Ontario Securities Commission | Commission des valeurs mobilières de l'Ontario | 22nd Floor 20 Queen Street West Toronto ON M5H 3S8 | 22e étage 20, rue queen ouest Toronto ON M5H 3S8

IN THE MATTER OF THE SECURITIES ACT
R.S.O. 1990, c. S.5, AS AMENDED

- and -

IN THE MATTER OF
HOME CAPITAL GROUP INC., GERALD SOLOWAY,
ROBERT MORTON and MARTIN REID

STATEMENT OF ALLEGATIONS OF STAFF OF THE ONTARIO SECURITIES COMMISSION

Staff of the Ontario Securities Commission ("Staff") make the following allegations:

I. Overview

1. Home Capital Group Inc. ("HCG") is in the business of offering residential and commercial lending to clients who do not meet the criteria of a bank or larger financial institution. HCG's residential mortgage portfolio constitutes approximately 90% of HCG's business. As a lending business whose primary product is residential mortgages, HCG's growth and performance are measured in part by the number of new mortgages originated ("Originations") in any given quarter.

2. On July 10, 2015, HCG announced that an ongoing review of its business partners had led it to terminate certain brokers, causing an immediate drop in Originations. The next trading day, HCG's stock price fell 18.9%, resulting in an approximate $600 million loss in market capitalization and significant investor harm.

3. Prior to this announcement, from February 2015 until July 2015, HCG misled its shareholders as to the immediate and on-going causes of the decline in Originations. Internally, HCG knew it had terminated certain brokers because it had discovered fraud in HCG's broker channels. In fact, in February 2015, HCG was completing a six-month investigation into fraudulent employment income documentation ("Project Trillium") which was overseen by a

special committee of the Board of Directors ("the Board"). Project Trillium confirmed that HCG was receiving fraudulent employment income documentation through its broker channels which had not been detected by HCG's underwriting controls. In particular, the findings of Project Trillium highlighted the scale of the fraudulent documentation flowing through HCG, and the serious systemic underwriting control deficiencies within HCG. Given the findings of Project Trillium, HCG implemented two significant changes: (1) termination of certain broker relationships; and (2) specific remediation of its underwriting processes and controls.

4. The changes implemented by HCG had a significant detrimental effect on Originations. First, the termination of brokers, which occurred mainly from November 2014 through the beginning of January 2015, caused an immediate drop in Originations because those specific brokers had historically referred significant volumes of business to HCG. Second, HCG's changes to its underwriting processes and controls also negatively impacted Originations as they caused HCG's processing time for mortgage applications to increase significantly, resulting in brokers sending applications to other lenders. Finally, as a result of the planned remediation of controls across all lines of the residential mortgage lending business, HCG itself planned a scale-back of business growth.

5. By February 10, 2015, the following principal investigative findings, remediation planning and action from Project Trillium were known by HCG:

- The insured ("Accelerator") mortgage business was down by 32.5% compared to Q3 2014;
- Effective January 15, 2015, Accelerator volume targets were being reduced by 50% to $100 million per month;
- HCG had terminated 4 underwriters, 2 brokerages and 30 brokers. There were a number of other brokers on management's watch list;
- The terminated brokers had a cumulative total of $881.4 million in Originations in 2014, representing approximately 10% of HCG's total 2014 Originations;
- Significant changes to the internal control structure were required to increase the accountability of the front line of the business, including separating sales from underwriting and implementing an employment income verification team;
- While testing was complete on the Accelerator side of the business, there was a concern that if brokers had supplied fraudulent employment and income documentation on the insured side of the business, they might be doing the same thing for uninsured ("Classic") mortgages. Work continued on the exposure assessment related to the Classic mortgage portfolio. The Corporate Compliance group was re-verifying employment and income information with employers for a sample of mortgages to salaried borrowers;

- Brokers were moving their business to other lenders because of increased processing times at HCG; and
- Executive compensation was deferred in conjunction with Project Trillium findings, including the compensation of Gerald Soloway ("Soloway"), Chief Executive Officer ("CEO") and Martin Reid ("Reid"), President.

6. HCG filed its 2014 annual financial statements and Management Discussion & Analysis (“MD&A”) (collectively the "2014 Annual Filing") on February 11, 2015 and its Q1 2015 interim MD&A ("Q1 2015 Interim Filing") on May 6, 2015. In its 2014 Annual Filing and Q1 2015 Interim Filing, HCG made materially misleading statements, blaming the decline in Originations on external vagaries such as macroeconomics, seasonality and competitive markets. Within HCG, it was known that the decline could not be attributed solely to the external factors HCG outlined in its public disclosures. Accordingly, each of the 2014 Annual Filing and Q1 2015 Interim Filing were made in breach of subsection 122(1)(b) of the *Securities Act,* R.S.O. 1990, c.S.5, as amended (the “Act”).

7. Further, statements made on HCG’s May 7, 2015 earnings call breached subsection 126.2 (1) of the Act because they were materially misleading concerning the causes of the drop in Originations.

8. Subsequent to HCG having failed to comply with its continuous disclosure obligations, in June 2015, the Chair of the Audit Committee of the Board ("Audit Committee") received a Whistleblower memorandum from a Vice President at HCG dated June 1, 2015 entitled, "*Failure to Comply with Timely and Continuous Disclosure Obligations and Related Concerns – Fraudulent Mortgages*". The Whistleblower's memorandum was submitted under the Whistleblower Policy and the Code of Conduct & Ethics Policy of HCG.

9. Finally, on July 10, 2015, for the first time, HCG began to tell its shareholders the reasons for the drop in Originations, by way of the news release issued on July 10, 2015 (the "July 10th NR") and material change report filed on July 17, 2015 ("the July 17th MCR"). Notably, the facts disclosed in the July 10th NR were known to HCG by February 10, 2015. HCG was also aware that significant changes to the internal control structure would be required by February 10, 2015. All of the foregoing constituted a material change in the business and operations of HCG. Accordingly, HCG was required to issue a new release and material change report within 10 days of the material change, in compliance with section 75(1) and (2) of the Act. This did not occur. In addition, the disclosure made in the July 10th NR and July 17th MCR was

not sufficient to enable a reader to appreciate the significance and impact of the material change and therefore did not comply with Form 51-102F3- *Material Change Report* ("51-102F3") of National Instrument 51-102 - *Continuous Disclosure Obligations* ("NI 51-102").

II. The Respondents

10. HCG is a reporting issuer in the province of Ontario, as well as all of the other provinces in Canada. Its registered and principal office is located in Toronto, Ontario. The common shares of HCG are listed on the Toronto Stock Exchange. HCG is a holding company whose principal business is conducted through its wholly owned subsidiary, Home Trust Company (the “Trust”), a federally regulated financial institution.

11. Soloway was the CEO and a director of HCG, Robert Morton ("Morton") was HCG’s Chief Financial Officer ("CFO"), and Reid its President during the period of the alleged non-compliance by HCG with Ontario securities law.

III. Background Information

A. The Importance of Originations to the Business of HCG

12. HCG’s residential mortgage business consists predominantly of two portfolios: (1) the Accelerator mortgages, which are mostly insured by Canada Mortgage and Housing Corporation; and (2) the Classic mortgages, which are not insured.

13. HCG had traditionally positioned itself as a growth company and continued to do so through 2014 and into 2015. Analysts and investors consider the number of Originations to be a material metric of HCG's continued growth. HCG itself normally reported on Originations each quarter. In HCG's 2014 Annual Report, Originations are specifically highlighted under the heading "Growing Our Core Business", and again under "Building Our Asset Base" where HCG states:

> Over the course of 2014, we renewed focus on Accelerator, our insured residential mortgage product. As a result of our efforts, originations for this component of our portfolio increased by 76.4% in 2014. This business segment continues to be one of our key offerings and helps to fulfill our mandate to offer a full line of products that meets the needs of borrowers and brokers.

14. Analysts consistently asked questions about Originations and HCG’s disclosure regarding Originations on earnings calls.

15. HCG distributes its lending products through its broker channels. Accordingly, HCG's relationships with brokers are integral to Originations and to HCG's business.

B. Project Trillium and HCG's Internal Understanding of the Findings

16. In June 2014, HCG became aware of irregularities associated with Accelerator applications handled by one or more of its underwriters. As a result, in August 2014, HCG launched an investigation known as Project Trillium to determine the scope, extent and cause of the problem. HCG discovered that its Accelerator underwriting team, including one of its highest volume underwriters, was falsely documenting that they had completed income verification steps when they had not actually done so ("Phantom Ticking") for a large proportion of mortgages underwritten, and further that employment/income information used to support the mortgage applications had been falsified.

17. Project Trillium revealed that HCG's internal lines of defence had failed and its underwriting department was processing fraudulent documentation undetected. It further revealed that HCG's underwriting policy was being circumvented because the practice of Phantom Ticking was a "learned" or systemic practice within the Accelerator underwriting group.

18. As a result of the findings of Project Trillium, HCG began terminating underwriters who were implicated in the conduct described above. By mid-November 2014, HCG had terminated three underwriters and another underwriter resigned based solely on the findings of Project Trillium.

19. HCG also terminated brokers and brokerages, which occurred mainly from November 2014 through January 2015. By February 10, 2015, HCG had terminated brokers and brokerages that had generated a cumulative total of $881.4 million in Originations in 2014, representing approximately 10% of HCG's total 2014 Originations. As ultimately noted by HCG in its July 10th NR and July 17th MCR, these terminations had an immediate negative impact on Originations.

20. Remediation of controls also had a predictable negative effect on Originations and HCG itself planned a scale-back of business to allow for implementation of remedial changes. In January 2015 management reported to the Board that, effective January 1, 2015, insured Originations would undergo a reduction in volume targets of $100 million per month during the

period of remediation of control groups and lines of defence (a 50% reduction of original targets). Further, in a presentation by Reid entitled *Project Trillium: Management Remediation Planning*, management of HCG confirmed its understanding of the way ahead by writing, "slower business growth over the next quarter will give us the opportunity to develop and implement fundamental strategic changes to the business."

IV. Particulars of HCG's Public Disclosure

A. Misleading Disclosures Made in February 2015

21. Following HCG's broker terminations and the planned remediation, HCG's public disclosure, made pursuant to the requirements of the Act and as required under NI 51-102, was materially misleading.

(i) 2014 Annual Filing

22. HCG filed its 2014 Annual Filing on February 11, 2015. The 2014 Annual Filing did not disclose the broker terminations, the significant remediation or the effect of these changes on Originations. These material facts, individually or collectively, would have been considered important by a reasonable investor in making a decision to buy, sell or hold HCG's securities.

23. Instead, the 2014 Annual Filing stated that the decline in Accelerator Originations reflected both seasonal factors and the very competitive market for prime insured mortgages. These statements were, in a material respect and at the time and in light of the circumstances under which the statements were made, misleading or untrue or did not state a fact required to be stated or that was necessary to make the statement not misleading, contrary to subsection 122(1)(b) of the Act and the requirements of NI 51-102.

24. Despite all that was known to HCG by the time of this filing, HCG added only the following three sentences to the Operational Risk section of its MD&A concerning the emergence of various types of fraud:

> In addition to cyber-crime, the Company is continuously exposed to other various types of fraud stemming from the nature of the Company's business. For example, the Company must often rely on information provided by customers and other third parties in its decisions to enter into transactions such as extending credit. The recent increasing pace of advancement in available technology has increased the sophistication and complexity of potential fraud crimes to which the Company is exposed.

25. Further, in an email dated February 9, 2015, two days before filing the 2014 Annual Filing, the CFO Morton stated that the additional disclosure related to Project Trillium was "…buried pretty deep within existing wording on cyber risk. I would be impressed if someone even asked about it."

26. Soloway and Morton certified the 2014 Annual Filing (including the Annual Information Form) as CEO and CFO, respectively. The 2014 Annual Filing did not set out the material facts known to HCG, Soloway and Morton at the time. Soloway and Morton failed to comply with subsection 122(1)(b) of the Act and National Instrument 52-109 – *Certification of Disclosure in Issuers' Annual and Interim Filings* ("NI 52-109") by certifying the 2014 Annual Filing which failed to set out material facts about a drop in Originations and the cause of the drop in Originations.

B. Misleading Disclosure in May 2015

(i) Q1 2015 Interim Filings

27. HCG filed its Q1 2015 Interim Filing on May 6, 2015. The Q1 2015 Interim Filing stated that "the first quarter was characterized by a traditionally slow real estate market, exacerbated by very harsh winter conditions. The Company has remained cautious in light of continued macroeconomic conditions and continues to perform ongoing reviews of its business partners ensuring that quality is within the Company's risk appetite."

28. One week before HCG filed its Q1 2015 Interim Filing, HCG had knowledge of the negative impact of the termination of brokers and remedial actions on Origination volumes. In his "1st Quarter 2015" Report ("President's Report") dated April 29, 2015, Reid stated that the decrease in Originations for Q1 2015 was mainly due to Project Trillium remedial actions. The President's Report further stated that HCG's "share of broker channel has deteriorated, mainly as a result of Trillium remediation."

29. HCG was also aware that the terminations and remedial process changes could have a negative effect on Origination volumes beyond Q1 2015. In a memo dated May 4, 2015 (the "May 4 Memo"), Morton advised the Audit Committee that the reduction in Originations for Q1 2015 could not be attributed to weather and seasonality alone and that the reduction had the potential to affect more than first quarter Origination numbers. Morton raised a concern about

the need to publicly disclose the fact that brokers had been terminated. Morton was also advised that management had determined that, based on current forecasted information, HCG might not meet its annual financial targets in 2015.

30. In addition, in the May 4 Memo, Morton advised that a decision had been made to add disclosure in HCG's filings in respect of "the recent impact the de-listing of brokers has had and may have on the results of the Company."

31. Still, in its Q1 2015 Interim Filing, HCG continued to mislead investors by explicitly attributing the first quarter Origination results to a traditionally slow real estate market, harsh winter, macroeconomics and an "on-going review of its business partners."

32. Investors were entitled to a transparent discussion in the MD&A of the commitments, events, risks and uncertainties facing HCG. Instead, HCG added a further two sentences to the Operational Risk section of the MD&A, which stated that HCG may encounter a financial loss as a result of an event with a third party service provider and that HCG may change relationships as appropriate. The disclosure was not sufficient to allow an investor to appreciate the reasons for the drop in Originations or the material risk to future growth of HCG that the termination of brokers and remediation of controls represented.

33. These facts known to HCG would have been considered important by a reasonable investor in making a decision to buy, sell or hold HCG securities. As such, the statements in the Q1 2015 Interim Filing about the cause for the decline in Originations were, in a material respect and at the time and in light of the circumstances under which the statements were made, misleading or untrue or did not state a fact required to be stated or that was necessary to make the statement not misleading, contrary to subsection 122(1)(b) of the Act and the requirements of NI 51-102.

34. Soloway and Morton certified the Q1 2015 Interim Filing as CEO and CFO, respectively. Soloway and Morton failed to comply with subsection 122(1)(b) of the Act and NI 52-109 by certifying the Q1 2015 Interim Filing which failed to set out material facts about a drop in Originations and the causes of the drop in Originations or the material risk to future growth of HCG that the termination of brokers and remediation of controls represented.

(ii) May 7, 2015 Earnings Call

35. Soloway, Morton and Reid participated in an earnings call with analysts held on May 7, 2015 following the filing of HCG's Q1 2015 Interim Filing. During the May 7, 2015 earnings call, Soloway and Reid made statements that were materially misleading or untrue.

36. Soloway was asked:

> Q: The first question I have is going back to originations, I totally get how, given what was going on with macro, well, you guys would be more kind of cautious on originations in the traditional business. I'm just trying to understand, I guess, from the prime insured side, are you guys saying that you were also kind of a bit careful there too, this being an insured product? Is that part of the reason why the originations kind of were where they were?

37. Soloway, simply responded - "Yes." Reid added, "...as Gerry pointed out earlier, just with the technology change, there were some bumps there. Just given the smaller size of the accelerator product, it was probably a little more noticeable there."

38. The analyst asked further, "Okay. So it was –okay, so it was a little bit of teething pains. But were you guys being a little more cautious on underwriting? I'm just trying to get a sense of, has it been because maybe brokers have been losing some market share, whether or not it's been small competition within the broker channel or to...". Soloway replied, "None of that has changed. I think it's very similar to what it was last year. There isn't a dramatic one quarter change. There's been no new competitor. There's been no new change in brokers. Brokers are exactly the same in my estimate."

39. Specifically, when asked about the decline in Originations for Q1 2015, Soloway attributed the continuing decline in originations to a range of factors including cold weather, macroeconomic conditions and a cautious approach to lending. Given the information known to Soloway, including as contained in the May 4 Memo and the President's Report, his statements were materially misleading and untrue.

40. On May 7, 2015, HCG, Soloway and Reid made statements contrary to section 126.2(1) of the Act that he knew or reasonably ought to have known, were in a material respect and at the time and in light of the circumstances under which they were made, and did not state one or more facts that were required to be stated or were necessary to make the statements not

misleading. These statements would reasonably be expected to have a significant effect on the market price or value of HCG's securities.

41. Morton and Reid authorized, permitted or acquiesced in HCG's and Soloway's misleading and untrue statements and are deemed to have failed to comply with Ontario securities law pursuant to section 129.2 of the Act.

C. Untimely Disclosure of the Material Change in July 2015

42. The terminations of brokers and the subsequent remediation arising out of the findings of Project Trillium, including changes to HCG's underwriting controls and procedures, constituted a material change in HCG's business or operations. HCG was aware of the material change by no later than February 10, 2015.

43. HCG did not issue a news release in relation to this material change until July 10, 2015. However, the facts disclosed in the July 10th NR and in the July 17th MCR and the remediation of controls were known to HCG in February 2015.

44. HCG breached subsections 75(1) and (2) of the Act and Part 7 of NI 51-102 by failing to issue a news release forthwith, and by failing to file a material change report within 10 days of February 10, 2015.

45. In addition, the July 10th NR and July 17th MCR disclosures were not sufficient for a reader to understand the actual nature of the material change, nor the significance of their impact on immediate and future quarters, and, as such, did not comply with Part 7 of NI 51-102 and Item 5 of Form 51-102F3 and subsection 122(1)(b) of the Act.

D. Conduct Contrary to Ontario Securities Law and the Public Interest

46. In summary, Staff allege the following breaches of Ontario securities law:

(a) HCG failed to satisfy its continuous disclosure obligations in its 2014 Annual Filing and Q1 2015 Interim Filing, by making statements that in a material respect and at the time and in light of the circumstances under which they were made, were misleading or untrue or did not state a fact that was required to be stated or that was necessary to make the statement not misleading, contrary to subsection 122(1)(b) of the Act;

(b) Each of Soloway and Morton falsely certified the 2014 Annual Filing and Q1 2015 Interim Filing by stating that the filings did not contain misrepresentations, contrary to subsection 122(1)(b) of the Act;

(c) HCG, Soloway and Reid made materially misleading statements on the May 7, 2015 earnings call by failing to tell the market the reasons for the decrease in Origination volumes and by failing to state facts that were required to be stated or that were necessary to make the statements not misleading, contrary to subsection 126.2(1) of the Act. These statements would reasonably be expected to have a significant effect on the market price or value of HCG's securities;

(d) HCG failed to satisfy its continuous disclosure obligations by failing to file a news release forthwith and to file a material change report within 10 days of a material change in the business, operations or capital of HCG, contrary to section 75 of the Act and Part 7 of NI 51-102;

(e) HCG made materially misleading statements in the July 10th NR and the July 17th MCR, which did not contain sufficient disclosure for a reader to appreciate the significance and impact of the material change, contrary to subsection 122(1)(b) of the Act and item 5 of Form 51-102F3 of NI 51-102; and

(f) Each of Soloway, Morton and Reid authorized, permitted or acquiesced in the above contraventions of the Act by HCG and are deemed to have failed to comply with Ontario securities law pursuant to section 129.2 of the Act.

47. Based on the foregoing, HCG, Soloway, Morton and Reid breached the Act and NI 51-102 and acted in a manner contrary to the public interest.

48. The statements made by officers of HCG on behalf of HCG during the earnings call on May 7, 2015 were misleading and therefore contrary to the public interest.

49. Staff reserve the right to make such other allegations as Staff may advise and the Commission may permit.

DATED at Toronto, Ontario this 19th day of April 2017.