

FEELING CONFLICTED? CSA AND CIRO PROVIDE VITAL GUIDANCE FOR REGISTRANTS

Posted on August 16, 2023

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On August 3, 2023, the Canadian Securities Administrators (“**CSA**”) and the Canadian Investment Regulatory Organization (“**CIRO**”) issued [Staff Notice 31-363 – Client Focused Reforms: Review of Registrants’ Conflicts of Interest Practices and Additional Guidance](#) (the “**Report**”), containing the much-anticipated results of a comprehensive compliance sweep of registered dealers, portfolio managers and investment fund managers conducted in 2022. The Report focuses on registrants’ implementation of enhanced conflict of interest (“**COI**”) requirements under the Client Focused Reforms (the “**CFRs**”), effective June 30, 2021. The CFRs introduced significant amendments to registrant conduct obligations under National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (“**NI 31-103**”) and corresponding rules applying to CIRO members.

The Report summarizes findings from compliance reviews of 172 firms registered as investment fund managers, portfolio managers, exempt market dealers, mutual fund dealers or some combination of these categories. Notably, of the registrants reviewed, 135 (78.5%) were found to have deficiencies in their COI policies or practices and were required to take corrective action.

For further helpful guidance and commentary, please see our [bulletin](#) that discusses the results of the British Columbia Securities Commission’s [2022 Annual Compliance Report Card](#) (the “**BC Report**”), which focused significantly on its CFR reviews of registrants.

Identifying and Addressing Material Conflicts of Interest

The CFRs require registrants to take reasonable steps to identify existing and reasonably foreseeable material COIs and address them in the best interests of clients. If a material COI cannot be addressed in the best interest of the client, it must be avoided altogether. While COI disclosure is necessary, it is not sufficient on its own to satisfy a registrant’s obligations. Each registrant’s policies and procedures must include controls to address each identified material COI. Many of the compliance challenges identified in the Report stem from inadequate controls to address material COIs beyond disclosure alone.

The Report cites the following examples of material COIs that were inadequately disclosed and/or inadequately

addressed through controls:

- **Internal Compensation and Incentive Practices:** Some registrants failed to identify the material COI that can arise when registered individuals are compensated using methods that may adversely affect a client, including where compensation is tied to fees collected from clients. In these cases, a registrant may be incentivized to act at the expense of their client for personal gain. The Report notes a few examples of controls implemented by registrants to address this COI, including annually reviewing compensation of registered individuals, removing investment selection and portfolio construction responsibility from individuals with revenue generation goals and periodically reviewing client accounts that impact a registered individual's compensation. Additional guidance regarding best practices for compensation arrangements was provided in the BC Report.
- **Third-Party Compensation:** Some registrants did not disclose the potential material COI where the sale of a security results in compensation to the registrant from a third party. The Report notes that such payments create an inherent material COI that could affect the selection of products that a registrant offers or could impact the decision of clients to invest. In addition to disclosure, registrants are expected to be able to justify recommendations based on the quality of an investment without influence from their own compensation.
- **Proprietary Products:** Certain registrants did not address the material COI that arises when the registrant trades in its own proprietary products. Beyond disclosure, the Report notes that registrants trading only in their own proprietary products should conduct due diligence on comparable, non-proprietary products to ensure that their own products remain competitive and be able to refuse clients that do not fit within the appropriate profile for the registrant's proprietary products.
- **Differences Between Fees Charged to Clients:** Some registrants did not disclose the material COI arising where clients were subject to different fee schedules, including circumstances in which one client was charged more than another for the same products or services. While a registrant may offer its clients fee differences in certain circumstances – such as due to account size or fee structure – the Report notes that other factors such as geographic location and level of seniority do not justify different fees and may create a material COI. Notwithstanding the foregoing, regulators have noted that the industry practice of negotiated fees for services and products offered to non-individual permitted clients does not create a material COI.
- **Supervisory Compensation:** Some registrants failed to consider situations where supervisors or branch managers received compensation tied to sales and revenue generated by the individuals they supervise. In these cases, the supervisor may be incentivized to put their own interests ahead of a client's by driving sales without regard for the client's best interests, creating a material COI. The Report recommends registrants ensure that, for the most part, supervisory staff compensation is not tied to revenue of

supervised individuals and that registrants ascribe low levels of bonuses tied to results compared to base salary.

- **Directorships:** Some registrants did not disclose circumstances where registered individuals were board members of issuers whose securities the registrant distributed or advised on. A material COI arises in such a case due to the individual's conflicting obligations to their clients versus their fiduciary duty to the issuer on whose board they serve. The Report provides a number of suggested controls to address this COI, including restricting the compensation that registered individuals may earn as directors or requiring that the individual resign where the material COI cannot otherwise be addressed in the best interests of clients.
- **Referral Arrangements:** Some registrants did not implement adequate controls to address referral arrangements. These include arrangements where fees were paid from the registrant to another party ("referrals in") and where fees were paid from another party to the registrant ("referrals out"). The Report notes that most registrants identified "referrals out" as a material COI, but many registrants failed to identify "referrals in" as a material COI. Registrants are required to perform adequate due diligence to ensure that "referrals out" are properly vetted and meet the best interests of the client, including taking into account factors such as financial health, professional qualifications and disciplinary actions. For "referrals in", the Report provides guidance to discourage registrants from providing preferential treatment to referred clients and to ensure that a registrant does not delegate registerable activities to the referral agent.
- **Trades Alongside Clients:** Some exempt market dealer firms were noted as having allowed their representatives to trade in the same issuers for which they act as dealer. The Report notes two material COIs that may arise: firstly, situations where a representative may prioritize their own trades before clients' trades; and secondly, where a representative learns that an issuer is intending to freeze redemptions and the representative may prioritize their own redemptions over clients' redemptions. The Report suggests that representatives not be permitted to trade alongside clients where the issuer's offering of securities is limited and that representatives be required to permit clients to redeem securities before the representative has the opportunity to do so for their own account.
- **Gifts/Entertainment:** While most registrants identified gifts and entertainment as a material COI, the Report notes that many failed to implement relevant controls. The Report suggests that registrants prohibit monetary gifts and monitor and document gifts that are provided, while setting limits on the gifts that can be provided or received over a given period of time. This COI was also highlighted as an area of concern in the BC Report.
- **Managing and Distributing Private Issuers:** Some registrants were found to lack policies to identify and address material COIs arising due to activities performed for proprietary issuers distributing their

securities pursuant to prospectus exemptions. For instance, the Report found that registrants had not independently assessed the value of issuers or had used stale values for calculating management and performance fees. The Report reminds registrants to use third-party resources such as auditors to value assets and calculate fees payable.

Training and Record-Keeping

In addition to disclosing material COIs and implementing controls, registrants are obligated to adequately train their staff regarding procedures when COIs arise. The Report notes that adequate training should be tailored to the registrant's business operations or size and include all necessary individuals. Training should assist individuals in recognizing material COIs and outline the internal process for reporting and, if necessary, escalation.

Furthermore, registrants are required to put in place protocols that accurately record the registrant's compliance with COI requirements. The Report notes that registrants should maintain adequate documentation of any training provided, such as copies of training content and attendance logs, in order to demonstrate compliance. The Report further suggests that registrants record, among other things, the factors used to match clients to investor profiles, the considerations used to assess whether proprietary products are competitive with alternatives in the market and the list of material COIs identified by the registrant.

Disclosing Conflicts of Interest

The Report also provides guidance to help registrants disclose material COIs to their clients, with a reminder to describe the nature and extent of the COI, the potential impact on and risks to clients, and how the COI has been, or will be, addressed. The Report notes that best practice for registrants in meeting this obligation is the use of headings or charts to ensure that each element is included for a given COI. The Report further notes that disclosure prepared by a third party (including an issuer distributing securities) does not release a registrant from its obligation to disclose material COIs and adequate controls to clients.

Conclusion

The Report supplements a suite of helpful guidance provided by the CSA and CIRO to assist registrants with their COI-related obligations under NI 31-103. Other resources available to registrants include the companion policy to NI 31-103, the BC Report and the CSA's [FAQ](#). These resources provide valuable information for the preparation of effective policies and procedures that are responsive to the CSA and CIRO's concerns. If not already, registrants should be aware of and prepared for additional CFR-focused sweeps that will be conducted throughout 2023.

To ensure your policies and procedures are and remain up to date with the latest requirements and guidance,

please contact any member of McMillan's Investment Funds & Asset Management Group.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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