BEFORE THE APPEAL BOARD OF THE FINANCIAL SERVICES BOARD

In the matter between

JOHANNES CORNELIUS VAN DER MERWE First Appellant

JOHAN C VAN DER MERWE MAKELAARS BK Second Appellant

and

DESIREE LUDEWIG Respondent

DECISION

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[1] The Ombud for Financial Services Providers found that first appellant, acting on behalf of second appellant and in the course of their business as financial services providers exempted in terms of the Financial Advisory and Intermediary Services Act 37 of 2002 ("the Act"), had been negligent in causing the respondent to invest in a company conducting trade in foreign currencies which, within a few months , went into liquidation , thus resulting in the loss of the investment. The Ombud held that although the liquidation, and consequently the loss, had been due to the fraudulent operation of the investment company, the loss was directly attributable to the negligence. The respondents were accordingly ordered to compensate the respondent in the sum of R468 159.62 plus interest, hence the appeal.

[2] As first appellant was all along acting as sole member and representative of his close corporation it is convenient, and appropriate, to refer to him and them in what follows as "the appellant".

[3] The investment company was Leaderguard Spot Forex Limited ("LSF") which was registered ,and carried on business, in Mauritius from early in 2003 until its liquidation on 24 March 2005. Its marketing company, Leaderguard Securities (Proprietary) Limited ("LS")

had commenced business in Durban about two years earlier , itself conducting foreign exchange ("forex") trading but certain exchange control difficulties prompted the group of four South Africans who were essentially in control of the companies to move the forex trading activities to Mauritius and to establish LSF there. LS also went into liquidation in 2005. The events with which the appeal is concerned took place between July 2004 and the date of liquidation of LSF.

[4] It is not in dispute – indeed it is a fact notorious in the financial services industry – that the Leaderguard collapse, involving the liquidation of LSF and LS, was caused by fraud on the part of certain of the directors who concealed the fact of massive trading losses by issuing statements to investors falsely showing positive investment returns.

[5] The predominant issues in the appeal are whether the appellant was negligent in regard to the respondent's investment in LSF and, if so, whether such negligence caused the respondent's loss , that is to say, whether it caused that loss in the eyes of the law even if it certainly did cause it in fact.

[6] In concluding that the appellant had been negligent, the Ombud found that even a cursory investigation would have revealed that the LSF scheme was unsustainable by reason of the costs and commission which LSF was committed to pay (some 22.2% per annum) before it would have been at liberty to pay investors any return at all. The appellant was accordingly at fault for having failed to establish that and to desist from the investment. From the record it appears that it was only after the collapse, in the course of discussions between affected parties , that it was alleged that LSF was obliged to pay LS costs and commissions of that considerable, and probably crippling, order. Nothing in the evidence shows that this ground of unsustainability (if the allegation was true) was reasonably ascertainable by financial services providers at any time relevant to this case. Moreover, the appellant gave oral evidence in an application in terms of s26B of the Financial Services

Board Act 97 of 1990 preparatory to this appeal (and therefore such evidence was before the Ombud when the determination now on appeal was made) and it was not put to him by counsel for the respondent that he could and should have discovered and acted on the information relied on by the Ombud. It follows that such information should not have been taken into account against the appellant.

[7] There are various conflicts on record between the respective versions of the appellant and the respondent. It is not necessary for present purposes to resolve them. The essential question raised by the negligence issue is whether the appellant ought to have foreseen the reasonable possibility that the investment in LSF might cause the respondent loss. Since many well-known forms of investment carry some risk of loss in certain circumstances, the foresight concerned is one of loss beyond that which could reasonably be expected and one which, given the respondent's financial circumstances, it would have been unreasonable to contemplate her having to bear.

[8] In July 2004 the appellant was instrumental in the respondent's investing R600 000 in Forex trading investments : R150 000 in the name of her son in LSF and R450 000 in her name in an American forex trading company, Gain Capital. He was not then subject to the jurisdiction of the Act. He nevertheless recounted fully to her the contents of the promotional material put out by the two companies relative to investment in forex trading. He also offered to arrange for her to interview Leaderguard personnel but she declined. He had begun referring his clients to Leaderguard in 2002, having himself undergone what he called Leaderguard training in 2001. He had made Leaderguard investments for a number of investors and had encountered nothing untoward. In fact he considered, as at July 2004, that this type of investment was providing better returns than investment in shares or unit trusts. What the respondent claimed to want was moderate capital growth over several years.

In completing information for purposes of these investments he recorded her net asset worth

in US Dollar terms as 343 442 i.e. at then prevailing exchange rates, between R2 million and R2.5 million. Accordingly, what was being committed to forex trading was between one-fifth and one quarter of that worth.

[9] By early November 2004 the Gain Capital investment had sustained a loss of about 10%. The respondent was dissatisfied with this. The upshot was that the balance of the investment in Gain Capital was switched to LSF and it is the investment in LSF at that time which is central to the negligence issue.

[10] The respondent claims to have been persuaded by the appellant to have made the switch. He says that he advised leaving the funds with Gain Capital. However that may be, the fact is that he remained involved as her financial adviser for the purposes of making this investment with LSF without dissuading her from pursuing it. He obviously did not feel so strongly about the matter that he thought it best to withdraw. It is not without significance that in his view the returns then being declared by LSF appeared to be good. He says he did not give the respondent advice as such on this occasion but what requires consideration is his placing the investment, seen in the light of what he conveyed to her some months before and what the relevant promotional material contains.

[11] For a start, the appellant should have been put on his guard by the alleged returns of LSF referring to the years before it began its business. That was something which ordinarily careful enquiry would have revealed to be misleading.

[12] Next, it is striking that both Gain Capital and LSF emphasise that investment in forex trading entails high risk and warn of the need to consider very carefully the investor's circumstances and financial resources. Given the relatively modest net asset worth of the respondent , one is left wondering at the outset about exposing a substantial portion of her net estate to such degree of risk when the object was to secure moderate growth over several years. Significantly, the marketing material of LSF, when referring to the types of investor

for whom forex trading is appropriate, only mentions one category of individuals and that is "high net-worth investors". The respondent did not fit that description.

[13] It is plain from his evidence that the appellant's knowledge of this kind of investment at the crucial time was limited to what he had been told by Leaderguard personnel and his understanding, also limited, of the marketing material.

[14] It is understandable to have regard to what an investment house says of its own product if

the object is to find out how the investment operates and what it is intended to achieve. But that is hardly the appropriate source of reliable information when what one is after is information as to the reliability and worth of the product. For that reason the respondent cannot be criticised for not accepting the offer to be told by Leaderguard staff what they said of it.

[15] As regards the marketing material , according to the appellant's understanding, the amount invested was only at risk in respect of 20%, while 80% was so secure as to be guaranteed free of risk. The relevant statements in the LSF material are these :

- "Capital invested has 20% stop-loss protection..."
- "Stop loss of 20%- maximum downside on capital is 20% of initial funds invested"
- "Maximum loss on Account 20% of initial invested capital".

Those are banner-type statements without any grammatical context. However, one then finds the following : "Mandates given on the moderate growth option limits the maximum draw down on invested funds to 20% of the original invested capital *at any given stage*". (Italics provided.) This suggests – or is at best ambiguous –that there is more than one stage when there can be a 20% draw down.

[16] More importantly, LSF's Risk Disclosure Notice contains the following warnings:

> "If you trade in futures, contracts for difference or sell options you may sustain a total loss of the margin you deposit with your broker to establish or maintain a position. If the market moves against you, you may be called upon to pay substantial additional margin

at short notice to maintain the position. If you fail to do so within the time required, your position may be liquidated at a loss and you will be liable for resulting deficit."

"Under certain trading conditions it may be difficult or impossible to liquidate a position. This may occur, for example, at times of rapid price movement. Placing a Stop-loss Order will not necessarily limit your losses to the intended amounts, because market conditions may make it impossible to execute such an Order at the stipulated price."

[17] Nothing in the respondent's investment limited the kind of transactions to which her funds

could be applied . She would have been exposed to the provisions just quoted. And the

second one speaks of a Stop-loss Order which can be placed. That is something different

from a 20% stop-loss provision applying across the board at all times.

[18] It is evident that there was no provision which limited only 20% of the respondent's investment to the risks of forex trading. Clearly the entire investment was exposed to loss. That was inherent in the nature of the investment. It was one into which the appellant should not, in our view, have allowed her to venture. In doing so, he failed to act as a reasonably careful financial services provider. The possibility of such loss in the ordinary course of forex trading was reasonably foreseeable. It follows that the Ombud was right to find that he was negligent in placing the residue of the Gain Capital investment in LSF.

[19] In finding that such negligence was the cause of the respondent's loss and that the appellant was liable to compensate her, the Ombud said this :

"The entire loss is directly attributable to respondents' negligence in placing complainant in a scheme which they did not understand. The 20% was not lost in legitimate trading, it occurred as a result of fraudulent conduct. Complainant was exposed to the fraud only because of respondent's conduct."

The reference to 20% was mistaken. Subject to the recovery of a liquidation dividend, the whole investment was lost. Furthermore, although it was correct to say that the respondent was exposed to the fraud only because of the appellant's conduct, that was all very well as far as factual causation of the loss was concerned. Plainly, her funds were in the hands of

LSF because of his actions. But for his conduct, she would not have suffered the loss. However, the law requires that for compensation for negligently caused harm to be awarded there must be not only a factual causal link between the negligence and the harm but also a causal link recognised by law.

[20] Principle and established case law (e.g. International Shipping Company (Pty) Ltd v Bentley 1990 (1) SA 680 (A)) says that legal causation requires that the negligence must be sufficiently closely or directly linked to the loss otherwise the loss will be too remote to found liability. That link will have existed in this case if the loss suffered by the respondent as a result of the appellant's negligence can be said to have been the reasonably foreseeable consequence of his conduct.

[21]The loss having flowed from the Leaderguard collapse and the liquidation of LSF, the question, then, is whether it was reasonably foreseeable that LSF was being operated fraudulently whether to the extent sufficient to cause its liquidation or at all.

There is nothing in the evidence to warrant that conclusion. Loss resulting from the ordinary consequences of forex trading was one thing; loss caused by wholesale fraud by those in control of the company was quite another. The latter kind of loss was not sufficiently connected to the negligence to result in there having been legal causation.

[22] For the respondent it was argued that the fraud merely accelerated what would in any event have been the total loss of the investment. However, the conclusion that the appellant's conduct exposed the respondent to reasonably foreseeable harm does not go far enough, and cannot go far enough, to establish, in the same breath, as it were, that such harm would probably, much less inevitably, have occurred.

[23] For these reasons the respondent should not have succeeded before the Ombud and the appeal must be allowed.

[24] There remains the question of costs. The appellant has obtained success but not on the

essential basis on which he fought the matter. He has not secured the overturn of the finding of negligence. He has escaped liability on a ground which does not bear on the matter of his conduct. In the exercise of the Board's discretion it seems to us that each side should bear its own costs.

[25] The Board's order is as follows:

1. The appeal is allowed. No order is made as the costs of the appeal.
2. The order of the Ombud is set aside and for it is substituted the following :

"The complaint is dismissed."

Dated this 23rd day of December 2011.

Judge C. T. Howie, Chair

J. D. Penna, Member

D. L. Brooking, Member