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Commission des valeurs mobilières de l'Ontario
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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

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

Hearing:	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		
Panel:	Christopher Portner	-	Commissioner
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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REASONS AND DECISION

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**").[1] 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:

(a) 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

1 As used in these Reasons, the term "Respondents" means, as the context requires (i) Nagy and Sanfelice; (ii) Nagy, Sanfelice and QHCM; (iii) Nagy, Sanfelice and QSA; or (iv) all of the Respondents.

during the Material Time and was also registered as the ultimate designated person ("**UDP**") of Quadrexx from December 18, 2009 to May 15, 2013.

(b) 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.

(c) 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[2] 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.

2 The term "QAM II Shares" is defined in paragraph [165] below.

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:[3]

> . . . 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."[4] 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."[5] The courts have included within the meaning of "other fraudulent means" the use of investors' funds in an unauthorized manner,[6] 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.[7]

[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.[8] 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.[9]

[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

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3 *Théroux* at para 24.
4 *Théroux* at para 24.
5 *Théroux* at para 17.
6 *R v Currie*, [1984] OJ No 147 (CA) pp 3-4.
7 *Théroux* at para 15; *R v Zlatic* (1993), 100 DLR (4th) 642 (SCC) at paras 18-22.
8 *Théroux* at paras 16-17; *R v Olan*, [1978] 2 SCR 1175 at p 6.
9 *Re Maple Leaf Investment Fund Corp.* (2011), 34 OSCB 11551 at para 315.

deprivation to another.[10] 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.[11] 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.[12] 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.[13]

[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.[14] 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.[15]

[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.[16]

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.[17]

[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.[18] 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

10 *Théroux* at para 24; *R v Zlatic* (1993), 100 DLR (4th) (SCC) at para 26.
11 *Théroux* at para 18.
12 *Théroux* at paras 23 and 25.
13 *Théroux* at paras 21 and 33; *Re Phillips* (2015), 38 OSCB 617 at para 187.
14 *Théroux* at para 20.
15 *Théroux* at para 26.
16 *Re Al-tar Energy Corp* (2010), 33 OSCB 5535 at para 221.
17 *Re ATI Technologies* (2005), 28 OSCB 8558 at paras 13-14; *Re Sunwide Finance Inc.* (2009), 32 OSCB 4671 at para 28; *Re Al-Tar Energy Corp*. (2010), 33 OSCB 5535 at paras 32-34.
18 *McDougall* at paras 26-39.

requirement for clear, convincing and cogent evidence does not elevate the civil standard of proof above a balance of probabilities.[19]

[29] The balance of probabilities standard requires the trier of fact to decide "whether it is more likely than not that the event occurred".[20]

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.[21]

[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)

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19 *McDougall* at para 46.
20 *McDougall* at para 44.
21 *Re Sunwide Finance Inc.* (2009), 32 OSCB 4671 at para 22, citing *Starson v Swayze*, [2003] 1 SCR 722 at para 115.

[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.[22]

[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.[23]

[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.

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22 *McDougall* at para 86.
23 *McDougall* at para 95.

[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**").[24] 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)

24 Exhibit 251 at p 12.

[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. <u>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</u>. 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.[25]
>
> (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;

(a) 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;

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

(c) 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

25 See also paragraph [74] above.

(d) 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.[26] 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.[27] 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

26 Exhibit 694.
27 Exhibit 695.

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, <u>but I know that was the end of the engagement</u>. [Emphasis added.]
>
> (Hearing Transcript, May 13, 2015 at p 59)

[142] In the second exchange,[28] 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:

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28 This exchange is already described in paragraph [107] above and is included again for convenience of reference.

> 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 <u>were in effect or being negotiated</u>, 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."[29]

[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."[30] 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

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29 The definition of fair market value employed in the Deloitte engagement letter dated December 11, 2008 (Exhibit 75).

30 *Théroux* at para 36.

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 QAM[31] 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 31 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.

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31 QAM is the acronym for Quadrexx Asset Management Inc. which is referred to in these Reasons as Quadrexx.

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.[32]

[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**

32 Although not identified by name, the principals were Nagy and Sanfelice.

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.[33] (Hearing Transcript, December 16, 2015 at pp 102-104)

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33 The Hearing Transcript mistakenly identifies the date as December 30th, 2012. The date should have been recorded as 2011.

[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.[34] 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

34 A footnote to Item 1.2 of the First QAM II OM indicated that certain of the holders of the Class "I" preference shares purchased by Quadrexx would be held by the principals of Quadrexx.

between $40.0 million and $100.0 million.[35] 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.[36]

[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"[37] 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

35 Item 2.5 of the First QAM II OM.
36 Item 2.6 of the First QAM II OM.
37 Exhibit 127.

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.[38] 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%[39] 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.

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38 The complete description in the First QSA OM was "Offering costs (e.g. legal, accounting, audit, printing, some Directors' compensation)".

39 The 4% amount is sometimes referred to in these Reasons at the "4% charge", "4% of the issue price of the Units" and the "4% fee".

[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] In 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*.[40] 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[41] 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

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40 RSC, 1985, c 1.

41 This amount is also referred to in testimony or in Staff's Written Submissions as $218,348 or $218,893. As the differences do not affect my analysis or findings, I have used the amounts disclosed in the hearing transcript or in Staff's Written Submissions, as the case may be. The same applies to the amount raised which is shown as $321,000 or $327,534.

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.[42] 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.

42 The undertaking was to cease trading Quadrexx securities. See paragraph [215] above.

> 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	$254,964
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	$185,397

[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:[43]

> [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

43 The text of the OM Footnote is set out in paragraph [271] above and is repeated here for convenience of reference.

> [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.

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44 The three QSA investor witnesses invested on the basis that they were eligible investors.

[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.[45] 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

45 *Re Sterling Grace & Co.*, 37 OSCB 8298 at para 203; *Re Takota Asset Management, Inc.* (2013), 36 OSCB 7808 at para 6.

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[46], 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)

46 Form 31-103F1 – *Calculation of Excess Working Capital.*

[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*[47] and the definition of "good faith" found in *Black's Law Dictionary*.[48]

> **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;

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47 *Webster's Encyclopaedic Dictionary,* Canadian ed. (New York, NY: Lexicon Publications Inc., 1988) at pp 338 and 465.

48 *Black's Law Dictionary*, 9th ed. (St. Paul, MN: West Publishing Co., 2009) at p 762.

(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.[49] 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.

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49 *Re Sextant Capital Management Inc.* (2011), 34 OSCB 5829 at paras 248-250.

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*"

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Christopher Portner