

## IIROC – CLS COMPLIANCE CONFERENCE 2013

# COMPLIANCE CONFLICTS CHALLENGE - FACTS SCENARIO

Early Stage Exploration Inc. (“ESE”) is a small mining company with its shares listed on the venture exchange. ESE is the brainchild of Kingsley Midas, a legend in the mining industry who is known as much for his sterling track record as for his larger than life ego. Kingsley Midas is ESE’s founder, Chairman and CEO and owns about 40% of ESE’s shares. Having made his fortune in mining gold and other precious metals, Kingsley Midas has decided to try his luck with mining rare earth elements. With three promising properties in West Africa, ESE hopes to one day become one of the leading producers of ipodium, a rare earth mineral used in the production of high-end smart phones.

Recently the spot price for ipodium has taken a hit as the smart phone market is starting to reach saturation at least in the near term. Fearful of missing out on the market cycle, ESE decides that it needs to raise money quickly to conduct the additional exploration and feasibility studies required to move forward with the development of its properties. ESE also owns the patent to an innovative, highly-experimental bubble-gum extraction technique which, if proven to be effective, could potentially reduce mining and processing costs significantly for ipodium and possibly other minerals as well. However, to date, ESE has not invested in the necessary research and the patent has sat dormant with ESE.

(1) Kingsley Midas calls up Jenny Dealmaker, his go-to investment banker at DealsRUs Securities, a small boutique dealer, to provide financing advice. Knowing that DealsRUs is also facing capital challenges and fearing a bought deal will not receive internal approval, Jenny recommends to ESE that the financing would be best conducted by way of a prospectus offering on a best efforts basis.

(2) Jenny Dealmaker goes home and tells her partner, Johnny Troll, that she has just landed a financing mandate with her star client. Recognizing ESE as Jenny’s star client, Johnny Troll reminds Jenny that his venture exchange-listed company, PatentTroll, is eager to obtain ESE’s bubble-gum extraction patent albeit at an opportunistic price. Jenny is also a director of PatentTroll. Seeing an opportunity for a second mandate from ESE with respect to the asset sale, Jenny promises to speak with Kingsley Midas about selling the patent to PatentTroll to raise additional money for ESE. Unbeknownst to Jenny, Johnny Troll purchases \$50,000 of ESE’s shares the next morning.

(3) Jenny calls Kingsley Midas proposing the asset sale of the bubble-gum patent to PatentTroll and suggests a reduced fee if both the financing mandate and the asset sale mandate are awarded to DealsRUs. Kingsley is receptive to Jenny’s proposal to monetize the patent. However, never one to give anything away for free, Kingsley tells Jenny he will convince ESE’s board to approve the sale of the patent to PatentTroll only if he personally receives a 9.9% interest in PatentTroll and that Jenny will need to ensure that a fairness opinion is provided to ESE’s board reflecting a nominal value for the patent. Jenny agrees to this. ESE agrees to award both the financing mandate and the asset sale to DealsRUs. DealsRUs proceeds to set up two separate deal teams - one for the prospectus offering and another for the patent asset sale.

(4) Since all of the investment bankers at DealsRUs are assigned to one of the two teams, Jenny asks Ricky Reporter, the firm’s research analyst, to prepare the fairness opinion for ESE’s board since Ricky will be restricted from preparing or issuing any research on ESE. Ricky is granted access to the dataroom containing detailed confidential information regarding ESE. Ricky ultimately determines to assign a nominal value to the patent since it is a non-producing asset on ESE’s books.

(5) Yesman is a senior associate with DealsRUs leading the prospectus offering deal team. Yesman calls Richgirl, an entrepreneurial billionaire, to try to get a sense of the market appetite and pricing range for such a share offering and stresses to her that the information is confidential. Richgirl becomes furious upon learning of ESE’s proposed share offering because it will dilute her current 9.9% of ESE’s outstanding shares and will likely cause ESE’s share price to drop. At the end of the call with Yesman, Richgirl immediately sells her entire holdings of ESE.

(6) Marta Hari, an IT summer student at PatentTroll, finds Johnny Troll’s notes on top of the photocopier describing ESE’s bubble-gum extraction patent as a game-changer that will revolutionize the entire mining industry. On her lunch break, Marta Hari sends an SMS message to Darryl Daytrader who immediately shorts \$100,000 of ESE shares and purchases \$100,000 of PatentTroll shares.

(7) As Yesman continues to conduct due diligence on ESE, she discovers, among other things, that ESE has entered into a series of consulting agreements with some number companies in West Africa. Yesman emails ESE and the rest of the deal team identifying the issue. Given the time constraints and wanting to keep everyone informed, she includes her preliminary analysis about the potential exposure if the consulting agreements turn out to be a scheme to corrupt foreign officials. When Kingsley Midas reads the email, he hits “reply all” saying “that’s just the way this business is done!” and that the consulting agreements are not relevant and should not be referred to in any way in the prospectus.

(8) As the day for filing the preliminary prospectus approaches, Yesman becomes increasingly concerned that Kingsley Midas has never attended a prospectus drafting session and is always travelling, making it impossible to schedule him for the oral due diligence session. Yesman raises this with Jenny Dealmaker who convinces her that, in the interest of time, it would be okay to proceed with only the CFO and VP Investor Relations attending the due diligence session via satellite phone from West Africa. One of the last due diligence questions is a query about new federal anti-bribery legislation in Canada and ESE’s compliance procedures. The phone reception is scratchy at best for the entire call and suddenly worsens. Yesman is quite certain she hears the ESE representatives state that there are not issues to discuss on that question and repeats the answer.

(9) The preliminary prospectus is finally filed and DealsRUs hits the ground running with its glossy roadshow PowerPoint presentation in hand. However, not even Kingsley Midas’s charisma and DealsRUs’s charts and graphs are enough to excite investors as the marketing process starts to fizzle. Kingsley Midas reaches out to Andy Adviser, a registered mutual fund representative and close personal friend, to see if he can assist with placing the remaining ESE shares with his high net worth clients and contacts. Andy Adviser (a former mining engineer) excitedly tweets to his numerous followers describing ESE as a leading ipodium mining company with projects in West Africa and patent owner of an experimental bubble-gum extraction process. He lavishly praises Kingsley Midas for his “golden touch” which has never lost money. The responding interest is overwhelming and the distribution is soon fully-subscribed. Andy Adviser claims he did not provide any investment advice regarding ESE and only forwarded the roadshow materials and preliminary prospectus to interested investors and helped them fill out the subscription agreements. Andy Adviser also helps investors fill out account opening documents to open online self-directed accounts with DealsRUs. Kingsley Midas instructs DealsRUs to pay Andy Adviser a finder’s fee for his participation in the distribution. DealsRUs sends Andy Adviser its standard referral agreement and insists that Andy sign it in order to be paid a referral fee.

(10) During the prospectus review process, ESE receives a detailed comment letter from staff at the Securities Commission. Among other things, they have concerns about ESE’s disclosure of its cash position and its operations in an emerging market economy. Separately, staff from the enforcement branch contact ESE and raise concerns over some irregular trading patterns in ESE’s stock. ESE refers the call to Jenny Dealmaker who suddenly realizes that there is no disclosure in the prospectus about the concurrent patent asset sale to PatentTroll. Relying on Johnny Reporter’s fairness opinion, Jenny determines that the asset sale is not a material transaction and decides not to advise the Commission about it. After clearing comments, the Commission finally receipts the final prospectus. As a result, the financing proceeds to closing.

(11) The closing of the financing is the last bit of good news for ESE. Shortly after closing, Marti Hari decides the world deserves know about bubble-gum extraction and tweets to her numerous followers about PatentTroll’s acquisition of the bubble-gum patent. As a result, the share price for PatentTroll skyrockets while the share price for ESE plummets. Trading in shares of PatentTroll and ESE are halted and investigations into potential insider trading of ESE and PatentTroll are commenced. Andy Adviser’s clients lodge complaints with securities regulators and threaten a class action suit. The Commission brings enforcement proceedings against ESE concerning, among other things, misrepresentations in ESE’s prospectus and the RCMP raids ESE’s offices as a part of an investigation into ESE’s consulting contracts in West Africa.

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