

## CSA Staff Notice 31-343

### *Conflicts of interest in distributing securities of related or connected issuers*

November 19, 2015

#### **Purpose**

Staff of the Canadian Securities Administrators (**CSA staff** or **we**) consider the identification of, and response to, conflicts of interest to be fundamental regulatory obligations. A registrant must manage conflicts that arise whenever it trades in or advises on securities issued by *related or connected issuers* (as defined in National Instrument 33-105 *Underwriting Conflicts*). Firms registered solely as exempt market dealers, that distribute securities of related or connected issuers with common mind and management (**captive dealers**) raise serious concerns in terms of how they respond to these conflicts of interest.

We consider a conflict of interest to be any circumstance where the interests of different parties, such as the interests of a client and those of a registrant, are inconsistent, competing or divergent. The inherent conflict of interest in the captive dealer business model may affect a registrant's ability to meet its know-your-client (**KYC**), know-your-product (**KYP**) and suitability obligations, and its duty to act fairly, honestly and in good faith with clients (**fair dealing duty**). National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) and its companion policy (**Companion Policy**) provide a principles-based framework that requires registrants to identify and respond to material conflicts of interest.

We think additional guidance (including “acceptable practices” and “unacceptable practices”) will help captive dealers meet their regulatory obligations. Although we intend this notice (**Notice**) to provide guidance to captive dealers, it may be useful to other registrants too. In this Notice, unless the context otherwise requires, a reference to registrants includes both firms and their registered individuals.

We intend this Notice to:

- set out our concerns with the conflicts of interest that arise from the captive dealer business model to help captive dealers decide how to respond to conflicts of interest by avoiding, or controlling and disclosing them
- suggest acceptable practices and unacceptable practices for addressing conflicts of interest
- outline what firms proposing to be captive dealers can expect when applying for registration
- outline what captive dealers can expect when CSA staff perform compliance reviews

#### **Registrant obligations**

##### *Conflicts of interest*

Registrants must comply with Part 13, Division 2 *Conflicts of Interest* of NI 31-103, which requires them to take reasonable steps to:

- identify existing material conflicts of interest and those that the firm reasonably expects to arise between the firm and a client, and
- respond appropriately to existing or potential conflicts of interest

The Companion Policy outlines three methods to respond to conflicts of interest: avoidance, control and disclosure. It also describes specific examples of conflicts of interest and gives guidance on how registrants can avoid, control and/or disclose them.

### *KYC, KYP and suitability*

Many prospectus exemptions allow issuers to raise capital from persons who can assess the merits of the investment without a prospectus. Certain of these investments are higher risk and often illiquid, and the information available to investors at the time of investment – and, in many cases, after investment – will be more limited. Any offering document used will not undergo prior review by the regulators, and the extensive continuous disclosure obligations on reporting issuers may not apply. Registrants play a critical role in ensuring that investors understand the risks associated with their investments and that the investments are suitable.

The KYC, KYP and suitability obligations and the fair dealing duty apply to all registered dealers and advisers, and apply to trades made under prospectus exemptions. CSA Staff Notice 31-336 *Guidance for Portfolio Managers, Exempt Market Dealers and Other Registrants on the Know-Your-Client, Know-Your-Product and Suitability Obligations* gives additional guidance on the applicable securities legislation requirements relating to KYC, KYP and suitability.

### **Concerns with captive dealers**

The captive dealer business model creates a material conflict of interest between the captive dealer's financial incentive to sell its related or connected issuer's securities, and its regulatory obligations, including KYC, KYP, suitability, and its fair dealing duty.

We have identified captive dealers who did not recognize that investors were their clients, instead treating them as clients of their related or connected issuers. A registrant's primary obligation is to ensure that the securities it recommends to investors are suitable for them.

The material conflict of interest inherent in the captive dealer business model gives rise to inconsistent, competing or divergent interests, which make it difficult for a captive dealer to fulfil its duties to investors objectively. We have identified the following problems among captive dealers:

- failing in their suitability obligations to investors because the registrant has poor product knowledge
- failing to disclose or providing inadequate disclosure to investors about related or connected issuers in cases where there is negative information (for example, where the issuer is experiencing financial difficulty), resulting in investors taking on more risk than they could bear or more risk than they wish to bear
- relying on related or connected issuers' product reviews and assessments to satisfy their KYP obligation, instead of providing a review or assessment independent of the related or connected issuer
- financial dependence on related or connected issuers, creating an incentive to distribute unsuitable products

- inadequate disclosure of significant fees and charges paid to related or connected issuers, in some instances for little or no apparent services performed, resulting in investors not understanding the costs associated with their investment
- related or connected issuers using the proceeds raised from their distributions for purposes other than those stated in their offering or marketing materials

CSA staff have identified the inability of captive dealers to identify and address conflicts of interest and the delegation of the suitability obligation as significant compliance deficiencies. We have taken regulatory action against registrants and issuers as needed, including suspension and referrals to enforcement.

### **Responding to conflicts of interest**

Captive dealers should avoid material conflicts of interest that they cannot address through controls and/or disclosure. Avoidance includes ceasing to provide a service, or dealing with a client, or not trading in a particular product or products. Captive dealers that solely or primarily trade in related or connected issuer securities are most at risk of being unable to address conflicts of interest through controls and/or disclosure. In this Notice, we provide suggestions to address conflicts of interest.

When we review captive dealer businesses, we will assess each business in relation to its related or connected issuers and their investment products, to assess the nature and severity of the existing conflicts of interest. In compliance reviews, we have seen instances where captive dealers could not demonstrate that they had met their conflicts of interest obligations under Part 13 of NI 31-103, because they did not:

- understand when, as a result of material negative changes to their business (for example, significant financial losses of a related issuer), they could no longer manage their conflicts of interest, and therefore should respond by avoiding them
- identify and document that they identified and responded to conflicts of interest, and why their response was appropriate
- assess each related or connected issuer product they sell in relation to each trade; instead they assumed that the suitability of one related or connected issuer product makes all of their related or connected issuer products suitable for an investor
- consider the concentration of related or connected issuer products in an investor's investment portfolio

We encourage captive dealers to:

- separate decision-making roles in related or connected issuer and dealer businesses
- establish policies and procedures that require an ongoing assessment of their captive dealer business models and the products they trade
- establish an independent review committee to conduct product due diligence and to consider on an ongoing basis whether to avoid, control, or disclose conflicts of interest
- consider offering securities of third-party issuers in addition to those of related or connected issuers, and ensure that dealing representatives are aware and understand that the firm offers a diversified product shelf
- provide balanced product training to sales staff by someone other than the issuer

- provide balanced training to sales staff outlining their responsibility to meet their KYP, KYC and suitability obligations

### **Captive dealers' registrant obligations**

Captive dealers that do not avoid conflicts of interest should demonstrate instead that they are controlling and/or disclosing them appropriately.

In our experience, captive dealers that do not appropriately control and/or disclose material conflicts of interest that result from their relationships with related or connected issuers will also fail to conduct KYC, KYP and suitability assessments properly.

Below are some effective practices for controlling and/or disclosing conflicts of interest. In our compliance reviews, we will focus closely on whether captive dealers have implemented any of these practices. We will expect captive dealers that have not done so to explain what alternative or additional methods they have in place.

#### **Acceptable practices<sup>1</sup>**

- Develop policies and procedures that describe how you will identify and respond to conflicts of interest.
- Document your independent KYP assessment, for instance by keeping a due diligence checklist and documents that demonstrate your review of key documents such as offering documents, business plans and financial statements.
- Have an independent review committee:
  - review policies and procedures to ensure they address conflicts of interest, KYC, KYP, suitability, and the fair dealing duty
  - conduct initial due diligence on related or connected issuer products, including an assessment of the accuracy and reliability of materials provided by the related or connected issuers
  - identify those products that pose too severe a conflict of interest to be distributed generally and consider whether trades in such products should be restricted to certain investors or classes of investors only

The independent review committee's review and approval of any product for distribution does not relieve the captive dealer of its obligation to ensure the product is suitable for each client.
- Provide clients with meaningful disclosure, including:
  - the issuer's audited financial statements
  - a simplified document, similar to a mutual fund fact sheet, with appropriate highlights and risk disclosures about the investment, including clear disclosure of the conflicts of interest and the concerns it raises
  - other relevant information, in plain language

<sup>1</sup> This is not an exhaustive list, and the adoption of one or more of these suggestions will not ensure compliance.

- Assign a responsible individual (such as the chief compliance officer or ultimate designated person), who has not been directly involved in any way with the trade in question, to ensure that investors understand:
  - the relationship between the captive dealer and the related or connected issuer
  - the key features of the investment (e.g. that the security is sold under a prospectus exemption and therefore may be illiquid, the risks of the investment and the compensation received by the captive dealer for the trade)
  - the concentration risks associated with investing in a limited number of related or connected issuers
- Provide training to ensure that registered individuals and other relevant staff understand the nature of the material conflicts of interest inherent in the business model and the importance of avoiding, managing and/or disclosing them.
- Have unrelated dealers distribute the securities of your related or connected issuers, demonstrating to CSA staff that a third party has reviewed the products and found them suitable for distribution.
- Sell products other than those of related or connected issuers; product diversification is an important factor to help reduce financial dependence of the dealer on an issuer.

### **Unacceptable practices**

- Fail to identify and document your assessment and response to the conflicts of interest inherent in your captive dealer structure.
- Assume that disclosing a conflict of interest alone is sufficient to respond to it.
- Inadequate policies and procedures to identify, determine the risk of, and respond appropriately to conflicts of interest.
- Assume that the related or connected issuer has complied with KYC, KYP or suitability requirements. Each captive dealer has an independent obligation to comply with these requirements and to keep compliance records. You cannot delegate the KYC, KYP and suitability processes.
- Present conflicts of interest disclosure in an obscure or confusing manner, such as in lengthy and complex documents. This disclosure should be in plain language, and easily understood by a reasonable person.
- Ask a client to waive conflicts of interest disclosure and/or a suitability assessment. Permitted clients may waive their right to a suitability review in writing.

### **Registration applications from firms proposing to be captive dealers**

In assessing new registration applications, CSA staff will consider applications by captive dealers on a case-by-case basis. The likelihood of harm to investors and to the capital markets will be the main factors in our determination. For example, we may not grant registration where the applicant proposes to distribute securities of a related or connected issuer whose financial statements raise concerns about its financial viability. We would be concerned in this circumstance, since the captive dealer may be financially dependent on the issuer and would therefore have an added incentive to distribute unsuitable securities in an attempt to improve the issuer's financial condition.

Our review of registration applications will include an assessment of the captive dealer's business plan, both in the short term and in the longer term. We will also assess the firm's policies and procedures manual to test if it has an adequate compliance system in place to control and/or disclose conflicts of interest. Depending on our assessment, we may advise the applicant that without changes, we may recommend a refusal of registration. We expect captive dealer applicants to be forthright in disclosing conflicts of interest to CSA staff reviewing the registration application. Failure to disclose conflicts of interest to CSA staff may result in a recommendation of refusal of registration.

### **Compliance reviews of captive dealers**

During our compliance reviews of captive dealers, we will, among other things, discuss with them why they did or did not adopt some or all of the effective practices in this Notice and assess whether the practices they have adopted are sufficient to address conflicts of interest in the captive dealer business model.

If we encounter conflicts of interest that captive dealers did not appropriately resolve, resulting in unsuitable sales, we will consider both the failure to resolve the conflict of interest and the suitability failure as significant deficiencies. Staff will closely monitor registrants' compliance with conflicts of interest, KYC, KYP and suitability requirements, and will take appropriate regulatory action to ensure compliance with securities legislation.

### **Reminder about changes in business models**

We expect all registrants to report changes in business models using Form 33-109F5 *Change of Registration Information (Form F5)*. Changes in business models can significantly affect the compliance risk of a firm, for instance by introducing material conflicts of interest. Registrants must file a Form F5, if they change their business structure to a captive dealer business model. Firms should assess their business models on an ongoing basis to comply with their obligations under securities legislation.

### **Questions**

If you have questions regarding this Notice, please refer them to any of the following:

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