Agencies battle over who dropped the ball as PACE credit union back under regulator’s control

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The abrupt resignation of PACE Savings and Credit Union’s entire board, CEO and another top executive was announced in a sparse news release shortly before 10 p.m. on a Friday night in November – a time often chosen to spare bad news from getting too much attention.

The short announcement gave little hint of the drama that had caused the scandal-plagued credit union to fall back under the full control of Ontario’s financial regulator just months after new leadership had been put in place to revamp its operations.

If anyone assumed that PACE’s problems were behind it when a regulator seized control of the credit union in the fall of 2018 and cleared out its senior ranks, they were mistaken. This most recent mass exodus of directors and senior executives is only the latest twist. It comes as hundreds of investors are looking to sue the credit union and former executives who ran its securities dealer subsidiary, Pace Securities Corp., over $49-million in losses they suffered on investment products sold to them over a two-year span. Some of those investments were sold to clients after regulators took control, and investors allege they were misrepresented as less risky than they actually were.

What should have been a comeback year for PACE, which is based in Vaughan, Ont., instead fell apart in a behind-the-scenes clash with its regulator, the Financial Services Regulatory Authority of Ontario (FSRA). The Globe and Mail has learned that an escalating dispute with the credit union’s new leaders over a potentially messy lawsuit seeking compensation for the investors’ losses, and a failed attempt to settle it quickly, opened a deep rift between the FSRA and the board of directors it had hand-picked in January to help put PACE back on track.

The two sides could not agree on who should share the blame for any harm done to members and investors – from the FSRA itself to low-level employees in the credit union’s branches. PACE’s leadership felt that the FSRA was partly responsible, according to multiple sources with knowledge of the dispute.

Those sources noted that the regulator had full control and oversight over the credit union when the ill-fated investment products were still being sold to investors. And they claimed that the FSRA had a chance to prevent losses before those investments cratered in value, but missed or ignored warning signs that something was wrong.

The FSRA, in turn, strenuously denies responsibility. The regulator remains laser focused on the “root cause” of the problem – alleged misconduct by the people at the securities dealer, Pace Securities Corp., and at the credit union who created and sold the investment products, according to FSRA chief executive officer Mark White.

Tensions came to a head in November when PACE’s directors and senior officers balked at the FSRA’s insistence on taking full control over handling the lawsuit, according to the sources and confidential internal documents.

The Globe is not identifying the sources because they were not authorized to discuss sensitive discussions between the credit union and its regulator.

The split between the FSRA and PACE’s leadership also reveals a rare glimpse of direct confrontation between the FSRA and another regulator. The Investment Industry Regulatory Organization of Canada (IIROC), which supervises investment dealers, flagged an array of concerns about Pace Securities in mid-2019.

But the FSRA and IIROC butted heads about whether the dealer had done anything wrong, according to sources and internal correspondence. While the FSRA tried to clear Pace Securities to get back to business, IIROC kept pressing for tougher restrictions to reform the dealer’s governance.

Throughout 2020, PACE was still under the FSRA’s close watch as a refreshed board and executive team worked to clean up deep-rooted problems in the credit union’s internal controls and loan books. But the regulator had gradually given more control to PACE’s leaders as the credit union regained solid footing.

The November confrontation over the Pace Securities lawsuit derailed that turnaround plan, as the credit union’s directors and officers accused the FSRA of flawed oversight, alleging that it had failed to protect investors from devastating financial losses.

Deep-rooted problems at PACE had first surfaced in the fall of 2018, leading to lawsuits over allegations of fraud and self-dealing by former PACE executives.

Seven months earlier, PACE’s future looked more promising. New management had begun to clean up an array of governance problems and legal issues plaguing the credit union, which were created under previous leadership.

Deep-rooted problems at PACE had first surfaced in the fall of 2018, leading to lawsuits over allegations of fraud and self-dealing by former PACE executives. The Deposit Insurance Corporation of Ontario (DICO), a predecessor regulator to the FSRA, uncovered a tangled web of suspect deals and payments and fired PACE’s long-time president and chief executive, Larry Smith, and his son Phillip Smith, who had taken over as CEO.

Both men have denied any wrongdoing. But the regulator alleged in court filings that it had uncovered a pattern of secret commissions and questionable dealings that were facilitated by former board members, who were also let go in 2018.

Since then, the credit union has been closely supervised and, at times, managed by regulators – first by DICO, and then by the FSRA since June, 2019. The regulators seized control of PACE as its administrator – a regulatory power reserved for stabilizing financial institutions in serious distress.

The hands-on role that DICO and the FSRA played in running PACE as administrator – including during a nine-month stretch from 2018 to 2019 when the investment products at the heart of the current lawsuit were still being sold to investors – is central to the FSRA's dispute with new directors and executives who were hired later to run PACE.

The investments were in preferred shares – a type of product that paid annual dividends and had characteristics of both stocks and bonds. They were issued by two companies controlled by then-Pace Securities CEO Joseph Thomson: Pace Financial Ltd. and First Hamilton Holdings Inc.

In most cases, the shares were sold by investment advisers at Pace Securities, but at times they were also sold through PACE Credit Union – an apparent breach of the law. Many people who bought the shares from 2017 to 2019 were unsophisticated investors aged 60 to 90 who put in tens or hundreds of thousands of dollars they had saved for retirement.

The preferred shares were underpinned by a basket of high-yield corporate bonds purchased, in part, with borrowed funds. But those underlying investments blew up early this year under pressure from margin calls made by Laurentian Bank Securities – the carrying broker for Pace Securities – and a plunge in markets after the first wave of the novel coronavirus arrived in North America.

By late April, shares purchased for $10 each were worth $1.62 and $1.44, respectively, wiping out $49-million in value. In mid-May, the FSRA and PACE chose to wind up Pace Securities rather than spend more money trying to rescue it.

Neither of them anticipated the damage that decision would cause. Panicked investors flooded PACE with calls, alleging that they had been led to believe the preferred shares were low-risk investments, akin to a government bond. In a matter of months, those complaints coalesced into the current lawsuit against Pace Securities, on behalf of about 700 investors.

In an early demand letter, a portion of which was reviewed by The Globe, lawyers at Paliare Roland Rosenberg Rothstein LLP sought to recover as much as $60-million in compensation for investors – a crippling sum for a financial institution of PACE's size, if not for insurance policies that could help offset some of the lawsuit's costs.

As PACE's board and management made early attempts to settle that claim quickly, tensions with the FSRA started to simmer. Lawyers for the credit union produced legal opinions arguing that the FSRA was partly responsible for the alleged harm done to investors.

The FSRA disagreed, insisting that liability rests with former leaders and staff at Pace Securities and the credit union who are alleged to have acted improperly, and with the credit union itself. As settlement talks stretched into October, lawyers at Paliare Roland circulated a draft order to start mediation that would have allowed the FSRA to participate. But the court order stated the regulator would not be a party to the litigation, according to documents reviewed by The Globe.

The board and executives at PACE pushed back, arguing that the FSRA should not be released from being named as a defendant in the lawsuit, sources said. The regulator has its own insurance policy protecting its directors and officers, and the credit union's management hoped that policy could be a source of funds to help compensate investors.

The FSRA believed it was already in charge of the credit union's response to the litigation over Pace Securities, as an extension of earlier legal matters still dogging the credit union. But to assert its authority, the regulator drafted a new administration order that would have clearly removed decision-making powers over the lawsuit from PACE's officers and directors.

Though the FSRA would not be named in the initial lawsuit brought by Pace Securities investors, the new order would allow PACE to file a separate claim against the FSRA to recover funds after the initial lawsuit was settled, according to sources. But it was unclear whether such a claim would succeed, as the FSRA insisted it had acted appropriately.

"I've always said, if FSRA's liable, we should pay," said Mr. White, the regulator's CEO, in an interview. "We just don't see anything that makes us liable."

Sources say PACE's officers and directors questioned whether the right to make a separate claim was a hollow offer, fearing that a settlement with investors could leave the credit union too financially drained to launch a further claim against its regulator.

But they also raised a far more serious question, sources said: whether FSRA was in a conflict of interest when using its powers as administrator to keep itself clear of the investors' litigation. As it happened, the new administration order was never issued, because tensions reached a flashpoint.

On Nov. 17, Mr. White called a virtual meeting with PACE's board.

The draft administration order was one item on the agenda. Others included the regulator's "serious concern" that PACE was not providing it with enough information. And Mr. White said the credit union had not made progress on a promise to consider

creating a recovery fund to give temporary help to investors facing financial hardship because of the losses they had suffered.

“Everything comes back to, what is the credit union’s obligation to its members?” he said. “And I was concerned that was getting lost.”

But he also discussed a plan that provoked a strong reaction from PACE’s board members. The FSRA intended to issue a compliance order against the credit union that would sanction some staff – including lower-level employees involved in selling the preferred shares. Penalties could include clawing back commissions earned from selling the shares, mandated training or other forms of remediation.

“People who participated in breaking the law shouldn’t be free of consequences. I think the credit union owes that to its members,” Mr. White said in his interview with The Globe. “And more importantly, there should be stronger sanctions against the people who orchestrated or were complicit in this [preferred] share program at the credit union, who broke the law.”

But some of PACE’s directors and executives felt the FSRA was unfairly blaming front-line employees who carried out duties imposed on them by senior managers through training and incentives, sources said. Directors were also wary of the impact that a compliance order against the credit union might have on their reputations, even though the alleged misconduct took place long before they joined PACE.

The meeting proved to be the final straw. PACE’s board chair George Cooke – a former insurance executive who was part of a three-member expert panel who recommended the creation of the FSRA four years ago – resigned that evening. Within days, the remaining eight board members, as well as CEO Barbara Dirks and chief risk officer Terri O’Brien, also stepped down.

The former directors and officers either declined to comment or did not respond to The Globe’s requests for comment.

“I was very disappointed when the board resigned,” Mr. White said. “People, at some point, have to protect their own interests when they feel that they’re in an impossible position. And so I knew this might happen.”

On Nov. 20, the FSRA seized full control of PACE as administrator once again, and hired a new CEO, David Finnie, three weeks later.

One undercurrent to the FSRA’s clash between PACE’s officers and directors was the regulator’s other long-running dispute – this one with IIROC, which had been investigating concerns over Pace Securities since mid-2018.

In late June, 2019, IIROC raised several concerns over governance and compliance at Pace Securities, as well as its role in selling the preferred shares, and asked the FSRA to use its position as administrator of PACE, which owned the dealer, to help.

The FSRA hired third-party experts to look into IIROC's concerns and halted the further sale of preferred shares. It also added FSRA senior legal counsel Paul Dempsey and Mitch Vininsky, a managing director at KSV Advisory who has been deeply involved in PACE's administration, to the Pace Securities board to oversee the probe.

When the FSRA's consultants produced their final reports in early November, 2019, the regulator's executive vice-president of legal and enforcement, Jordan Solway, wrote a letter to IIROC saying the reviews found "no areas of concern regarding [Pace Securities'] operations that cannot easily be addressed or which potentially give rise to a risk of public harm," according to a copy obtained by The Globe. As a result, he planned to "let [Pace Securities] resume normal operations."

At the time, the FSRA had decided that PACE should no longer own an investment dealer and, as administrator, was trying to sell the dealer.

Mr. Solway wrote in his letter that the FSRA investigated IIROC's concerns "for the express purpose of maximizing value for the Credit Union members by remediating any issues and carrying out the Administrator's ultimate objective of selling [Pace Securities] to its current management."

IIROC wasn't satisfied. On Nov. 28, 2019, a senior official responded with a letter voicing "major concerns" IIROC still had about Pace Securities and the preferred shares, and reservations about the reports by the FSRA's consultants. On Jan. 15, 2020, IIROC handcuffed a sale of Pace Securities by imposing terms and conditions on the dealer. Last June, it launched disciplinary action against Mr. Thomson, the former CEO, and former chief compliance officer Gerald McRae.

Mr. Thomson disputes the allegations, and Mr. McRae has declined to comment on the matter. IIROC spokesperson Andrea Zviedris also declined to comment on an active enforcement matter.

Directors and officers at PACE who resigned in November felt that the FSRA's insistence that Pace Securities had no major issues, even after IIROC disagreed, marked a missed opportunity to uncover wrongdoing at a time when the preferred shares could have been unwound with most of their value intact.

As PACE's lawyers tried to lay the groundwork to settle the investors' lawsuit this fall, they sent letters in early October to potential defendants – including the FSRA and Mr. Thomson. In a letter obtained by The Globe and Mail, lawyers alleged that one of the "fundamental failings" by credit union managers overseen by the FSRA as well as Pace Securities executives was "the vigorous and sustained defence of [Pace Securities] and the sale of the preferred shares against IIROC and [Laurentian Bank Securities]."

But the FSRA's CEO, Mr. White, disputes that claim. He said when IIROC approached the FSRA as administrator of the credit union, "we were actually not a regulator per se at that time," but acting instead "on behalf of the credit union as a responsible owner" of Pace Securities.

"We hired experts to conduct an investigation and we relied on that work of the experts," he said.

Mr. White also said there is an "extremely high bar" for finding a regulator negligent when it is acting as an administrator. "The policy is that you want to have the regulators coming in to intervene in a fearless manner to remediate the harm."

A second attempt to settle the investors' claims is now under way. On Dec. 22, lawyers at Paliare Roland filed a motion to enter mediation early next year, with the FRSA once again exempted from being named as a party.

The lawsuit still hangs over PACE as the FSRA tries once more to nurse it back to full health. Mr. White said PACE is viable as a credit union and has a "foundation for success," with a new CEO, most members staying loyal and solid capital levels and liquidity. He still hopes to return the credit union to members' control when a solution for the Pace Securities investors can be reached.

"Investors get harmed by the bad actors," Mr. White said. "They're the cause of the harm. I know it would be great if the regulators found the harm sooner and stopped it sooner, but let's remember, the people that caused this harm, they're the ones that should really be held to account."

HOW THE PACE CREDIT UNION SAGA UNFOLDED

September 28, 2018:

PACE Savings and Credit Union is placed under administration by a regulator, the Deposit Insurance Corp. of Ontario (DICO), which cited governance issues and alleged fraud and self-dealing by top executives.

June 8, 2019:

The Financial Services Regulatory Authority of Ontario (FSRA) is launched by the Ontario government, amalgamating two previous regulators – DICO and the Financial Services Commission of Ontario (FSCO) – under a single body to supervise the province's credit union sector. FSRA assumes oversight of PACE.

Late June, 2019:

Another regulator, the Investment Industry Regulatory Organization of Canada (IIROC) – which oversees investment dealers – raises concerns with FSRA over alleged governance issues and conflicts of interest at Pace Securities Corp., the investment dealer subsidiary of PACE, as well as the way it sold risky preferred shares to investors.

November, 2019:

FSRA tells IIROC that a review of Pace Securities by third-party consultants found "no areas of concern ... which potentially give rise to a risk of public harm." IIROC responds by repeating its "major concerns" about Pace Securities.

January 29, 2020:

Members of PACE elect a new board of directors for the credit union, the candidates recommended by FSRA after a search by executive recruiters, putting in motion a transformation plan to put PACE back on solid footing.

May 14, 2020:

After the preferred shares sold through Pace Securities suffer heavy losses over several months, FSRA and PACE decide to wind up the investment dealer, cementing $49-million in losses suffered by about 700 investors.

August 10, 2020:

Facing a potential lawsuit from investors, PACE announces it will try to negotiate a settlement with investors who suffered losses from preferred shares sold through Pace Securities and the credit union.

November 17, 2020:

Tensions over the handling of investors' claims against the credit union and Pace Securities come to a head at a meeting of the credit union's board, called by FSRA CEO Mark White. PACE board chair George Cooke resigns.

November 20, 2020:

FSRA takes full control of PACE after the resignations of several of the credit union's board members, its CEO and chief risk officer.