Ethics for Exempt Market Dealers

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The presentation will consist of three main parts.

First, I will discuss ethics in the context of professional standards of conduct and provide examples of proper and improper conduct.

I will then focus on conflicts of interest, which present possibly the most difficult issues for ethical conduct.

Finally, I will illustrate some of the issues associated with conflicts of interest by means of a case study involving the sale by an exempt market dealer (EMD) of securities issued by a related business.

What is Ethics?

In every society, there are some forms of conduct which are considered proper and others which are deemed improper. Ethics is about determining which forms of conduct are proper.

In order to decide whether a given conduct is proper, we need a yardstick. In everyday life, the yardstick is provided by our values, which are our fundamental beliefs. Societies recognise their most important values as laws. The practical effect of recognising a value as a law is that its breach is officially sanctioned and punished.

Ethical Conduct in the Securities Industry

In the securities industry, ethical conduct is governed by the requirements of securities legislation. These requirements are rooted in the specific realities of the industry, in particular, the overarching need for trust. The securities industry cannot function unless clients are confident that their advisers are trustworthy—that they are honest and have the client's interests at heart.

Why does ethical conduct matter? First, it is a prerequisite for being allowed to work in the industry. In order to be registered (or continue to be registered) as a dealer or a dealer's representative, you must meet certain requirements, including integrity. Integrity is closely related to ethical conduct. You cannot meet the integrity requirement unless your conduct is ethical. Because integrity is mandated by securities legislation, failure to behave in an ethical manner may lead to sanctions, including permanent exclusion from the industry.

Equally important, ethical conduct is a business imperative. In an industry where trust is paramount, ethical conduct makes plain business sense. It provides dealers and representatives with an advantage over competitors with lower standards.

The Standard of Conduct in Securities Legislation

We said that ethical conduct in the securities industry is governed by the requirements of securities legislation. To be specific, registrants must observe:

- first, a principles-based standard of conduct
- secondly, specific business conduct requirements, such as know-your-client and know-your product

It is very important to know the standard of conduct as well as the specific business conduct requirements. Many people get into trouble not because they are dishonest but simply because they do not know what is expected of them.

The standard of conduct is basically the same in all jurisdictions of Canada, except Quebec. In British Columbia, it is found in section 14 of the *Securities Rules.*

- Subsection (1) requires registrants to deal fairly, honestly and in good faith with their clients.
- Subsection (2) requires registered representatives of a dealer or adviser to deal fairly, honestly and in good faith with the clients of the sponsoring dealer or adviser. Here, “adviser” means “portfolio manager”.

The key words are “fairly, honestly and in good faith”.

The Standard of Conduct of SROs

IIROC and the MFDA, as self-regulatory organisations (SROs), have elaborated on the statutory standard of conduct. I know: you will tell me that the SROs have no authority over you since EMDs are under the tender loving care of the securities commissions themselves. Bear with me for a moment and you will see why I am taking you on this detour.

The first requirement of the SROs simply repeats securities legislation. It says that members and their representatives must deal fairly, honestly and in good faith with clients.

The subsidiary requirements elaborate on the fundamental requirement to deal fairly, honestly and in good faith with clients. SRO members and their representatives must:

- observe high standards of ethics and conduct in the transaction of business
- not engage in any business conduct or practice which is unbecoming or detrimental to the public interest
- be of proper character and have proper business repute, and
- have appropriate experience and training

These subsidiary requirements are instructive because they provide an operational context to the fundamental requirement to deal fairly, honestly and in good faith with clients. They give a more concrete character to the fundamental requirement and make it easier to visualise.

Examples of Proper Conduct

Here are some examples of business practices which follow from the statutory standard of conduct for dealers:

- Understand the personal and financial circumstances of clients. Otherwise, your recommendations are unlikely to be suitable.
- Always make recommendations which are suitable to the client. For example, do not sell a product which will lock in the client's money for the long term when you know that the client will need access to the money in the near future. Bear in mind that many exempt market products are illiquid.
- Present all investment recommendations fairly and without false or misleading statements. For example, when recommending a security, do not say that it will be listed on an exchange unless the issuer has actually made an application to an exchange to have the security listed.
- Clearly distinguish fact from comment when making recommendations. For example, if you are showing projections of future results, make sure the client understands that these are just projections.
- Protect the confidentiality of client information. For example, when trying to close a deal with Mr. Smith, do not try to impress him by saying that Mr. Jones, who is a savvy investor, has bought the product.

Some of these practices have been codified into specific rules but they all follow logically from the standard of conduct.

Examples of Improper Conduct

In the interest of balance, let us now provide some examples of improper conduct. In the course of compliance reviews of exempt market dealers, the securities commissions have found common deficiencies in the following areas:

- trading in securities without registration
- making unsuitable recommendations, including failure to observe know-your-client and know-your product requirements
- selling products under the accredited investor exemption to clients who do not qualify
- handling conflicts of interest inadequately, including lack of disclosure; we will have more to say about this in a moment
- not making adequate disclosure when recommending the securities of related issuers; again, we will have more to say about this
- using improper marketing materials

The Fiduciary Standard

So far, we have been discussing the standard of conduct required by securities legislation. It is the standard which the regulators will use to assess your conduct and decide whether enforcement action is warranted. The standard requires dealers to deal fairly, honestly and in good faith with clients.

In addition, under the common law, you may be subject to a more demanding standard known as the fiduciary standard. This is the standard of conduct which an unhappy client will probably invoke when taking you to court. A fiduciary standard applies when one person is under a duty to act in another person's *best interests*.

In a normal commercial transaction, both parties are deemed to be equal and each party is entitled to advance its own interest. For example, if I am selling my house and the roof is obviously leaking, I have no obligation to direct the attention of a potential buyer to the gaping hole in the roof. It is up to the buyer to take notice of the hole and decide if this should influence his decision to buy or the price that he should pay.

Contrast this with a fiduciary relationship. In a fiduciary relationship, one party is under an obligation to act in another person's *best interests*, which means placing the interests of the other party ahead of one's own interests.

The Fiduciary Duty of Dealers under the Common Law

The courts have found on a number of occasions that persons giving investment advice owe a fiduciary duty to their clients. In one case, the Supreme Court of Canada said:

> "The courts have consistently shown a willingness to enforce a fiduciary duty in the investment advice aspect of many kinds of financial service relationships."[1]

The courts have been particularly inclined to find a fiduciary duty in situations where the client is vulnerable.

A Statutory Fiduciary Duty

The securities commissions are currently carrying out a consultation on the appropriateness of enhancing the statutory standard of conduct for dealers and advisers. The question is whether the statutory duty to deal fairly, honestly and in good faith with clients should be replaced with a statutory fiduciary duty.

If a statutory fiduciary duty is implemented, how might this affect you? Let me give an example. The requirement to deal fairly, honestly and in good faith with clients is closely associated with the suitability requirement. Suppose you have evaluated product A and concluded, in the light of the client's circumstances, that it is suitable to the client. You have fulfilled your duty under the suitability requirement.

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[1] *Hodgkinson* v. *Simms* ((1994) 3, S.C.R. 377)

The fiduciary standard would require you to go one step further. You would have to ensure not only that the recommended investment is suitable but also that it is in the best interests of the client. Suppose that there is another product B which is identical in all respects to product A except that the client is required to pay a lower commission. Clearly, product A cannot be in the client's best interests, given that he or she would benefit from a lower commission if buying product B, which is otherwise identical with product A. How far do you need to go to locate product B, assuming it does exist in the first place? Quite obviously, you cannot be knowledgeable about all the products in the marketplace but where do you draw the line? Is it even possible to draw a line objectively? These are difficult issues which would need to be addressed.

So, a statutory fiduciary duty will affect you because it may require you to enhance your business practices. It will also make it easier for clients to sue you. Clients will no longer need to prove the existence of a fiduciary duty, for example, on account of their vulnerability. It will be sufficient to point to the relevant section of the *Securities Act*.

Ethical Conduct and Conflicts of Interest

Let us now look at situations involving conflicts of interest. These situations present possibly the most difficult issues for ethical conduct.

A conflict of interest exists when your interests pull in one direction and those of your client in another. I have provided a number of examples, all of which are relevant in an EMD context:

- remuneration
- lending to or borrowing from clients
- selling complex or opaque products
- selling shares or debt instruments issued by a company managed by the same persons as the EMD, and
- situations where a representative has business activities outside of the dealer

How to Respond to Conflicts of Interest

Securities legislation requires all registered firms to identify and respond to material conflicts of interest.[2]

How do you respond to a conflict of interest? Clearly, you must do so in the light of your obligation to deal fairly, honestly and in good faith with clients. The proper response in a given case depends on the type of conflict involved.

Possible responses are:

1. avoiding the conflict of interest
2. disclosing it to the client

[2] National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, section 13.4

3. taking steps to control it and disclosing it to the client

Response 1 – Avoiding a Conflict of Interest

Avoiding a conflict of interest means not proceeding with the course of action that would give rise to the conflict. You must avoid a conflict of interest when:

- the related course of action is prohibited by law, or
- it is so contrary to the interests of the client that no other response is reasonable

When Prohibited by Law

Avoidance is the only proper response when the related course of action is prohibited by law.

For example, exempt market dealers and their representatives are prohibited from lending money, extending credit or providing margin to a client. The prohibition is intended not only to limit your credit risk but also to prevent conflicts of interest.

When Contrary to the Interests of the Client

A conflict of interest should also be avoided when it is so contrary to the interests of the client that avoidance is the only reasonable response. Let us look at two examples.

Complex Products

The first example involves the sale of complex products. You know of a product that pays a high commission, and it is clearly in your interests to sell it. However, the product is complex, opaque and extremely risky. You carry out a due diligence exercise on the product and conclude that it would not be in your clients' interests to own it.

In this situation, the only reasonable response may be to avoid the conflict of interest by refraining from selling the product to your clients.

Borrowing from Clients

The second example involves borrowing from clients. Exempt market dealers and their representatives are not expressly prohibited from borrowing money from clients. However, this course of action inevitably colours the relationship between you and the client and creates a conflict of interest. How can you possibly make recommendations with the requisite objectivity and serenity when you are indebted to the client, particularly if payments of principal or interest are overdue?

Response 2 – Disclosing a Conflict of Interest

If you decide to avoid a conflict of interest, you have effectively eliminated it and there is no need to disclose anything to the client. On the other hand, if you decide to proceed with a course of action that involves a conflict of interest, you must disclose the nature and extent of the conflict whenever the client would reasonably expect to be informed.

Disclosure must be made before or at the time of providing the service to the client. This enables the client to decide with full knowledge of all relevant facts whether to go ahead with the transaction or not.

In some cases, disclosure on its own is sufficient. The dealer's remuneration for selling a product constitutes a good example. Most clients will agree that you must be fairly paid for your work. However, within the bounds of fairness, the client will want your remuneration to be lower whereas you will want it to be higher.

This conflict of interest is addressed through disclosure. As part of the relationship disclosure information, dealers are required to provide to their clients a description of the remuneration they receive in connection with the different types of product that they sell. The disclosure is made at the beginning of the relationship with the client and whenever there is a significant change in the information.

Response 3 –Disclosing *and* Controlling a Conflict of Interest

There are cases when disclosure on its own is not sufficient. In such cases, disclosure must be accompanied by measures to control the conflict of interest.

Earlier, we discussed the issues when a dealer or a representative borrows money from a client.

If a representative is allowed to borrow money from a client, it may be possible for the dealer to control the conflict of interest by assigning a different representative to service the client.

A Case Study – Selling Securities of Related Issuers

To illustrate some of the issues associated with conflicts of interest, let us examine a case study involving the sale by an exempt market dealer of debt securities issued by a related issuer.

An exempt market dealer and an issuer are typically related when the same individuals manage both entities. In some cases, the EMD is specifically set up to distribute the securities of the related issuer, which may be a business or a family of investment funds.

The securities commissions have identified a disproportionate rate of compliance deficiencies among EMDs that distribute the securities of related issuers. They have given notice that they will focus compliance attention on such dealers and will take enforcement action when the dealers are found to be acting contrary to securities legislation.

The case study is based on an actual enforcement case involving an exempt market dealer.

Two brothers owned and managed a group of companies comprising a used-car dealership, a finance company and an exempt market dealer. The finance company provided car loans to the customers of the used-car dealership. How did it get the money with which to make the car loans? By raising money from investors in the form of high-yield debt instruments distributed on the exempt market through the related EMD.

In the words of one witness, the various companies were "all one organization … getting cars, leasing cars and financing the leasing of those cars."

What were the issues in this case?

Loan by the Finance Company to the Used-car Dealer

First, the finance company lent a large sum of money to the used-car dealer to finance the inventory of cars. The loan was unsecured and did not carry interest, which was an inappropriate use of investors' money.

Secondly, the non-interest bearing loan to a related party constituted a conflict of interest which the exempt market dealer was under an obligation to disclose to its clients. However, at no time was the existence of the loan disclosed to them.

Financial Condition of the Finance Company

Thirdly, the finance company was making losses. Its financial condition was actually worse than indicated by its accounting losses. All the car loans to the customers of the used-car dealership were subprime loans. A large sum of money was tied up in accounts receivable, most of which were overdue and probably uncollectible. However, no provision had been made for bad debts.

The EMD was under an obligation to disclose to its clients the risks associated with the financial condition of the finance company. However, no disclosure was made.

Fourth, the EMD did not take into account the risks associated with the financial condition of the finance company when recommending its securities to clients. It therefore failed to discharge its suitability obligation.

Marketing Materials

Fifth, the marketing materials of the finance company which the EMD made available to its clients were misleading in many respects and consequently in breach of securities legislation, which prohibits the making of false statements about any matter that a reasonable investor would consider relevant in deciding whether to buy a security.

Source of Payments by the Finance Company

Finally, the finance company apparently repaid its loans and made interest payments to its investors on the due dates. However, the EMD was unable to explain the source of the money used by the finance company to service its loans.

Decision of the Securities Commission

The irregularities came to light in the course of two compliance reviews by Staff of the securities commission. At the end of the second review, Staff recommended the suspension of the EMD's registration.

The securities commission took into account the issues we have just discussed. It concluded from the EMD's pattern of conduct that it lacked the integrity required of a registered firm, and decided to suspend its registration. It did not matter to the commission that some of the issues implicated the finance company rather than the EMD because both companies were owned and managed by the same individuals and their businesses were inextricably linked.

For More Information

If you wish to learn more about ethical conduct, you may wish to take the *Ethics for EMD Representatives* course offered by IFSE Institute (www.ifse.ca). The material for this presentation is based on the course. I am told that participants at this workshop are eligible for a special price of $99, which represents a 33% discount, until April 30.

We have now come to the end of the presentation. Thank you for your attention. I will be happy to answer any questions.