

**PONZI SCHEMES VERSUS W. A. ROBINSON & ASSOCIATES LTD.**

By Wayne A. Robinson

**Many people have expressed interest about what a Ponzi scheme is and how to identify one. We thought it prudent to outline our thoughts on the matter.**

It has been a tumultuous year and a half with bankruptcies, bank failures, chapter 11's, all over the US and, to add insult to injury, the occurrence of the whole Madoff Ponzi scheme (the largest fraudulent scheme possibly in the history of modern man). Now in Canada, there is suspicion of a money manager in Quebec, Earl Jones, running a Ponzi scheme.

It is not an easy task to assure investors, friends and colleagues that you are honest and trustworthy because the words and assurances are rather hollow when they turn out not to be true and that has happened a lot this last while.

**On Saturday June 20, 2009 at the Annual General Meeting of Frontenac Mortgage and Investment Fund in Kingston, I addressed the whole matter of Ponzi schemes. Rather than rewriting it I have taken the liberty to just extract from my speech.**

“What is a Ponzi scheme and who is Bernie Madoff? A Ponzi scheme is a fraudulent investment operation that involves promising or paying abnormally high returns to investors out of the money paid in by subsequent investors, rather than from net revenues generated by any real business. It is named after Charles Ponzi, a rather infamous Italian/Canadian/American who devised endless fraudulent schemes in his lifetime to bilk investors.

Bernie Madoff is an American businessman and the former chairman of NASDAQ, who recently admitted to running a massive investor fraud, the largest Ponzi scheme in history and has since been sentenced to 150 years in jail. He founded the Wall Street investment firm, Bernard L. Madoff Investment Securities in 1960 which was one of the largest in all of Wall Street.

Madoff was arrested last year after he confessed to his sons that he had swindled investors of roughly \$50 billion dollars of his investors' money.

**How does an investment firm counteract the comparison to Madoff and the concept of a Ponzi scheme? This problem has caught many money managers around the world off guard and has caused them many sleepless nights.**

What do well-run firms have that Madoff did not? Firstly they do not run a Ponzi scheme but at times that reality falls on deaf ears.

Good firms do real work and care for their clients. They work from the basis of client interests first and they buy real assets and manage those assets to the best of their ability.

They report consistently and honestly on the affairs of the investments.

They allow and encourage investors to ask tough questions and they answer those questions quickly and in detail.

They function well within the regulatory regimes and adhere to generally accepted principles of prudent management and accurate and timely reporting. They deal with concerns and complaints by investors in an orderly and thought out fashion.

They have checks and balances in place such as controls on cash and cash equivalents. There is separation of duties between deal making, review, analysis, administration and enforcement. Audits are frequent and auditors' recommendations are considered by management. Changes are made in an orderly fashion.

A governance model is in place and reviewed often. Changes are made to address market realities.

**W. A. Robinson & Associates Ltd and Pillar Financial Services have been committed to these principles since inception and will continue to adhere to them.**

**We can provide you with some professional references that you are most welcome to contact and ask about our systems and processes.**

**Our banker:**

**Ms. Sandra White  
Investment Manager  
Royal Bank of Canada  
Sharbot Lake, Ontario KOH 2PO  
(613) 279-3980  
Fax 279-2173**

**Our lawyer:**

**Kenneth W. Smith**  
**Barrister and Solicitor**  
**27 Foster Street**  
**Perth, Ontario K7H 3E3**  
**(613) 267-5910**  
**Fax 264-0789**

**Our Securities lawyer:**

**Martin Aquilina**  
**Gowlings, Lafleur, Henderson**  
**Barristers and Solicitors**  
**160 Elgin St.**  
**Ottawa, Ontario K1P 1C3**  
**613-786-0170**

**Our company and principals are in good standing with the following regulatory and professional organizations:**

1. Ontario Securities Commission [www.osc.gov.on.ca](http://www.osc.gov.on.ca)
2. L'autorité des marchés financiers [www.lautorite.qc.ca](http://www.lautorite.qc.ca)
3. The Institute of Financial Analysts, (Toronto Society) [www.cfainstitute.org](http://www.cfainstitute.org)
4. The Institute of Advanced Financial Planners, [www.iafp.ca](http://www.iafp.ca)
5. Financial Planners Standards Council of Canada, [www.fpsccanada.org](http://www.fpsccanada.org)
6. Real Estate Institute of Canada, [www.reic.ca](http://www.reic.ca)
7. Canadian Institute of Lenders and Mortgage Brokers, [www.caamp.org](http://www.caamp.org)
8. Society of Trusts and Estate Practitioners. [www.step.ca](http://www.step.ca)

**I thought I should also outline how our underwriting and administration process works. Firstly, I will outline our investment strategies for MICEO.**

***Investment Strategies***

The Corporation's business consists in lending money, principally to individuals, for the purposes of acquiring, developing, maintaining or upgrading residential and other real property, against the security of a mortgage granted on such property. The purchase of a single security, namely, the Common Shares, allows an investor to participate with other investors in a common fund holding a variety of mortgages.

The Corporation works closely with retail mortgage brokers throughout Ontario and western Quebec in order to market itself as a lender of choice in the non-conventional

mortgage market segment. In this manner, it expects to be well positioned to receive referrals on mortgage lending opportunities that do not meet the criteria of the major lending institutions and/or will involve borrowers in rural areas typically not well serviced by major lenders. As a result, the Corporation's investments in non-conventional mortgages are expected to earn a higher rate of interest than is generally obtainable through usual mortgage lending activities. In furtherance of its strategy, the Corporation:

- (i) will make loans in amounts up to 80% of the fair market value of the mortgaged property, subject to certain restrictions, as more fully set out under "Investment Restrictions", for initial terms of up to five years;
- (ii) may from time to time engage in bridge financing activities including the financing of new home construction;
- (iii) targets that at least 70% of the mortgages held will be as first mortgagee and no more than 30% of the mortgages held will be as second mortgagee;
- (iv) allows for up to 49% of the mortgages held to be on commercial or mixed-use properties;
- (v) intends to generally invest in open mortgages carrying a fixed rate of interest;
- (vi) targets holding a cash or near cash position equal to approximately 5% of its total assets; and
- (vii) will not buy or sell mortgages in the secondary market, hold a fractional interest in a mortgage or participate in mortgage syndications except as provided under the Corporation's Investment Policies (see "Investment Policies" paragraph (vi).)

The Corporation maintains a revolving credit facility (line of credit) in the amount of \$3,000,000 with the Royal Bank of Canada. The facility is secured by an assignment of the Corporation's receivables, a general security agreement and a hypothec over the Corporation's movable property. The Corporation does not intend to pursue a leveraged investment strategy i.e., it will not borrow money (including drawing on its line of credit) in an attempt to increase the Corporation's returns by taking advantage of the difference between the interest earned on the loans made by the Corporation and the cost of borrowing the money to make such loans. The line of credit will instead be used to smooth out the Corporation's cash flow. In effect, the timing of large cash inflows from mortgage payments and new investments is unpredictable, as is the need for funding investments. The facility allows the Corporation to maintain its liquidity requirements within the limits of its investment policies while placing a higher continuous percentage of its assets in its mortgage portfolio. Used in this way, the availability of this line of credit ultimately enhances the overall return of the Corporation.

### ***Operating restrictions***

The Corporation's investment practices are subject to certain operating, lending and other restrictions which have been adopted by the Board of Directors. According to these restrictions, the Corporation *may not*:

- (i) make a mortgage loan if, immediately after the closing of the loan transaction, the amount so lent would be greater than 10% of the book value of the Corporation's net assets;
- (ii) guarantee securities or obligations of any person or company;
- (iii) engage in securities lending;

- (iv) engage in derivative transactions for any purpose;
- (v) lend money on the security of a mortgage, unless an independent appraisal by a qualified appraiser of the real estate which is the primary collateral for the loan, has been obtained;
- (vi) develop, manage or acquire (except by foreclosure or other enforcement of its rights as mortgagee) any real property;
- (vii) enter into a forward commitment binding on the Corporation unless the Corporation has, at the time such commitment is made, sufficient cash or “near cash” securities to fund the loan to which the commitment relates; or
- (viii) otherwise conduct its business in a manner that would cause the Corporation not to qualify as a “mortgage investment corporation” under the Income Tax Act (Canada) or that would result in the Common Shares not being a “qualified investment” for RRSPs, RRIFs RESPs, TFSAs and DPSPs under the Income Tax Act (Canada).

### ***Operating policies***

In addition to the foregoing operating restrictions, the Corporation adheres to the following operating policies:

- (i) the Corporation must obtain a Phase I environmental audit where the real estate to be provided as security for a mortgage loan is commercial property. Where the real estate is not commercial property, a Phase I environmental study will not be commissioned unless the Administrator deems such an audit to be necessary;
- (ii) the Corporation will obtain title insurance in respect of real property provided as security for a mortgage loan in such amounts and on such terms as the Administrator considers appropriate or, in the alternative, will obtain a favourable title opinion from a solicitor;
- (iii) the Corporation must establish and maintain property tax escrow accounts in respect of real estate property provided as security for a mortgage loan unless the Administrator has determined, under limited and exceptional circumstances, that the establishment of such an account is not necessary; and
- (iv) the legal title to each mortgage and other investments of the Corporation must be held by and registered in the name of the Corporation.

### ***Investment policies***

The Corporation has adopted certain policies which establish the investment criteria for the Corporation’s investments. By entering into the Management Agreement (see “Material Contracts – Management Agreement”), the Manager has agreed to abide by and apply these policies, which are as follows:

- (i) the Corporation is required to have at all times approximately 5% of its total assets in cash, “near-cash” securities (such as term deposits, guaranteed investment certificates or money market securities) or have cash readily accessible (for example, through a line of credit) in order to meet redemption requests (see “Redemption of Securities”). The Corporation must also be in a position to redeem a prior mortgagee's interest in a given property if the Manager considers that it would be advantageous for the Corporation to do so having regard to the market value of the property and the amount of mortgage debt due to the Corporation;
- (ii) the Corporation may not hold any indebtedness, whether by way of mortgage or otherwise, of a person who is a shareholder of the Corporation or of any other

person who does not deal at arm's length with the annuitant of an RRSP or RRIF which holds Common Shares;

(iii) the Corporation may not make any loan or investment which does not meet the "Canadian content" requirements of paragraph 130.1(6)(c) of the Income Tax Act (Canada);

(iv) the Corporation may not make a loan which, together with all other mortgage loans that have priority over or rank *pari passu* with such loan, exceeds 80% of the fair market value of the mortgaged property, except when: (a) such mortgage is insured under the *National Housing Act* (Canada) or any similar legislation of a province, or (b) the excess over 80% is insured by an insurance company registered or licensed under the *Insurance Companies Act* (Canada) or similar legislation of a Canadian province or territory;

(v) the Corporation may not make a loan secured by a mortgage on a property in which: (a) any senior officer or director of the Corporation, the Administrator or the Manager, or (b) any associate or affiliate of a person referred to in (a) has an interest as mortgagor;

(vi) the Corporation will consider holding a fractional interest in a mortgage or participate in a mortgage syndication only on an exceptional basis and only with the approval of the Board of Directors;

(vii) the Corporation will not trade in mortgages in the secondary market although the Corporation retains the ability, in exceptional circumstances, to assign a mortgage to a third party;

(viii) the Corporation may not hold a mortgage the term of which exceeds five years, but mortgages held by the Corporation may contain provisions permitting the mortgagor, when not in default, to renew the mortgage for one or more additional terms.

### **How do we receive mortgage applications, and how are they evaluated, reviewed, funded, registered and administered?**

All borrowers' applications come through the Mortgage Broker network across Ontario and Western Quebec through an electronic platform called Filogix. It comes ready to be underwritten by our staff. They carry out a full due diligence on the application and if it meets strict criteria, a conditional commitment is made back to the broker to present to the borrower and obtain their acceptance. When all the conditions are met then the final commitment is issued. The borrowers' legal counsel prepares all the documents for review by our legal counsel, Ken Smith, and upon his vetting, the mortgage is funded through the Royal Bank's RBC Express system. The borrowers' lawyer registers the mortgage before releasing funds and provides our office with a full reporting letter on the transaction along with a preauthorized payment plan. The file now goes to administration where the mortgage is set up on a electronic system called TEA which takes the monthly payments of interest, principal and taxes from each mortgagor.

Our CFO, Kevin Cruickshank, CA, each month prepares a profit and loss for the Corporation and prepares a dividend distribution report for the administration staff to increase the shares held in each investor account. Each quarter, the CFO prepares a detailed report to be presented to the Board of Directors where it is reviewed and approved. The Corporation is audited each year and the auditors' report is presented to the Audit Committee and then finally to the Annual General Meeting. The auditor is charged with the responsibility to report to the shareholders on all matters that might concern him on the operations and reporting of the Corporation.

All mortgages are registered without exception at the regional Registry offices in the name of the Corporation, Mortgage Investment Corporation of Eastern Ontario. The mortgages normally also call for title insurance on each property.

Additionally W. A. Robinson & Associates Ltd is required by law to report all complaints by investors directly to the Ontario Securities Commission and the L'authorité des marchés financiers. We are pleased that we have not had a complaint about our operations, staff or management since the system came into place in 2003.

W. A. Robinson & Associates Ltd is also fully bonded with Guarantee Insurance Company of America, (Institutional Bond 14) and carries as well, Errors and Omissions Insurance for \$5 million dollars. Both these coverages are relatively difficult to obtain and costly to maintain. We would be pleased to provide any investors with copies of either of these policies and proof of registration with any of the regulatory bodies mentioned earlier in the letter.

**We hope this article has given the reader some guidelines on what to look for when looking for investment counsel or money managers. An investor needs to understand the philosophies, policies and control over the investments. When an investor does their due diligence in checking out the people and organizations they entrust their money with, they go along way to protecting themselves.**

**Wayne A. Robinson, CFA**

President

Financial Planner, Investment Counsel & Portfolio Manager

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