

## SRO Notices and Disciplinary Proceedings

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### 13.1.1 Summary of Public Comments Respecting Proposed Amendments to MFDA Rule 2.1.4 and Response of the MFDA

#### SUMMARY OF PUBLIC COMMENTS RESPECTING PROPOSED AMENDMENTS TO MFDA RULE 2.1.4 AND RESPONSE OF THE MFDA

On September 23, 2005, the Ontario Securities Commission published for public comment the proposed amendments to MFDA Rule 2.1.4 (the “**Proposed Amendments**”). The MFDA proposal was published in Volume 28, Issue 38 of the Ontario Securities Commission Bulletin, dated September 23, 2005.

The public comment period expired on October 23, 2005.

Two submissions were received during the public comment period:

1. IGM Financial (“IGM”)
2. Investment Funds Institute of Canada (“IFIC”)

Copies of comment submissions may be viewed at the offices of the MFDA, 121 King Street West, Suite 1000, Toronto, Ontario by contacting Laurie Gillett, Manager, Communications and Membership Services (416) 943-5827.

The following is a summary of the comments received, together with the MFDA’s responses.

#### **General Comments**

IGM expressed an overall concern with respect to the “extremely broad nature of the amendments and its impact on the business of the Member.”

IGM also noted that the Investment Dealers Association does not have a provision equivalent to Rule 2.1.4.

#### **MFDA Response**

The Proposed Amendments do not broaden the application of the existing Rule, but rather are intended to simply clarify the role of the Approved Person in the management of conflicts of interest, as Approved Persons are important points of contact with clients in the conduct of Member business. Our intent is that interpretation of the amended Rule will be consistent with past and present practice, with the additional expectation that Approved Persons must notify the Member when they identify a potential conflict of

interest and act accordingly in resolving the issue in the best interests of the client.

As we apply the Rule presently, MFDA staff do not contemplate requiring Members to anticipate every possible conflict, regardless of the remoteness of a problem arising, and provide written disclosure to clients. Rather it is intended that written disclosure be provided where there is a substantial likelihood that a reasonable client would consider the conflict important when entering into a proposed transaction.

It is important to note that there are two distinct aspects under both the existing and the amended Rule 2.1.4. There is a requirement that written disclosure be provided to clients of potential conflicts that have been identified, but there is also an obligation to address the conflict by the exercise of responsible business judgment influenced only by the best interest of the client. In satisfying this second requirement, MFDA Staff expect that in many cases Members will take action that goes beyond simple disclosure. For example, this may involve prohibiting the proposed transaction or advising the client to obtain independent advice prior to proceeding with the proposed transaction.

With respect to the issue of an equivalent provision under IDA rules, it is our understanding that the IDA is in the process of amending its by-laws so that, in addition to specific requirements that would be imposed in relation to certain types of conflicts of interest, proposed IDA By-law 29.31 would also include a general requirement that IDA member firms must ensure that disclosure of conflicts of interest is made to clients in all situations in which there is a substantial likelihood that a reasonable client would consider the conflict important in making an investment decision.

The comments go well beyond the issues arising from the proposed amendments and relate mainly to the existing Rule. The appropriate response, therefore, is to provide more general guidance on the position of MFDA staff with respect to the interpretation of the amended Rule 2.1.4, and we will be issuing a Member Regulation Notice to address questions regarding the intended scope and application of the Rule.

#### **Definition of Conflict of Interest**

The commentators suggested that the general rule should include a definition of “conflict of interest” or more specific guidance as to situations giving rise to conflicts of interest. This guidance would either specifically exclude certain types of conflicts or provide an exclusion from the definition if there was adequate disclosure provided to the client, for example in the case if a related party issuer.

### **MFDA Response**

Rule 2.1.4 is intended to function as a rule of general application with respect to the treatment of conflicts. It is meant to provide Members with a broad principle under which specific standards are to be created to resolve and manage the conflicts that Members encounter in the conduct of business. MFDA staff are concerned that by including a precise definition with exclusions from the rule, the benefits of the principled approach we have taken with respect to this issue will be lost. The inclusion of a definition may encourage the practice of structuring business in such a way to take advantage of technical exclusions, while ignoring the general purpose of the rule to ensure that conflicts are properly managed with the clients' best interests in mind.

Both commentators provided examples of situations to illustrate their point that disclosure provided in accordance with present standards would be enough to address the conflicts arising in those situations. MFDA staff recognize that the principle contained in the rule can in many cases be addressed simply through disclosure. However, we do not believe it is necessary or practical to attempt to include in the rule a list of situations where the rule can be satisfied by way of disclosure alone.

### **Materiality of Conflicts**

Both commentators suggested that a materiality threshold be included in the general rule, and that it is unreasonable to expect that each and every conflict regardless of materiality be subject to the rule. The commentators noted that the concept of nominal value monetary and non-monetary benefits to and from clients have already been dealt with in Member Regulation Notice MR-0047, supporting the concept of exceptions from the conflicts rule based on materiality.

### **MFDA Response**

MFDA staff do not expect that every conflict regardless of materiality would be subject to the requirements of Rule 2.1.4. Rather, as noted above, it is intended that written disclosure be provided where there is a substantial likelihood that a reasonable client would consider the conflict important when entering into a proposed transaction.

### **Compliance with other Rules**

Both commentators suggested that the general rule clearly provide for exemptions from having to comply with the rule if there is compliance with other applicable rules such as the commission rebate rules, referral arrangements, etc. In particular, the commentators also requested clarification and guidance respecting the application of Rule 2.1.4 to outside business activities.

### **MFDA Response**

MFDA staff take the position that it would not be appropriate to provide for an explicit exemption from the

general rule, where compliance with other rules and regulations can be demonstrated. As noted above, Rule 2.1.4 is intended to function as an overarching principle that must be observed when dealing with conflicts of interest. In many cases compliance with specific rules created to deal with particular situations that involve conflicts of interest may be sufficient to discharge the Member's and Approved Persons' responsibilities under the Rule. However, there are other situations where existing requirements do not necessarily adequately address the conflict issue. As an example, simple disclosure of referral fees under MFDA Rule 2.4.2 may not be sufficient to properly address conflict issues that arise under certain referral arrangements. As stated in Member Regulation Notice #0047 (*Personal Financial Dealings with Clients*), the appropriate course of action to address a conflict of interest will depend on the nature of the conflict and the client's circumstances. In situations involving a potentially significant conflict of interest, the exercise of responsible business judgment may require a prohibition on the type of transaction giving rise to the conflict.

With respect to outside business activities, MFDA Staff expect Members to consider issues relating to potential conflicts of interest that may arise from the Approved Person's duties as a salesperson and his or her outside business activity prior to approving such activity. As stated in Member Regulation Notice #0040, this would include consideration of compensation to be paid under the arrangement, the nature of the relationship between the Approved Person and the outside entity, and any other potential conflicts that are identified. If any such conflict cannot be properly managed in accordance with Rule 2.1.4, the outside activity should not be permitted. Members also have an ongoing obligation to monitor outside business activities for conflicts of interest that may arise. Where conflicts of interest arise from the Approved Person's duties as a salesperson and his or her outside business activity, Members must determine what action is appropriate to address the conflict. Such action may involve providing disclosure or if the conflict is significant and direct and cannot be resolved in favour of the client, a Member may be required to prohibit the activity.

### **Exercise of Business Judgment**

Both commentators suggested that the exercise of business judgment is related to the concept of materiality. The commentators suggested that a broader exception to having to specifically raise all conflicts with the client be permitted on the basis of the business judgment rule.

### **MFDA Response**

As noted above, MFDA staff do not contemplate requiring Members to anticipate every possible conflict, regardless of the remoteness of a problem arising, and provide written disclosure to clients. Rather it is intended that written disclosure be provided where there is a substantial likelihood that a reasonable client would consider the conflict important when entering into a proposed transaction.