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COMPLIANCE & LEGAL  
SECTION

# *Conflicts of Interest & the Challenges They Present*

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# Overview

Seminar will cover both the retail and capital markets:

- Define Conflicts of Interest
- Discuss regulatory expectations
- Discuss how to identify and manage conflicts
- Discuss firm examples
- Discuss CIPF protection, including past insolvencies.

# What is a conflict of interest?

A conflict of interest arises when there is an actual or perceived conflict between the interests of one party and their duties, obligations and responsibilities towards another party.

# Types of Conflicts

- General Conflicts
- Firm vs Client Conflicts
- Client vs Client Conflicts
- Employee vs Client Conflicts
- Employee vs Firm Conflicts
- Third Party vs Client Conflicts

# What do the CSA and IIROC say about Conflicts of Interest?

- Identify material conflicts of interest that exist and that may arise
- Address actual or potential conflicts – consider, avoid, supervise
- Disclose unavoidable conflicts
- Develop and maintain written policies
- Educate and train all employees

# Internal Policy Expectations

- Ensure Policies and Procedures
- How do we monitor an existing OBA if new conflicts arise?
- Confirmation from employees that their OBA disclosure has not changed and if there is an update. It has been disclosed on a timely basis?
- Monitor attestations, terms and conditions

## Global Settlement Research Analyst Settlement US (April 2003, amended March 2010)

- 10 US firms signed; agreed to collectively pay disgorgement and civil penalties of US\$800MM + other costs
- Enforcement against 2 research analysts: Jack Grubman (\$7.5MM) and Henry Blodget (\$2.5MM)
- Found examples of “fraudulent research reports” or reports which were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about the covered companies, and/or contained opinions for which there were no reasonable bases
- Physical and economic separation between Research and Investment Banking: insulate Research from pressure from Investment Banking for opinions that assist Investment Banking to obtain mandates

# Rural/Metro Corporation

- Delaware Court found M&A advisor liable for US\$78.5MM in damages to shareholders of Rural/Metro after it advised company to accept a sale price of \$17.25 per share from a buyer from whom it was seeking a financing mandate; court found that actual value of share at the time was \$21.42 and ordered advisor to pay the difference between actual value and sale price (March, 2014, upheld on appeal in November 2015)
- Advisor also fined US\$2.5MM by SEC for “materially false and misleading statements in a presentation to” its client’s board which informed the disclosure in the proxy circular (August, 2016)
- Other Similar Cases: Del Monte Foods (Barclays), Kinder Morgan (Goldman Sachs)



# CIPF Protection

CIPF's involvement is triggered on member firm insolvency.

Member firms are investment dealers that are members of IIROC. These investment firms are also automatically members of CIPF.

Currently, there are more than 170 member firms.

CIPF covers missing property - this is property held by a member firm on behalf of a client that is not returned to the client following the firm's insolvency.

CIPF does not guarantee the value of the investments, or cover any drop in the value of the investments, even if the investment is in an entity related to the member firm.

# First Leaside Securities Inc.

## 2012 – Firm Suspension

- In 2012, FLSI was suspended by IIROC
- Type 2 Introducer
- 100% owned by holding company, FLWM
- One Principal owned more than 99% of issued shares of FLWM
- Two Principals were Directors of FLWM
- FL Group manufactured, marketed and sold units in limited partnerships and funds
- In 2013, an IIROC Hearing Panel permanently barred the two Principals from IIROC membership and imposed fines and costs.

### IIROC's Allegations against the Principals

*Misrepresentation of Fund Products*

*Misleading Marketing Material*

*Two Principals Failed to Give Consideration to the NAAFs*

*Two Principals Put Their Own Interests First in Soliciting Sales of FL Properties Fund*

*One Principal was in a Conflict of Interest*

# Graydon Elliott Capital Corporation

## 2007 – Firm Suspension



In 2007, GE was suspended by the IDA



Type 2 Introducer



100% owned by holding company, Graydon Elliott Capital Partners (GECP)



Many of the claimants' losses related to high-yield promissory notes issued by GECP



GE reached a settlement agreement with the IDA under which GE agreed not to contest the Suspension Order. Its membership was terminated by the IDA.

# BlackRock Case

- April 20, 2015 – SEC Charged BlackRock Advisors LLC with breaching its fiduciary duty by failing to disclose a conflict of interest created by the outside business activity of a top-performing portfolio manager.
- BlackRock agreed to settle the charges and pay \$12 million penalty. The firm also must engage in independent compliance consultant to conduct an internal review.
- Daniel Rice was managing energy-focused funds and separately managed accounts at BlackRock when he founded Rice Energy and personally invested approx. \$50 million in the company. Rice Energy later formed a joint venture with a publicly-traded coal company that eventually became the largest holding (almost 10%) in the \$1.7 billion BlackRock Energy & Resources Portfolio (largest Rice-managed fund).

# BlackRock Case (continued)

- SEC's order found that BlackRock knew and approved of Rice's investment and involvement with Rice Energy as well as the joint venture, but failed to disclose this conflict of interest to either the boards of the BlackRock registered funds or its advisory clients.
- The SEC's order also found that BlackRock and its then-Chief Compliance Officer caused the funds' failure to report a "material compliance matter" – namely Rice's violations of BlackRock's private investment policy – to their board of directors.
- For details: [SEC Press Release](#)

# Compensation, Incentives, and Conflicts of Interest

- Certain referral arrangements
- Compensation heavily weighted towards sales activity and revenue generation
- Discretionary bonuses (no set bonus criteria)
- Monetary and non-monetary incentives to favour proprietary products
- Cross-selling incentives
- Manager compensation tied to staff sales/revenue targets

# Compensation, Incentives, and Conflicts of Interest (continued)

- Retroactive compensation increases
- Product and/or service specific promotions and competitions
- Deferred compensation
- Penalties for poor sales practices

# Questions from the Audience

1. An advisor has a client who is the founder of a public company (small cap); the advisor owns shares in that company and is also recommending shares of the company to other clients. The company has sponsored some of the advisors events. The advisor claims to have done due diligence and is comfortable recommending it to her clients. Is there any real or perceived potential conflict of interest and what is the dealer's position in this case?
2. How do you recognize the conflict between Legal, who put the firm first, and Compliance, who put the client first?
3. Since the topic will be conflicts of interest, I am curious regarding the ban on embedded commissions paper currently out for comment - in the industry there are various conflicts of interest that exist and generally the approach is to put controls in place to mitigate the risk of the conflict. With the ban on commissions the CSA seems to be skipping this to an outright ban. Wondering if the speakers have any thoughts on why this conflict would not be managed like others that exist.



## Questions from the Audience

4. How detailed should the disclosure be given to regulators (examples director or president of non-traded company, owner of a business that is in the process of winding down etc.)?
5. What is expected for the supervision of OBA's. Should supervisors be showing up at the church of a registrant acting as a deacon? Asking for minutes of a chamber of commerce meeting where a registrant is on the board? Getting a google map to "see" the real estate ventures?
6. Should a dealer approve an OBA of an insurance advisor to a licensed assistant (IR) to an IROC Advisor?

# Regulatory and Legislative References

- [IIROC Rule 29](#): Business Conduct
- [IIROC Rule 42](#): Conflicts of Interest
- [IIROC Rules Notice 13-0039](#) : Recommendations and best practices for distribution of non-arm's length investment products
- [Rules Notice 13-0163](#): Disclosure and approval of outside business activities
- [Rules Notice 16-0068](#) (April 6 2016) and [Rules Notice 16-0297](#) (December 15 2016): Managing Conflicts in the Best interest of the Client and Status Update
- [IIROC Rule 43](#): Personal Financial Dealings with Clients
- [IIROC Rule 3400](#): Research Restrictions and Disclosure Requirements
- [OSC Policy 33-601](#): Guidelines for Policies and Procedures Concerning Inside Information
- [National Instrument 33-105](#): Underwriting Conflicts
- [MFDA Rule 2](#): Business Conduct
  - Rule 2.1.4: Conflicts of Interest

# Regulatory and Legislative References (continued)

- **Universal Market Integrity Rule 7.7** – Trading During Certain Securities Transactions – prohibits dealer who is underwriting offering of illiquid securities from soliciting orders of to purchase those securities that trade on a secondary market, at certain prices levels
- [National Instrument 31-103](#): Registration Requirements and Exemptions. Principles-based, requires registrants to identify and respond to material conflicts of interest; contain, disclose or avoid
  - 13.4 - 13.6: Conflicts of Interest
- **CSA Staff Notice 31-343** (November 19, 2015) – Conflicts of interest in distributing securities of related or connected issuers.
- **National Instrument 81-102, Part 4** – Conflicts of Interest - prohibits a portfolio manager from investing a fund in securities, during and for 60 days after an affiliate or related parties are underwriting the securities, unless certain exemptions are met; self dealing – can't invest fund or enter into certain other transactions (securities lending, repurchase or reverse repurchase agreements) with parties related to the fund's administration and management, with some exceptions;
- **National Instrument 81-107**- Independent Review Committees for Investment Funds – IRC required for each publicly offered fund to opine on conflicts of interest matters referred to it by the Fund's manager

# CLS SUB-COMMITTEE EDUCATION

## REMINDERS

- For Conference call attendees, please send an email to [registrations@clseducation.ca](mailto:registrations@clseducation.ca) for your CE Credits.
- **Save the Dates:**

### 2017 Events

- Thursday June 15th, 2017, Breakfast Seminar, Topic TBA, Montreal QC
- Tuesday September 26th, 2017, Breakfast Seminar, Topic TBA, Toronto ON
- June 2017, The 7th annual CLS Education Golf Tournament & Dinner, Toronto ON
- Monday, December 4<sup>th</sup>, 2017 (**tentative date**), CLS Annual Compliance Conference, Toronto ON
- Tuesday December 5<sup>th</sup>, 2017, CLS Holiday Reception, Scotia Plaza, Toronto ON

# Thank You for Attending Today's Event

## QUESTIONS?