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

AND

IN THE MATTER OF
JACK BANKS a.k.a. JACQUES BENQUESUS

Hearing:	**January 8-9 and February 14, 2003**		
Panel:	**Paul M. Moore, Q.C.**	**-**	**Vice-Chair (Chair of the Panel)**
	M. Theresa McLeod	**-**	**Commissioner**
	H. Lorne Morphy, Q.C.	**-**	**Commissioner**
Counsel:	**Karen Manarin**	**-**	**For Staff of the Ontario Securities Commission**
	Edward L. Greenspan, Q.C.	**-**	**For Jack Banks**

REASONS FOR DECISION

I. The Proceeding

[1] This proceeding began as a hearing under section 127 of the *Securities Act* (the Act) in the matter of Jack Banks and Larry Weltman.

[2] Just before the hearing began, Weltman settled with Commission staff and conceded that he had acted contrary to the public interest as alleged by staff. The hearing was adjourned and a separate Commission panel consisting of Vice-Chair Wetston and Commissioner Davis was convened and approved the settlement agreement.

[3] Following that, we resumed the hearing to deal with Banks only.

II. Staff's Allegations

[4] In their statement of allegations, staff alleged that the orders requested in the notice of hearing are in the public interest because Banks, as the chairman of the board of directors, president and chief executive officer of Laser Friendly Inc. (LFI):

(i) knowingly permitted share certificates of LFI to be delivered in circumstances where he knew or ought to have known that the certificates could and would be used to deceive third parties;

(ii) failed to ensure that sufficient controls existed to prevent the share certificates from being used for an improper purpose;

(iii) failed to take immediate steps to cancel and to attempt to retrieve share certificates and agreed to permit such certificates to remain in the possession of others, even after he had received notice that one or more of the share certificates may have been used for an improper purpose; and

(iv) pleaded guilty, in a criminal proceeding in the State of New York with respect to a matter unrelated to the series of transactions at issue in this proceeding, to having intentionally engaged in a scheme constituting a systematic ongoing course of conduct with intent to defraud while inducing and promoting the issuance, distribution, exchange, sale, negotiations and purchase of LFI shares.

[5] No breach of the Act was alleged by staff.

[6] Counsel for staff emphasized that the real issue in this proceeding was not whether Banks behaved with an intent to defraud anyone, but whether Banks met the standards of business conduct expected of a market participant who had the corporate governance responsibilities that Banks had

at LFI.

III. Banks' Position

[7] Counsel for Banks argued that the knowledge of other individuals connected with LFI could not be attributed to Banks, and that there was no evidence that Banks was aware of the 'red flags' suggested by staff.

[8] Counsel for Banks also argued that Banks fulfilled his duties as a director and as chief executive officer once the transactions were approved by the board of directors, and that he was entitled under subsection 135(4) of Ontario's *Business Corporations Act* (the OBCA) to rely in good faith on his subordinates and LFI's outside counsel to ensure that everything was carried out in accordance with the approvals.

IV. Overview

[9] This proceeding was one of a series of criminal and civil proceedings in Canada and the United States involving Banks and Weltman.

[10] In the State of New York, in the criminal proceeding mentioned in the statement of allegations, which related to securities fraud, Banks and Weltman pleaded guilty to having intentionally engaged in a scheme constituting a systematic ongoing course of conduct with intent to defraud. Based on his guilty plea, Banks was convicted. He was sentenced to five years of unsupervised probation, and was ordered to pay restitution in the amount of US$400,000 to injured persons, as well as a fine of US$100,000.

[11] In Ontario, based on events connected with the transactions at issue in this proceeding, Bank Leu AG launched an oppression action under the OBCA. On November 29, 2001, Justice Lederman of the Superior Court of Justice ruled in Bank Leu's favour: *Bank Leu AG v. Gaming Lottery Corp.*, [2001] O.J. No. 4715 (QL). That decision is presently under appeal.

[12] Counsel for Banks moved that we exclude as evidence Banks' criminal conviction in New York, and the reasons and findings of Justice Lederman in the civil action.

[13] We admitted the criminal conviction as evidence of the fourth allegation. We excluded the findings and reasons of Justice Lederman on the grounds that the findings would not stand if the appeal succeeded, and that evidence used in the civil action was available to be used in this hearing.

[14] Certain materials in evidence in the civil action, including the transcripts of the testimony of Weltman and Swartz, were, on consent, admitted in evidence by us.

[15] Apart from materials admitted on consent, staff called only one witness, Paul Stein, who was

LFI's external counsel at the material time. His testimony lasted an entire day. Banks did not testify and no evidence was called on his behalf.

[16] Counsel for Banks suggested that much of Stein's testimony should be given little or no weight where it was prefaced by statements such as "I believe" and "I was under the impression that". When we questioned Stein as to the basis of his impressions, he stated in some instances that he could not point to any new facts which were not before us regarding his testimony. Counsel for Banks suggested that such testimony was opinion evidence and not from a qualified expert. We do not regard it as opinion evidence in the technical sense. It was direct evidence based on his experience with LFI over an extended period and his exposure to Banks, Weltman and Swartz. His impressions were relevant and confirmatory of the conclusions as to Banks' knowledge which we are making based on all the evidence.

[17] Even if it could be regarded as opinion evidence, we note the following from A. Bryant, J. Sopinka & S. Lederman, *The Law of Evidence in Canada*, 2d ed. (Toronto: Butterworths, 1999) at 605-607:

> Modern Statement of Lay Opinion Rule: Helpfulness
>
> Dickson J. (as he then was) in *R. v. Graat* all but did away with the illogical distinction between so-called fact and opinion where the witness's testimony is founded on personal knowledge. He pointed out the numerous exceptions to the opinion rule that had developed and concluded:
>
>> Except for the sake of convenience, there is little, if any, virtue, in any distinction resting on the tenuous, and frequently false, antithesis between fact and opinion. The line between "fact" and "opinion" is not clear.
>
> Returning to broad principles, Dickson J. put the admissibility of such evidence on a rather simple basis:
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>> The witnesses had an opportunity for personal observation. They were in a position to give the Court real help.
>
> Dickson J. held that lay persons may testify about their observations where the witness is "merely giving a compendious statement of facts that are too subtle and too complicated to be narrated separately and distinctly." Couched in these terms, the modern opinion rule for lay witnesses should pose few exclusionary difficulties when based on the witness's perceptions. The real issue will be the assessment and weight to be given to such evidence after it is admitted. Thus, the law has moved away from the requirement of "necessity' in the case of lay witnesses whereby opinion evidence was received only if the witness could not "owing to the nature of the matter adequately convey to the jury the data from which such inference is made."

[…]

> Courts now have greater freedom to receive lay witnesses' opinions if: (1) the witness has personal knowledge; (2) the witness is in a better position than the trier of fact to form the opinion; (3) the witness has the necessary experiential capacity to make the conclusion; and (4) the opinion is a compendious mode of speaking and the witness could not as accurately, adequately and with reasonable facility describe the facts she or he is testifying about.

V. Facts

A. LFI

[18] LFI was a corporation incorporated under the OBCA. It was a diversified gaming company that manufactured and supplied products to the lottery, parimutuel, bingo and charitable gaming industry. It later changed its name to, among others, Gaming Lottery Corporation and GalaxiWorld.com Limited.

[19] From August 1993 to July 1998, LFI was a reporting issuer and its common shares traded on the Toronto Stock Exchange (TSX). At the material time, its shares also traded in the United States on the NASDAQ system. In 1994, LFI had a market capitalization of less than $70 million and its net income was under $3 million. The income from the three transactions at issue in this case was projected to be US$9.6 million over a one-year period.

[20] As the majority shareholders of LFI, Banks and his wife stood to benefit significantly from the increase in LFI's net income and any enhancement of share value that could be expected to flow from that increase.

[21] Banks was the chairman of the board, president and chief executive officer of LFI as well as a director. He had experience with corporate governance in public companies. According to Stein, Banks was a sophisticated owner-manager of LFI and, at least with regard to the transactions for which Stein dealt directly with Banks before Weltman was hired, Stein did not need to constantly explain business concepts to him. According to Stein, "[Banks] understood business concepts and he was a very sharp guy."

[22] Together, Banks and his wife held 55.86% of LFI's common shares. Although his wife was the largest single shareholder, she was not a director or officer of LFI, and by all indications, she was not a factor in the events at issue in this proceeding.

[23] There were four directors on LFI's board: Banks; Weltman; James Hal, who was a relative of Banks; and Amram Assayag, who was Banks' rabbi.

[24] Weltman was an accomplished accountant. Banks hired him in 1994 because of his qualifications and abilities. At the material time, in addition to being a director, Weltman was LFI's executive vice-president and chief financial officer.

[25] The other relevant officer of LFI was Eleesha Swartz. At the material time, she was LFI's general counsel and corporate secretary. She had previously been an associate of Stein's.

[26] Banks, Weltman and Swartz were a closely-knit team. LFI's office was small and LFI had few employees. Banks and Weltman worked closely together. Their offices were next to each other. There was no formal chain of command at LFI and everyone reported to Banks.

[27] Stein testified that when Swartz was providing instructions, she often said "This is what Jack wants" or "This is what Larry told me to do".

[28] Stein had been LFI's outside counsel since the 1980s. Over the years, he had helped LFI with a variety of corporate and securities matters and spent approximately 10-15% of his time on legal work for LFI and other companies owned by Banks. Stein worked closely with Banks until Weltman became an officer of LFI, after which Stein dealt principally with Weltman and Swartz.

[29] Stein's impression was that Banks knew what was going on at LFI, and that throughout the events in issue, Banks was in close contact with Weltman.

[30] Stein told Banks directly that LFI should be wary about the transactions in question.

[31] Banks, Weltman and Swartz knew that Stein had questioned the commercial viability to the other parties of the transactions. Banks replied that LFI "just wanted the money".

B. The Roll Program

[32] In the fall of 1994, an American businessman named James Farrell asked Weltman if LFI was interested in participating in a transaction referred to as a Regulation S Stock Subscription Roll Program (the Roll Program) with two organizations which Farrell represented: Helix Capital Corporation (Helix) and Delta West Management Trust (Delta).

[33] Farrell represented to Weltman that the Roll Program would work as follows. Helix and Delta were agents of major European banks. The banks wanted to improve their balance sheets. Helix and Delta would subscribe for large amounts of LFI shares. The shares would not be paid for or officially issued for a year. Share certificates would be held in escrow during that time, and the purchase price for the shares would be secured by an interest-bearing debenture. At the end of the year, LFI could cancel the share certificates but keep the interest payments. (In fact, LFI had no intention of ultimately issuing any shares under the Roll Program and intended to exercise its right of cancellation.) Everyone would profit from LFI's participation in the Roll Program: the balance sheets of the banks would look better, Farrell and his colleagues would receive commissions, and LFI would be able to keep millions

of dollars in interest payments. Pursuant to Regulation S under *The Securities Act of 1933* and comparable provisions of Canadian securities law, the transaction would be exempt from registration and prospectus requirements.

[34] Weltman brought this proposal to Banks. Banks and Weltman called Stein. Stein was instructed to review and make any changes to the documentation provided by Farrell that would enable LFI to participate in the Roll Program.

[35] Stein reviewed the proposed documentation that was sent to him.

[36] Two transactions were proposed at the beginning: one with Helix (the Helix transaction) and one with Delta (the Delta I transaction). These two transactions were entered into pursuant to a resolution of the board of directors of LFI signed on November 8, 1994 (the November 8 resolution). A second transaction with Delta (the Delta II transaction) was entered into on December 5 and approved by a board resolution on December 16 (the second resolution).

[37] Stein was not instructed to conduct due diligence into LFI's potential partners, nor did anyone at LFI do any. In particular, no one asked to see financial statements for Helix and Delta. Stein told Weltman and Swartz on several occasions that Stein did not understand the commercial viability to the other parties of the transactions. (Weltman did not understand the commercial viability either.)

[38] When Stein was invited to make any inquiries he wanted to about the commercial viability, he told Weltman that that question was for LFI to satisfy itself on.

[39] Swartz sent Stein a draft directors' resolution for his review. Stein added a recital indicating that the share certificates would be deposited and held by an escrow agent. Stein was not concerned with the legality of the deal *per se*, but with the potential for fraud if LFI lost control of the share certificates, the need for a good escrow agreement, and the viability of the Roll Program from a commercial point of view.

[40] Banks informed the other directors about the proposed transactions, and in lieu of a meeting, the four LFI directors signed the November 8 resolution, which authorized LFI to participate in the Roll Program. LFI was authorized to enter into subscription agreements for a total of 30 million shares at US$4.00 per share, for a total price of US$120 million, with LFI to receive interest under the Roll Program at a rate of 3% per year, for a total of US$3.6 million. Even if LFI elected to cancel the share issuance at the end of the year, it would keep the interest payments. The directors also resolved that share certificates be issued and be held by an escrow agent.

[41] On November 8, Stein notified the TSX about LFI's intended participation in the Roll Program. The TSX accepted Stein's notice on the understanding that LFI would seek the TSX's consent before issuing any shares under the program, and that any share certificates would be held in escrow by an escrow agent.

[42] On November 10, LFI entered into a subscription agreement with Helix for the Helix

transaction. The agreement was a subscription for 15 million shares at US$4 per share, for a total purchase price of US$60 million, at the 3% interest rate.

[43] That same day, the required share certificates were printed and sent to Stein. Certificates 12093 to 12100 (the Helix Certificates) purported to represent shares that were fully paid and non-assessable. Contrary to Stein's advice, they did not contain a legend indicating that the shares were in fact not paid for and were subject to the terms of the subscription agreement.

[44] There was repeated pressure over the week from Weltman and Helix for Stein to deliver the Helix Certificates. Stein was emphatic that there be an escrow agreement in place for the Helix transaction.

[45] On November 11, LFI entered into a similar subscription agreement with Delta for the Delta I tranaction, for 15 million shares at US$4.00 per share, at the 3% interest rate. Share certificates (the Delta I Certificates) were printed and sent to Stein.

[46] On November 15, Swartz asked Michael Howery, the lawyer representing Delta, to send her a draft escrow agreement for the Delta I transaction for her review and a form of undertaking not to release the Delta I Certificates. Howery committed to hold the relevant share certificates in trust and not to release them without LFI's prior written approval.

[47] On November 16, Stein and Gary Moore, a Helix representative, finalized a temporary agreement, instead of the escrow agreement contemplated in the November 8 resolution. Under the temporary agreement, Moore undertook to notify LFI one business day in advance of any intended transfer of the Helix Certificates. Relying on that undertaking, Stein sent Moore the Helix Certificates.

[48] On November 17, Moore sidestepped Stein and wrote to Weltman, proposing that the Helix Certificates be held in trust by Moore or by a reputable financial institution. That same day, unbeknownst to Stein, Swartz agreed to Moore's proposal. After learning what had happened, Stein informed her that LFI had just lost control over the Helix Certificates.

[49] Certificate 12093 for 2.5 million shares was eventually sent to a branch of the Bank of Montreal in Toronto. On November 18, Moore informed LFI of his intention to do this, and confirmed on November 29 that the delivery had been made. However, he never informed LFI that Helix had proceeded to use the certificate in connection with a separate securities lease transaction involving a company called Red Oak Ltd., whose principal was Guido Bensberg, or that on November 23, Bensberg had pledged Certificate 12093 as collateral for a loan to Bensberg from Bank Leu. (When Bensberg later defaulted on the loan, Bank Leu lost C$4.3 million and attempted to realize upon Certificate 12093.)

[50] On November 24, based on instructions from Swartz, but without an escrow agreement in place, Stein sent Howery the Delta I Certificates.

[51] Stein testified that his only involvement in the Delta I transaction was regarding the legend on the Delta I certificates and delivery of them as instructed by Swartz.

[52] Somehow, the Delta I Certificates were deposited with U.S. brokerage firm Dean Witter in a form allowing transfer.

[53] Upon realizing that someone had tried to pass the Delta I Certificates, Dean Witter called the U.S. Securities and Exchange Commission (SEC), which in turn called someone at LFI on December 5.

[54] Farrell told Weltman that the Delta I certificates had been delivered to the wrong depository, that to move them out of that depository into the correct depository would take too long to place the stock with an appropriate bank. Therefore, according to Weltman, "Farrell was asking all the companies involved in that bundle to cancel that stock and to issue replacement certificates to a new depository." Farrell asked that replacement certificates (the Replacement Certificates) be printed and sent elsewhere.

[55] On December 5, Weltman executed a subscription agreement on behalf of LFI for the Delta II transaction for 15 million shares at US$4.00 per share with a total subscription price of US$60 million. The interest rate was 10% and would result in LFI receiving an additional US$6 million in interest payments even if the share issuance was cancelled at the end of the year. Share certificates (the Delta II Certificates) were printed that same day and were sent to LFI by courier.

[56] On December 6, with no escrow agreement in place, Weltman travelled to Detroit and hand-delivered the Delta II Certificates to Farrell.

[57] Upon being notified about the phone call from the SEC regarding the Delta I Certificates, Stein referred LFI to a U.S. law firm, Jones Day, for assistance with the matter. On December 6, Swartz was informed that Jones Day had learned that the Delta I Certificates had been deposited with Dean Witter, instead of the proper depository, and that there had been an attempt "to pass certificates to Dean Witter as clear," and that Dean Witter had called the SEC.

[58] On December 8, Swartz asked Delta to return the Delta I Certificates immediately for cancellation and indicated that she would be prepared to deliver the Replacement Certificates based upon an undertaking to return the Delta I Certificates forthwith.

[59] Pursuant to a direction dated December 8, Swartz instructed the transfer agent to print two share certificates representing 10 million and 5 million LFI common shares, respectively. As a result, Replacement Certificates representing 15 million "fully paid and non-assessable" LFI shares were printed in the name of "Delta West Management Trust".

[60] The Replacement Certificates contained a legend indicating that there were certain transfer restrictions pursuant to Regulation S. In addition, Swartz typed a further legend on the Replacement Certificates indicating that they were subject to the terms and conditions of a subscription agreement

and debenture.

[61] On December 9, Swartz and Weltman participated in a telephone call with Jones Day and the SEC during which the SEC questioned Weltman and Swartz regarding the Roll Program. They were informed that the SEC was making a preliminary inquiry into violations of the registration requirement of federal securities laws. The Helix and Delta transactions were both discussed. Swartz's notes of a phone call involving Jones Day on December 9 contain the phrases "badges of fraud" and "building case against Farrell".

[62] Given the apparent SEC fraud investigation, Jones Day advised LFI to withdraw immediately from the Roll Program and retrieve all share certificates issued thereunder.

[63] Stein agreed with that advice.

[64] Banks was told by either Weltman or Swartz about the SEC investigation and the concerns of Jones Day. On December 12, Banks told Weltman or Swartz, or both of them, that notwithstanding the phone call from the SEC and the concerns of Jones Day, he still wanted the Replacement Certificates sent out. Without first obtaining possession of the Delta I Certificates, Swartz sent the Replacement Certificates to a Michigan company named Omnibank.

[65] On December 12, upon learning that its advice to terminate LFI's participation in the Roll Program and recover all share certificates had not been followed, Jones Day resigned as counsel. Stein then referred LFI to another U.S. firm, White & Case.

[66] White & Case apprised themselves of the situation and spoke with Swartz by phone on December 15. Swartz's notes from the call include the phrases "clear that a fraud has taken place – large scale", "advice terminate agreements", "aiding & abetting a fraud" and "discussed all with Larry Friday afternoon".

[67] Either Jones Day or White & Case informed Stein, Swartz and Weltman that based on the SEC officials involved, the SEC's interest in the matter was at a fairly high level. Conference calls involving Weltman, Swartz, Stein and attorneys from White & Case were held on December 16. Swartz's notes from a telephone conversation with White & Case on December 16 state in places "fraud going on", "enforcement priority", "focus – on arrangers of transaction" and "obligation to ensure shares not traded in violation of Reg S".

[68] Banks, Weltman and the other directors had not signed a resolution authorizing LFI to participate in the Delta II transaction before it was transacted. However, on December 16, Banks and the other directors signed a resolution dated as of December 5 authorizing LFI's participation in the Delta II transaction.

[69] On January 3, 1995, the SEC issued subpoenas requiring Weltman and Swartz to attend at the offices of the SEC and provide sworn testimony in connection with the SEC's investigation. Weltman and Swartz did so on January 5.

[70] On January 10, Weltman and Swartz had a telephone discussion with White & Case. Swartz's notes from the call state "on notice that securities fraud being committed", "instruments perpetrate fraud" and "if know it's a fraud terminate agreement and demand certificates back".

[71] Between January 18 and 20, Swartz wrote to the holders of Delta I Certificates and Delta II Certificates and asked that the certificates be returned.

[72] On January 19, in a fax to Weltman and Swartz, White & Case advised that

(i) there was no record that Delta existed;

(ii) Helix was an offshore company registered in the Turks and Caicos Islands;

(iii) the Helix Certificates were used as assets in support of a loan from a Canadian bank and were delivered to that bank; and

(iv) LFI should consider the loss contingency that could arise if a lender extended funds based on a borrower's balance sheet that reflects as an asset a share certificate issued by LFI.

[73] Between January 25 and 27, all of the Delta certificates were returned to Swartz. They were cancelled shortly thereafter.

[74] On February 1, in a letter to Swartz, White & Case further advised LFI as follows:

> [W]e believe there is a substantial risk that if Helix's customer were to be unable to repay the loan from its lending bank, the bank could assert a claim against Laser Friendly for any resulting loss, and probably would be able to raise serious questions as to whether it was aware of the fact that the Laser Friendly certificates did not represent fully paid and issued shares, and whether Laser Friendly was not knowingly participating in fraudulent misrepresentations by its borrower as to the value of the security the borrower had provided.
>
> On the basis of the foregoing, we believe that you should, as a matter of urgeny, (a) terminate the agreements with Helix (and Delta West if the two certificates issued to it have not yet been returned to you) on the ground that they did not fully disclose to you the uses to which the certificates would be put in inducing you to enter into those agreements, and (b) take all available actions to recover the certificates you have delivered.

[75] In the ensuing months, except for certificate 12093, all of the Helix Certificates were retrieved and cancelled. Certificate 12093 remains in the possession of Bank Leu.

[76] As late as April 2, 1995, when Helix had paid LFI only US$40,000 in interest and

US$384,383 was owing, Weltman wrote to Helix confirming that "certificates 12093 and 12095, amounting to 5,000,000 share will remain in the program to function the payment … above."

[77] In summary, LFI entered into subscription agreements with Helix and Delta designed to yield, within one year, US$9.6 million in interest payments for a possible issuance of 45 million shares at a time when there were approximately 17 million shares outstanding. Given LFI's financial position at the time, the transactions were very significant to LFI.

[78] As it turned out, LFI received only US$40,000 in actual interest payments under the Roll Program, notwithstanding the terms of the subscription agreements.

C. Banks' Criminal Conviction

[79] On September 27, 2000, Banks pled guilty to violating article 23-A of the General Business Law of the State of New York ("Fraudulent Practices in Respect to Stocks, Bonds and other Securities"). In particular, he pled guilty to:

> Intentionally engag[ing] in a scheme constituting a systematic ongoing course of conduct with intent to defraud ten and more persons and to obtain property from ten and more persons by false and fraudulent pretenses, representations and promises, and so obtained property from one and more of such persons while engaged in inducing and promoting the issuance, distribution, exchange, sale, negotiations and purchase of a security, to list shares of a company with different names during the scheme, including Laser Friendly Inc., Gaming Lottery Corporation, and other names.

[80] The facts supporting the conviction, which Banks admitted, were as follows:

(i) Banks was in a control management position and a control ownership position with GalaxiWorld, a publicly traded company named Laser Friendly;

(ii) through Laser Friendly, Banks entered into a transaction to purchase the Speciality Manufacturing division of Ace Novelty Co., a company in the gaming industry;

(iii) the gaming industry is highly regulated;

(iv) Banks and Laser Friendly "were warned" that on the closing of the transaction, the licence issued to Ace Novelty would be null and void;

(v) Laser Friendly completed the final closing without obtaining licensure and operated Specialty Manufacturing without being licenced and without informing the State of Washington upon closing; and

(vi) Laser Friendly "undertook the material risk that if its concealed conduct were discovered by the State of Washington and not approved," Laser Friendly and "its financial condition would be significantly adversely affected."

[81] Pursuant to his guilty plea, Banks agreed to:

(i) "leave the United States and not ever return to the United States except on those occasions when required or permitted to do so by court order";

(ii) divest himself of all "control ownership positions" in publicly traded companies;

(iii) leave and resign from all "control management positions" held in publicly traded companies;

(iv) pay a fine of US$100,000; and

(v) pay restitution in the amount of US$400,000.

VI. Analysis

A. The Roll Program

[82] LFI's participation in the Roll Program required LFI to issue share certificates containing the statement that the shares represented by the certificates were fully paid and non-assessable. These certificates bore the signature of Banks. The statement was untrue.

[83] Based on the evidence, we find that the Roll Program had no commercial justification. It only made sense if share certificates were used for an improper purpose. Having share certificates held in an effective escrow arrangement might have prevented the share certificates from being pledged or otherwise used improperly, but would have rendered the Roll Program useless to the representatives of Helix and Delta.

B. The Commission's Public Interest Jurisdiction

[84] The Commission has a public interest jurisdiction that extends to corporate governance.

[85] In *Re Standard Trustco Ltd.* (1992), 15 O.S.C.B. 4322 (*Standard Trustco*), the Commission referred to proposals regarding new powers in section 127 of the Act in connection with a person's ability to be a director or officer of an issuer. Having found that the conduct of certain directors and officers did not meet the standards expected of them, the Commission said at 4378: "If we had such powers now, at the very least, we would have made an order reprimanding the respondents against

whom we have made findings and we would have considered the appropriateness of further orders under the amendments."

[86] In 1999, such powers were added to the Act and are now contained in paragraphs 7 and 8 of subsection 127(1) of the Act:

> **127. (1) Orders in the public interest** -- The Commission may make one or more of the following orders if in its opinion it is in the public interest to make the order or orders;
>
> […]
>
> 7. An order that a person resign one or more positions that the person holds as a director or officer of an issuer.
>
> 8. An order that a person is prohibited from becoming or acting as director or officer of any issuer.

[87] When exercising this jurisdiction, we are required to give effect to the purposes of the Act, set out in section 1.1 of the Act:

> **1.1 Purposes** – The purposes of this Act are,
>
> (a) to provide protection to investors from unfair, improper or fraudulent practices; and
>
> (b) to foster fair and efficient capital markets and confidence in capital markets.

[88] When exercising our jurisdiction, the legislature has also instructed us to have regard to the fundamental principles set out in section 2.1 of the Act, including the maintenance of high standards of fitness and business conduct to ensure honest and responsible conduct by market participants. The legislature has defined "market participant" to include reporting issuers and their directors and officers.

[89] Since the decision of the Divisional Court 16 years ago in the *Canadian Tire* case [*Re C.T.C. Dealer Holdings and Ontario Securities Commission* (1987), 59 O.R. (2d) 79], it has been settled law that even if a person has not breached a specific provision of Ontario securities law, the Ontario legislature intended that the Commission have the ability to make a preventative order in the public interest if that person's past conduct suggests that an order is necessary to prevent future harm. That legislative intent was unanimously emphasized by the Supreme Court of Canada in *Committee for the Equal Treatment of Asbestos Minority Shareholders* v. *Ontario (Securities Commission)*, [2001] 2 S.C.R. 132 at paras. 39-42 (*Asbestos*).

[90] As the Commission pointed out in *Standard Trustco* at 4364-4365, in exercising our public

interest jurisdiction concerning corporate governance, we must go beyond considering whether the respondent complied with the duty of care, diligence and skill set out in the OBCA. We must determine whether the conduct of the respondent was contrary to the public interest.

[91] A hearing under section 127 is not the place for the Commission to set out new standards or principles of good corporate governance to the detriment of a respondent. However, where a respondent has egregiously failed to adhere to existing standards or principles of corporate governance, and a respondent's past conduct has convinced us that without one or more orders, future harm is likely to occur, it is appropriate for us to make an order in the public interest.

[92] Not every lapse in the duty of a director or officer of an issuer will raise a public interest concern. However, a public interest concern will arise, at a minimum, over a lapse that demonstrates (i) an inability to adhere to high standards of fitness and business conduct which ensure honest or responsible conduct; (ii) a careless disregard for, or indifference to, reasonably foreseeable, serious consequences of a failure to meet high standards of fitness and business conduct; or (iii) unfair, improper or fraudulent practices impacting participants in the capital markets.

[93] In this regard, if a person has committed securities fraud in Ontario or another jurisdiction, and that person is a director or officer of an issuer, we should carefully consider the need for an order under subsection 127(1) of our Act to protect our markets.

C. The Standard of Business Conduct Expected of Banks

[94] Subsection 134(1) of the OBCA states:

> **134. (1) Standards of care, etc., or directors, etc.** – Every director and officer of a corporation in exercising his or her powers and discharging his or her duties shall,
>
> (a) act honestly and in good faith with a view to the best interests of the corporation; and
>
> (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

[95] In *Soper v. Canada*, [1998] 1 F.C. 124 (C.A.) at para. 34 (*Soper*), Justice Robertson observed that diligence is simply the degree of attention and care expected of a person in a given situation.

[96] At issue in *Soper* was the standard required of directors in the context of section 227.1 of the federal *Income Tax Act*, which provided a due diligence defence to a director who exercised "the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances." Justice Robertson noted at para. 40 that the wording of the provision is virtually identical to the language used in corporate law statutes, and that this standard

is inherently flexible:

> Rather than treating directors as a homogenous group of professionals whose conducts is governed by a single, unchanging standard, [section 227.2] embraces a subjective element which takes into account the personal knowledge and background of the director, as well as his or her corporate circumstances in the form of, inter alia, the company's organization, resources, customs and conduct. Thus, for example, more is expected of individuals with superior qualifications (e.g. experienced business-persons).

[97] Justice Robertson also noted at para. 26 that there is a positive duty imposed upon directors to take an active role and to participate in the decision making process:

> It would be silly to pretend that the common law would stand still and permit directors to adhere to a standard of total passivity and irresponsibility. … [T]he law today can scarcely be said to embrace the principle that the less a director does or knows or cares, the less likely it is that he or she will be held liable. Further to this point, the statutory standard of care will surely be interpreted and applied in a manner which encourages responsibility. Accordingly, the director who acts irresponsibly, for example, by failing to attend all board meetings now does so at his own peril.

[98] While all directors and officers are held to the same standard of care, all directors and officers do not stand in the same position, in that they are not all possessed of the same information and they do not occupy the same "comparable circumstances." The most common distinguishing feature between directors is whether they are inside directors (typically senior officers involved in the management of the company) or outside directors (those who have been brought onto the board so that they can share their expertise and experience with a company in which they do not play a day-to-day managerial role). Inside directors and senior officers, such as Banks, will ordinarily have a much better knowledge of the affairs of the company. Accordingly, their duty to react diligently to certain events or problems may be higher than that of an outside director. As a result, in ascertaining the actual duty of care in a given circumstance, more will usually be expected of inside directors. As Justice Robertson said in *Soper* at para. 44:

> I am not suggesting that liability is dependent simply upon whether a person is classified as an inside as opposed to an outside director. Rather, that characterisation is simply the starting point of my analysis. At the same time, however, it is difficult to deny that inside directors, meaning those involved in the day-to-day management of the company and who influence the conduct of its business affairs, will have the most difficulty in establishing the due diligence defence. For such individuals, it will be a challenge to argue convincingly that, despite their daily role in corporate management, they lacked business acumen to the extent that that factor should overtake the assumption that they did know, or ought to have known, of both remittance requirements and any problem in this regard. In short, inside directors will

> face a significant hurdle when arguing that the subjective element of the standard of care should predominate over its objective aspect.

[99] That statement is even more applicable where, as in the case before us, the director is also the chairman of the board, the president and (with his wife) the controlling shareholder of a company with few employees.

[100] Justice Robertson added at para. 41 that:

> The standard of care set out in subsection 227.1(3) of the Act is, therefore, not purely objective. Nor is it purely subjective. It is not enough for a director to say he or she did his or her best, for that is an invocation of the purely subjective standard. Equally clear is that honesty is not enough. However, the standard is not a professional one. Nor is it the negligence law standard that governs these cases. Rather, the Act contains both objective elements-embodied in the reasonable person language-and subjective elements-inherent in individual considerations like "skill" and the idea of "comparable circumstances". Accordingly, the standard can be properly described as "objective subjective".

[101] In determining whether the duty of care, diligence and skill required of a director or officer under subsection 134(1) of the OBCA has been met, the trier of fact must look at all the available evidence. Where, as in *Soper*, a statutory provision has been breached and a due diligence defence is possible, it is up to the respondent to establish the defence. Where no breach of any law is alleged, as in our case, while the respondent need not establish a due diligence defence, we must decide whether there has been a failure of the duty under subsection 134(1) of the OBCA based on the evidence, including the testimony, if any, from the respondent.

[102] As the chief executive officer of LFI, Banks had primary responsibility for LFI's business and operations. All other officers reported to him. He had oversight responsibility for all material matters at LFI. He was an intelligent business person experienced in the corporate governance of public companies. He was a hands on owner-manager with a small, tightly-knit management team with no structured hierarchy.

[103] Accordingly, we had to determine what a reasonably prudent person would have done in Banks' circumstances.

[104] The duty of care, diligence and skill imposed on Banks under the OBCA required him to ascertain the commercial viability of the Roll Program before recommending it to the other directors. He was required to ask tough questions, and it was not enough just to focus on the potential financial gain to LFI, or for him to be satisfied with an answer that other LFI officers were looking into it or that other companies had conducted similar programs. If, after asking tough questions, he still could not determine the commercial viability of the program, he was required to ensure that LFI retained independent experts to provide satisfactory answers to the tough questions on which he could

reasonably rely.

[105] His duty also required him to understand the potential for fraud that signed share certificates presented when they purported to be for shares that had been issued as fully paid and non-assessable. He had a duty to ensure that adequate safeguards were in place so that the share certificates could not be used for an improper purpose.

[106] The exercise of care and diligence required of him was not a one-time event. Banks was required to be proactive, to monitor LFI's participation in the Roll Program, and to obtain regular reports from his subordinates as to how LFI's participation in the Roll Program was unfolding. He had a duty to supervise the other officers and ensure that the Roll Program was being executed in an appropriate manner. In this regard, we agree with what the Alberta Securities Commission said in *Re Cartaway Resources Corp.* (2000), 9 A.S.C.S. 3092 at 3126:

> The CEO will normally be held to a higher standard than the board and the rest of management because the CEO bears direct responsibility for establishing the standards of behaviour and processes of the corporation. The CEO may delegate duties to the rest of management, but the CEO will always remain primarily responsible for overseeing the performance of such duties, especially in junior companies that generally lack documented procedures.

[107] Before approving the Roll Program, Banks should have had reasonable grounds for believing and formed the belief that the Roll Program made commercial sense for the other parties. No one pays millions of dollars without a benefit in return. Otherwise, the Roll Program would have been too good to be true. Furthermore, unless he understood the benefit to the other parties, Banks should have been suspicious that the representatives of Helix and Delta might use the share certificates for an improper purpose. At a minimum, he should have reasonably satisfied himself that they were real and reputable parties.

[108] Once the Roll Program was put into operation, if Banks was unaware of how it was working in practice, he should have asked and been fully apprised about the state of affairs concerning the execution of the Roll Program, at least before he authorized the issuance of the Replacement Certificates and before he signed on December 16 the resolution authorizing the Delta II transaction.

D. Standard of Proof

[109] Although Banks was not a registrant under the Act, counsel for Banks argued that the standard of proof applied in *Re Donnini* (2002), 25 O.S.C.B. 6225, should be applied here. While we do not agree with that, we find that the evidence satisfies that higher standard of proof.

E. What Did Banks Know?

[110] Weltman brought the Roll Program to Banks and he approved it. He explained it to the other directors. He knew that LFI stood to make a lot of money from the program. It was a very material program for LFI and, indirectly, for him. He knew that Stein was uneasy about the transactions and at some point advised Banks of this. He knew after December 5 that the SEC was inquiring into the Roll Program. He knew that Jones Day had withdrawn its legal representation. He knew that Delta I Certificates had gone missing and that Delta had requested replacement certificates. He knew that the resolution approving the Delta II transaction was signed on December 16 and backdated to December 5.

[111] Counsel for Banks suggested that the evidence showed that Jones Day had withdrawn because of the SEC inquiry. The evidence was not clear that Banks was told that Jones Day had withdrawn because its advice to withdraw from the transactions had not been followed. It is inconceivable to us that Weltman and Swartz would have told Banks only part of the story concerning Jones Day. We are satisfied that they would have told him the full story.

[112] Considering the tight-knit nature of LFI's management team, the way Banks had operated on previous occasions and what we know Banks actually knew, we conclude that Banks knew the way in which the Roll Program was operating.

F. Did Banks Meet the Standard Expected of Him?

[113] There was no evidence that Banks himself understood the commercial viability to the other parties of the Roll Program and every reason to conclude that he did not.

[114] Banks should have ensured that for contracts of significance to LFI, such as the Roll Program, due diligence was conducted into the companies and persons who were promising performance. Under the circumstances, the integrity and reputation of the other parties was crucial, and Banks was required to be satisfied on a reasonable basis that LFI was dealing with real and reputable parties.

[115] The public expects that the share certificates of a public company that are in public circulation are what they purport to be. It was vital to LFI and the public interest that an escrow agreement with an independent and reputable third party be put in place before LFI released share certificates evidencing fully paid shares. A reasonable person would have foreseen that the share certificates, if released into the marketplace, either accidentally or wilfully, could cause damage, and such person would have actively ensured that adequate safeguards were put in place and were operating appropriately.

[116] Banks should have become personally and proactively involved in the face of a phone call from the SEC, an apparent SEC fraud investigation and the concerns expressed by Jones Day. He should have ceased LFI's participation in the Roll Program, rather than releasing another round of share certificates and signing a board resolution after the fact for a transaction that had not been authorized at the time it was entered into. His failure to take immediate steps to contain a dangerous

situation suggests strongly to us that Banks was indifferent to the foreseeable consequences to others in the marketplace and was motivated solely by the monetary benefit that LFI hoped to secure for itself.

[117] Counsel for Banks argued that subsection 135(4) of the OBCA permitted Banks to rely in good faith on Weltman, Swartz and Stein to carry out the Roll Program as authorized. Subsection 135(4) is a defence to liability under sections 130 and 131 of the OBCA, which are not relevant to the issues before us.

[118] Furthermore, subsection 135(4) would only be relevant to Banks' conduct as a director, not as the chief executive officer.

[119] In addition, any reliance under subsection 135(4) must be in good faith, and is limited to reports made by a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to the statement made by such person. Although Weltman was an accountant and Swartz and Stein were lawyers, we had no evidence before us that Banks obtained and in good faith relied on any reports of the kind referred to in subsection 135(4).

[120] On the contrary, the advice that Stein gave concerning the Roll Program was full of concern, and in a material respect (the escrow provisions) was not followed. Stein's advice regarding the inclusion of a warning legend on the share certificates was not followed.

[121] Based on what Banks knew, he should not have left things to Weltman and Swartz. Such reliance would have been unreasonable. As the Commission said in *Standard Trustco* at 4365-4366:

> It was not appropriate in the circumstances for the respondent directors to have placed as much reliance on management as they did, both in terms of relying on management's financial statements and relying on management to consult with the outside lawyer and auditor. Directors should not rely on management unquestioningly where they have reason to be concerned about the integrity or ability of management or where they have notice of a particular problem relating to management's activities.

[122] Counsel for staff submitted at the outset that staff was not alleging fraudulent conduct on the part of Banks, but only that he had failed in his duty as a director and officer of LFI such that his conduct calls for an order in the public interest. In this regard, we agree with what the Commission said in *Standard Trustco* at 4359: "It is not necessary for us to find that the respondents acted wilfully or deceitfully in order to exercise our public interest jurisdiction."

[123] If in fact Banks did not know all the events described above, then his lack of knowledge was all the more egregious. The standard of conduct expected of Banks required a sound understanding of the legitimacy of Helix and Delta and of the Roll Program as a whole, and ongoing engagement by him. If he was unaware of all the problems that emerged, then he performed his duties with reckless abandon.

[124] Banks' conduct in connection with the Roll Program was egregious and fell far short of the standard expected of him. It showed a careless disregard for harm which was reasonably foreseeable and ultimately occurred. It spoke volumes about his fitness to continue as a director or officer of an issuer.

VII. Sanctions

[125] Orders under section 127 are "preventive in nature and prospective in orientation": *Asbestos* at para. 45. In addition, participation in our markets "is a privilege and not a right": *Erikson v. Ontario Securities Commission*, [2003] O.J. No. 593 at para. 56 (QL).

[126] Banks pleaded guilty to intentionally engaging in a scheme constituting a systematic ongoing course of conduct with intent to defraud. This was criminal conduct and it was securities-related. This conduct arose in Banks' capacity as a director and officer of an issuer. Together with his conduct in connection with the Roll Program, the criminal conduct demonstrated to us that Banks should be restricted from acting as a director or officer of any issuer, and be prevented from participating in our capital markets.

[127] In addition, Banks' admission of criminal guilt in a securities-related matter calls for a vigorous package of preventive sanctions. If we do not restrain Banks properly, confidence in our markets would be weakened.

[128] We are therefore ordering, pursuant to paragraphs 7 and 8 of subsection 127(1) of the Act, that Banks resign any positions he holds as a director or officer of any issuer, and that he be prohibited permanently from becoming or acting as a director or officer of any issuer.

[129] His indifference to the foreseeable consequences to others in the marketplace, together with his singular focus on the monetary benefit that LFI hoped to secure for itself, convinced us that he should be removed from our markets. We are therefore also ordering, pursuant to paragraph 2 of subsection 127(1), that Banks cease trading in securities permanently.

[130] Finally, we are ordering, pursuant to paragraph 6 of subsection 127(1), that Banks be reprimanded.

[131] Pursuant to the settlement agreement between Weltman and staff of the Commission, the Commission ordered that:

(i) pursuant to paragraph 2 of subsection 127(1) of the Act, Weltman cease trading permanently;

(ii) pursuant to paragraph 6 of subsection 127(1), Weltman be reprimanded;

(iii) pursuant to paragraph 7 of subsection 127(1), Weltman resign any position he holds as a director or officer of any issuer; and

(iv) pursuant to paragraph 8 of subsection 127(1), Weltman is prohibited permanently from becoming or acting as a director or officer of any issuer.

[132] The sanctions we are ordering against Banks are consonant with those against Weltman.

Dated at Toronto this 23rd day of April, 2003.

"Paul M. Moore"
Paul M. Moore

"M. Theresa McLeod"
M. Theresa McLeod

"H. Lorne Morphy"
H. Lorne Morphy