unit accordingly.

VALUATION COMMITTEE

In the future, and consistent with best practices, FLSI may establish a valuation committee to review the price of a Trust Unit set each quarter or for such other period as may be advisable in the circumstances.