

Research Study

**Collapse of Portus Alternative Asset
Management Inc. and Norshield Asset
Management (Canada) Ltd.**

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April 3, 2006

**Commissioned by the
Task Force to Modernize Securities Legislation in Canada**

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G. Wesley Voorheis is a Partner of Voorheis & Co. LLP which acts as a strategic advisor to institutional and other shareholders with respect to their investments in Canadian public and private companies. He has also acted as an advisor to a number of hedge funds in Canada and has recently been involved in the collapse of the Norshield Financial Group, an alternative investment manager based in Quebec. Prior to the establishment of Voorheis & Co. LLP, Mr. Voorheis was a partner in a major Toronto law firm.

I¹ set out below certain background information and the principal preliminary observations which I have drawn from my review of the collapse of (a) Portus Alternative Asset Management Inc. (“PAAM”) and Portus Asset Management Inc. (“PAM”); and (b) Norshield Asset Management (Canada) Ltd. (“Norshield”) and various related corporations. My review has been restricted to publicly available information relating to the collapse of PAAM and Norshield. The investigations conducted by the receivers of each of PAAM and Norshield are ongoing and additional material information relating to the collapse of these companies will likely be uncovered as these investigations continue. As a result, the observations contained herein are preliminary in nature and are subject to change as additional information relating to the collapse of Portus and Norshield becomes available.

My review was based primarily on the published reports of KPMG Inc. (“KPMG”), in its capacity as receiver of the property, assets and undertaking of PAAM and related corporations (which can be found at www.portusgroup.ca/sections/reports.html) and the First Report dated July 12, 2005 and the Second Report dated November 15, 2005 of RSM Richter Inc. (“RSM Richter”), in its capacity as receiver of the property, assets and undertaking of Norshield and related corporations. Particular reference should be made to the Ninth Report of KPMG dated September 19, 2005 (as it contains a detailed examination of the investment structures developed and marketed by Portus and the investments and transactions actually implemented by Portus) and to the Second Report of RSM Richter dated November 15, 2005 relating to Norshield. Copies of these Reports (with selected Schedules) are available² as Tabs A and B.

I have also had discussions with representatives of KPMG and RSM Richter with respect to the collapse of Portus and Norshield, but these discussions have, of necessity, been restricted to the statements made in their respective reports and other publicly available information relating to Portus and Norshield.

Notes:

¹ This memorandum was prepared by Wes Voorheis, a partner of Voorheis & Co. LLP. Mr. Voorheis is also the Manager Member of a Special Litigation Committee established in March 2004 to supervise certain litigation in which Cinar Corporation was then involved. This litigation includes litigation commenced by Cinar Corporation against Norshield, various related corporations and others.

² Copies of the documents attached as Schedules to this memorandum are available upon request from Wes Voorheis by e-mailing mmakar@voorco.com.

The investment structures employed by both Portus and Norshield were extremely complex. The Ninth Report of KPMG (at paragraph 6) states that “[t]he Investment Structures that were developed and marketed by the Portus Group are extremely complicated, and involve a series of sophisticated transactions. In addition, the funds received from the Investors flowed through a myriad of bank accounts in financial institutions both in Canada and other countries.” The Second Report of RSM Richter (at paragraph 11) states that: “[t]he Norshield Companies employed an intricate and complex corporate and investment structure involving multiple jurisdictions and corporations. The complexity of this structure made the Receiver’s task of identifying and recovering assets difficult, time-consuming and costly”.

Other factors which have made an examination of the collapse of Portus and Norshield difficult include that a significant number of documents and files were either removed from the premises of the companies or were otherwise unavailable to the Receivers. It appears from the reports of KPMG that attempts were made to destroy data contained in the electronic records of Portus and that the records of Portus were incomplete and in some cases non-existent. The Second Report of RSM Richter indicated that a significant number of documents and files were removed from the premises of Norshield prior to the arrival of RSM Richter, that there were indications that computers had been removed from such premises and that, based on its preliminary review, the available records of Norshield appeared to be “incomplete”. There was also a lack of co-operation with the Receivers by the respective principals and controlling shareholders of each of Portus and Norshield.

Selected Background Information

PAAM was registered as an investment counsel and portfolio manager and as a limited market dealer under the *Securities Act* (Ontario) (the “Act”). PAAM carried on the business of a portfolio manager and developed financial products for direct and indirect distribution to both accredited and retail investors. PAM was not registered. PAM was responsible for the marketing and distribution of PAAM’s portfolio management services and the financial products that were developed by PAAM. PAM was also responsible for maintaining the books and records of Portus.

The initial product offered by PAAM was units of a unit trust known as Market Neutral Preservation Fund (“MNPF”). The investment structure for MNPF, which was extremely complicated, is described in Part C of the Ninth Report of KPMG, and a diagram of the structure is contained as Schedule C-1 to the Ninth Report. MNPF was established in February 2003 with PAM as manager and PAAM as investment

advisor. Units in MNPF were sold by way of offering memorandum to “accredited investors” in Canada purportedly in reliance upon the accredited investor exemption.

PAAM subsequently altered its business model to enable it to offer its investment products to all investors rather than continuing to engage in the direct sale of units of MNPF to accredited investors. PAAM accomplished this by offering to manage the assets of clients of third party dealers on a discretionary basis. The Managed Account structure had the appearance of investors simply retaining a money manager who would invest their assets on a discretionary basis. Investors were told that the discretion would be exercised in a particular way and their funds invested in what was described as “Canadian Portfolio Securities” and other securities referred to in the discretionary management agreement which investors were asked to execute. These Managed Account structures involved the issuance of units of a series of trusts, known as BancNote Trusts (“BNTs”), to a corporation related to PAAM. Between July 2003 and February 2005, 12 different series of BNT units were offered. The BNT structures were to invest the assets they received in principal protected deposit notes of a major bank which would provide for the return on maturity of the principal amount invested plus an equity return that was linked to the value of the units of an offshore hedge fund that was to be managed by PAAM. Société Générale (Canada) was the issuer of these principal protected deposit notes. The KPMG reports indicate that no information was provided to Portus investors about the principal protected notes issued by Société Générale (Canada) acquired by the various BNTs.

An offering memorandum was provided to investors under both the MNPF structure and the Managed Account structures. No prospectus was ever issued by PAAM or PAM in respect of these Managed Account structures. Under the Managed Account structure, Portus appears to have taken the position that no prospectus exemption was required because, at least technically, no security was being sold (i.e., it was a portfolio management function only). This Managed Account structure is described in greater detail in paragraphs 62 and following of the Ninth Report of KPMG. A diagram of this structure is included as Schedule C-2 to the Ninth Report of KPMG.

KPMG stated in the Ninth Report that certain of the investment structures which were to have been established by Portus do not appear to have been established properly because PAAM did not purchase the securities for the Managed Accounts as it had promised in the relevant offering documents. Further, the supplemental trust indentures that were to be entered into for the purpose of establishing all but one series of the BNTs were never executed.

As KPMG noted, although a separate account should have been established for the cash and investments underlying each series of BNTs, all of the notes and uninvested cash received from the investors were co-mingled in the MNPF account.

KPMG also “identified possible fraudulent preferences and fraudulent conveyances” under the *Bankruptcy and Insolvency Act* (Canada).

According to OSC staff, Portus investors placed approximately \$800 million in Portus sponsored products. As at January 13, 2006, Portus assets located by KPMG included C \$133 million and U.S. \$36 million in cash as well as principal protected notes with a purchase price of \$529 million and a maturity value of \$611 million.

Norshield was registered as an investment counsel and portfolio manager, commodity trading counsel and commodity trading manager under Ontario securities law and as an advisor with an unrestricted practice under the *Securities Act* (Quebec). An affiliated company, Olympus United Group Inc. (“Olympus Group”), was registered as a limited market dealer and mutual fund dealer under the Act and was a member of the Mutual Fund Dealers Association of Canada. Norshield was the manager and advisor of a variety of hedge funds and alternative investment products offered across Canada by Olympus Group. These products were sold primarily as classes of preferred shares in Olympus United Funds Corporation (“Olympus Funds”), a Canadian corporation. Approximately 90% of the funds invested by Norshield’s retail investors flowed from Olympus Funds to Olympus United Bank and Trust SCC, a Barbados bank, and from there to Olympus Uninvest Ltd., a Bahamian corporation, and ultimately were paid to Mosaic Composite Limited (“Mosaic”), a Bahamian company, where they were invested. The ownership of Mosaic at the relevant time is unknown. In 2001, Olympus Group was created to market hedge fund products to retail investors.

By November 15, 2005, RSM Richter had recovered only \$4 million from the approximate \$132 million invested by Canadian retail investors in the Norshield group of companies. (RSM Richter had also identified an additional amount of approximately \$4.5 million of realizable assets of Olympus Bank) and efforts are currently underway to recover such assets.

The Second Report of RSM Richter stated (paragraph 101) that, in addition, “it would appear that more than \$350 million of investments by Institutional Investors and the Direct Uninvest Investors into Olympus

Univest remains outstanding". A copy of a corporate chart for Norshield is attached to the Second Report of RSM Richter.

In March 2004, Royal Bank of Canada issued Olympus United Univest Principal Protected Hedge Fund Linked Deposit Notes, Series I, pursuant to an Information Statement dated January 19, 2004. The return on the Notes was linked to the performance of a notional portfolio of a basket of hedge funds. The Basket Manager was Norshield whose objective was to achieve substantial capital appreciation while maintaining a low level of performance volatility through allocating assets to managers of hedge funds including affiliates of Norshield who collectively invested in a wide range of stocks, bonds, futures and other financial instruments.

RSM Richter was appointed monitor of Norshield and related corporations on June 3, 2005. (It was subsequently appointed as receiver.) The RBC principal protected notes were redeemed by RBC on June 10, 2005.

Principal Observations

I set out below my principal preliminary observations arising from my review of the collapse of Portus and Norshield. As noted above, these observations are preliminary in nature as they are based on publicly available information relating to the collapse of PAAM and Norshield. My observations are subject to change as additional information relating to the collapse of these companies becomes publicly available.

As noted above, the investment structures employed by both Portus and Norshield were extremely complicated and involved a series of sophisticated transactions. This complexity, when combined with the lack of co-operation from the controlling shareholders of the two companies and the unavailability, for one reason or another, of relevant documentation, has hindered the investigations into the collapse of Portus and Norshield and has made the task of the Receivers in identifying the flow of funds and recovering assets difficult. In the case of Norshield, it appears that there may never be a meaningful recovery of invested assets.

I have seen no evidence which leads me to conclude that the collapse of either Portus or Norshield was the direct result of an inadequate statutory regime or that these collapses could have been avoided if applicable securities legislation contained material restrictions or requirements relating to the actual operation of the business of either company. As indicated below, investors' monies were not invested as

indicated in the offering documents and were used in part to pay operating expenses (including performance and other fees), underlying documentation evidencing the investment structures was not properly put in place, investors' funds from different offerings of securities were co-mingled and not segregated by investment products and other conduct took place or is alleged to have taken place which is under investigation or regulatory scrutiny. I do not believe that additional substantive regulation would have prevented the collapse of these companies.

However, I do believe that enhanced regulatory oversight through a timely investigation or examination into the business and affairs of these companies would likely have revealed a handful of significant issues in the operations of these companies that could have led to an earlier discovery of what actually was going on at Portus and Norshield. I discuss this issue more fully below.

I also believe that the collapse of at least Portus may have involved substantial non-compliance with existing securities regulatory requirements. See the allegations in the OSC Staff Statement of Allegations relating to Portus below. In Norshield, no securities regulator has to date, to my knowledge, issued a statement of allegations against Norshield or its principals nor has RSM Richter, as receiver, issued a report in which it outlines or alleges any non-compliance with any applicable securities regulatory requirements.

In the case of Portus, one of the key issues is whether the securities being sold by Portus were suitable or appropriate investments for the investors (and the investors included tax deferred plans under the *Income Tax Act* (Canada)) and whether the dealers, financial planners and others who referred their clients to Portus fulfilled their responsibilities in terms of conducting due diligence on Portus or the investments to be made by their clients in Portus sponsored securities. Copies of the Advisor Information Guide and Referral Tool Kit dated March 2004 and the RSP Resource Kit dated January 2004 used by Paradigm Alternative Asset Management Inc. (now PAAM) to market its products are available² as Tab C. The management fees (a fixed fee of up to 2.25% and a performance fee of 18%), referral fees (4% to 5%), trailer fees (1% plus other performance fees), etc. paid in connection with the issuance and sale of PAAM's products were very high and were a red flag to some industry participants, causing them to avoid referring their clients to PAAM. The magnitude of the fees payable was a red flag to these industry participants prompting them to conclude that the prospect of a reasonable return on invested assets was unlikely (or worse).

On January 13, 2006, the OSC and the Mutual Fund Dealers Association of Canada issued a press release in which they announced a plan that would require “some 55 investment and mutual fund dealers to repay investors all fees” received from PAAM in connection with “client referrals”. In total, excluding fees that had already been recovered, about \$12 million in fees was paid out of funds invested in Portus to MFDA and IDA Ontario-registered dealers. The January 13, 2006 press release stated that:

“The OSC, the MFDA and the IDA have been reviewing dealer regulatory issues arising from the referral of clients to Portus. Regulatory issues arose from the due diligence process undertaken by dealers to approve referrals to Portus, the supervision of the appropriateness of client referrals and related compliance functions.”

The press release indicates that acceptance of the OSC and MFDA plan by a dealer would “resolve the regulatory issues in Ontario regarding dealer due diligence and supervision”. The plan required each dealer to submit its referral policies and procedures to the applicable SRO for review, and the dealer to correct any deficiencies in those procedures that were identified by the SRO. A copy of this press release is available² as Tab D.

In addition, it can be argued that Portus was doing indirectly what it couldn't do directly, i.e., it was, in effect, selling trust units directly to retail investors under the Managed Account structure without issuing a prospectus and in circumstances where no prospectus exemption was available. In substance, although not technically, investors under the Managed Account structure were effectively purchasing units of the trusts. PAAM was not registered as an underwriter and was therefore not qualified to effect such a distribution. Units of the trusts were issued to investors without compliance with the prospectus requirements of applicable securities legislation. (The trusts themselves acquired the principal protected notes issued by Société Générale (Canada) in reliance on what is now section 2.34 of National Instrument 45-106.)

On October 5, 2005, Staff of the Ontario Securities Commission issued a Statement of Allegations against PAAM and others in which OSC Staff alleged that Portus engaged in the distribution of securities without filing prospectuses contrary to section 53(1) of the Act in circumstances where exemptions were unavailable, or where reliance on exemptions constituted an abuse of the exemptions contrary to the purposes and objects of the Act, and that Portus traded in units of the trusts without being registered to do so contrary to section 25(1)(a) of the Act, in circumstances where exemptions were unavailable, or where

reliance on exemptions constituted an abuse of the exemptions contrary to the purposes and objects of the Act. The OSC Staff also alleged that (a) Portus did not properly collect and assess know your client and suitability information contrary to OSC Rule 31-505 in part because all clients were put into the same investment structure and no client applications were rejected for suitability reasons; (b) Portus maintained deficient and in some instances no books and records; (c) the activities of Boaz Manor, as associate portfolio manager, were not the subject of proper review by Portus' senior portfolio manager contrary to OSC Rule 31-502; (d) Portus engaged in improper or inadequate pricing of units of the trusts offered by it by calculating prices not in accordance with the manner of pricing disclosed in the relevant offering memoranda contrary to OSC Rule 31-505; (e) interim or audited financial statements of the trusts were not filed with the OSC contrary to the Act; and (f) Portus maintained inadequate policies, procedures and internal controls contrary to OSC Rule 31-505. OSC Staff also alleged that Portus misrepresented the nature of the investments being made by investors and the fees associated with these investments and that Portus' chief compliance officer failed in his responsibilities to be aware of the alleged deficiencies in Portus' operations. A copy of the Statement of Allegations by OSC Staff is available² as Tab E. To my knowledge, no hearing has yet been held by the OSC into the allegations made by OSC Staff against Portus.

I am not aware of any investigation that has been conducted to date to determine whether the accredited investor exemption relied upon by Norshield was abused by it in any jurisdiction in Canada.

As noted above, I believe that enhanced regulatory oversight including, in particular, periodic inspection by securities regulators, would likely have uncovered evidence indicating the true state of affairs of both Norshield and Portus. A timely investigation would have revealed that:

- a) investors' monies were not invested as indicated in the offering documents:
 - (i) in the case of Portus, "a significant amount of the Investor Funds received by the Portus Group was diverted for purposes other than investments" (Ninth Report, para. 98). In particular, investors' monies raised from the sale of units of the various BNT series were not used to purchase the portfolio known as "Canadian Portfolio Securities" as indicated in the offering documents and other aspects of the investment structure (i.e., supplemental trust indentures creating the BNTs) were never in fact created; and

- (ii) in the case of Norshield, it appears that investors' monies were flowed ultimately through to Mosaic and invested by Mosaic. RSM Richter has been unable to determine who owned Mosaic at the relevant time and has been unable to determine what Mosaic has done with the investor funds. This flow of funds was not described in the Norshield offering documents;

- b) investor funds were used improperly including to pay operating expenses:
 - (i) in the case of Portus, the Ninth Report of KPMG indicates that approximately 13% of the assets invested by Portus investors were used for operating expenses (including the payment of performance and other fees) and for other purposes related to the conduct of Portus' business; and
 - (ii) in the case of Norshield, a significant portion of the investor funds were used to pay operating expenses for Norshield's business and were spent on speculative investments, some of which were in entities related or connected in some manner to Norshield or its principals (see pages 39 and 40 of the Second Report of RSM Richter);

- c) the monies raised by each of Portus and Norshield in connection with the sale of the hares of the various Olympus Funds in the case of Norshield or of units of the various BNT series or other investment products offered by Portus were co-mingled and not segregated by investment product or issuer;

- d) in the case of Norshield, the net asset values of the various investment funds may have been calculated improperly, i.e., inflated. The management fees payable to Norshield were based on these net asset value calculations. As RSM Richter indicated in paragraph 17 of its Second Report: "The method of calculation of the Net Asset Values used by the Norshield Companies, Olympus Uninvest and Mosaic ... may have resulted in incorrect and possibly inflated subscription and redemption values. ... approximately 90% of Retail Investor funds flowed from Olympus Funds, to Olympus Bank, to Olympus United and ultimately were invested into Mosaic through the purchase of shares in that entity. To the extent the underlying value of certain of the assets of Mosaic were impaired and it could not fulfill its obligation to Olympus Uninvest, the values at which the shares of investors

(throughout the investment chain) were subscribed for and/or redeemed would have been inflated. In addition, any inflated redemption values could have contributed to the lack of liquidity of the Norshield Companies and Olympus Uninvest.”;

- e) an audit or investigation of Portus would have revealed a tremendous growth in assets under management at Portus B knowledge of this growth in assets to someone monitoring Portus’ affairs would likely have been, in the circumstances, a red flag of something potentially amiss;
- f) the operations of both companies were dominated by one individual, and other employees did not have the decision-making or operational authority or knowledge that would have been expected in the circumstances; and
- g) there was no evidence (at least that I have seen) that the compliance officer of Portus was aware of the alleged deficiencies in Portus’ business and the true state of affairs at the company.

My investigation did not extend to whether the outside auditors of Norshield or Portus or their respective compliance officers were aware of any of the evidence relevant to the respective collapse of the companies. I am not aware of any investigation which has been conducted to date relating to the conduct of the various third party service providers to Portus and Norshield or what responsibility, if any, such service providers have in connection with the collapse of these companies.

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