



Ontario  
Securities  
Commission

CIM des  
valeurs mobilières  
de l'Ontario

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**IN THE MATTER OF  
CALDWELL INVESTMENT MANAGEMENT LTD.**

**STATEMENT OF ALLEGATIONS**  
(Subsections 127(1) and (2) and Section 127.1  
of the *Securities Act*, RSO 1990, c S.5, as amended)

**A. ORDERS SOUGHT:**

1. Staff of the Enforcement Branch (“Staff”) of the Ontario Securities Commission (the “Commission”) requests that the Commission make the following orders:
  - (i) pursuant to paragraph 1 of subsection 127(1) of the *Securities Act*, RSO 1990, c S.5, as amended (the “Act”), that the registration of Caldwell Investment Management Ltd. (“CIM” or the “Respondent”) under Ontario securities law be terminated, or be suspended or restricted for such period as is specified by the Commission, or that terms and conditions be imposed on CIM’s registration;
  - (ii) pursuant to paragraph 6 of subsection 127(1) of the Act, that CIM be reprimanded;
  - (iii) pursuant to paragraph 9 of subsection 127(1) of the Act, that CIM pay an administrative penalty of not more than \$1 million for each failure by CIM to comply with Ontario securities law;
  - (iv) pursuant to paragraph 10 of subsection 127(1) of the Act, that CIM disgorge to the Commission any amounts obtained as a result of non-compliance with Ontario securities law;
  - (v) pursuant to section 127.1 of the Act, that CIM pay costs of the Commission investigation and the hearing; and
  - (vi) such other order as the Commission considers appropriate in the public interest.

**B. FACTS**

2. Staff makes the following allegations of fact:

**Overview**

3. Best execution is a critical tool in ensuring protection for investors and investor confidence in the market.
4. Advisers, such as CIM, are required to make reasonable efforts to achieve best execution of orders when acting for clients. Best execution is defined as the most advantageous execution terms reasonably available under the circumstances. In order to meet the reasonable efforts standard, an adviser must have, and abide by, policies and procedures that outline the process it has designed toward the objective of achieving best execution. The policies and procedures should describe how the adviser evaluates whether best execution was obtained and should be regularly and rigorously reviewed.
5. Over an almost four year period, CIM failed in its obligation to provide best execution of equity and bond trades for its clients which resulted in overpayments by its clients.
6. CIM executed most of its client trades through Caldwell Securities Ltd., (“CSL”) its own related investment dealer, placing it in a clear conflict of interest.
7. Notwithstanding the conflict of interest, CIM had inadequate policies and procedures in place to ensure that it sought best execution for its clients. CIM did not have an adequate process in place to ensure that it was obtaining the most advantageous execution terms reasonably available under the circumstances for its clients. CIM also did not regularly evaluate whether best execution was obtained for its clients.
8. Moreover, CIM made misleading statements to clients of the Mutual Funds (defined below) by asserting that the brokerage fees paid by the Mutual Funds would be paid at the most favourable rates available to the Mutual Funds.
9. Even though CIM had an Independent Review Committee (the “IRC”) in place, the IRC was unable to properly monitor best execution practices because CIM provided inaccurate and insufficient information to the IRC.

## **Background**

10. CIM was incorporated in Ontario in 1990. During the period of January 1, 2013 to November 15, 2016 inclusive) (the “Relevant Period”), CIM was registered as an adviser in the category of portfolio manager (“PM”) and investment fund manager (“IFM”) in Ontario and elsewhere.
11. During the Relevant Period, CIM acted as the IFM and PM for a number of Caldwell-related mutual funds, including the Caldwell Balanced Fund (“Balanced Fund”) and the Caldwell Income Fund (“Income Fund”) (together, the “Mutual Funds”) and performed portfolio management services for clients under separately managed discretionary accounts (“SMAs”).
12. CSL was incorporated in Ontario in 1980 and is registered as a dealer in the category of investment dealer in Ontario and elsewhere. CSL is also a member of the Investment Industry Regulatory Organization of Canada.

## **Conflict of Interest**

13. The selection of a dealer should not be influenced by the adviser’s self-interest. When there is a conflict of interest, advisers should ensure that they are putting their clients’ interests ahead of their own interests.
14. CIM’s Compliance Manuals (defined below) provided that “...it is likely that CIM would be considered to be a fiduciary in the context of its Clients due to the knowledge and power imbalance between the parties. CIM will conduct its affairs assuming it is in a fiduciary relationship with its Clients.”
15. CIM’s fiduciary duty to its clients (including the Mutual Funds) required CIM to place its clients’ interests above its own interests when executing client trades.
16. CIM had a conflict of interest in directing client trades to CSL for execution given the common ownership of both CIM and CSL by Caldwell Financial Ltd. (“CFL”).

17. This close relationship resulted in CIM choosing CSL to execute most of CIM's client trades despite the fact that equity commission rates and bond spreads in many cases were more favourable at unaffiliated dealers.
18. By choosing CSL as a dealer for the majority of CIM's client trades, CIM conferred a benefit on CSL in the form of commissions on equity trades and additional spreads or mark-ups on bond trades ("CSL Mark-Ups"). This selection ultimately conferred a benefit on CFL, the common shareholder of CIM and CSL.
19. For the Mutual Funds, CIM's conflict of interest was reviewed by the IRC. A standing instruction from the IRC required the brokerage arrangements with CSL to be at terms as favourable or more favourable than could be executed through another dealer. CIM certified semi-annually to the IRC that the standing instruction had been complied with.
20. As set out below, CIM provided both inaccurate and insufficient information to the IRC for it to properly carry out its responsibilities under National Instrument 81-107 *Independent Review Committee for Investment Funds* ("NI 81-107"), including the IRC's responsibility to review and assess the adequacy and effectiveness of the standing instructions to address CIM's brokerage arrangement with CSL.

#### **The Investment Funds and the SMAs**

21. During the Relevant Period, CIM managed approximately nine investment funds including the Mutual Funds. The Mutual Funds are reporting issuers and traded in both equities and bonds during the Relevant Period.
22. CIM also managed approximately 300 SMAs during the Relevant Period.
23. CIM's assets under management ranged from approximately \$250 to \$400 million during the Relevant Period.

#### **CIM's Lack of Policies and Procedures Regarding Best Execution**

24. During the Relevant Period, CIM's compliance policies and procedures were set out in the CIM compliance manuals updated December 2012 and June 2015 (the "Compliance Manuals").

25. During the Relevant Period, CIM failed: (i) to set out in writing its process for obtaining best execution; and/or (ii) to have a best execution process in place that included provisions for selecting dealers, trade evaluations, post-trade analyses or other evidence of reviews to evaluate whether CIM's best execution obligation was being met.
26. CIM failed to provide consistent explanations to Staff regarding CIM's policies and procedures regarding its best execution process. During Staff's investigation, CIM provided Staff with conflicting information about its process for executing bond trades during the Relevant Period. This conflicting information was the result of CIM not having clear, documented and consistent policies and procedures to describe CIM's trading process, including how it was designed to reasonably achieve best execution.
27. As a result of the conduct set out in this Statement of Allegations, CIM failed to meet its best execution obligation under section 4.2 of National Instrument 23-101 *Trading Rules* ("NI 23-101") during the Relevant Period.

#### **CIM's Misleading Statements Regarding Best Execution to Mutual Fund Investors**

28. Notwithstanding the lack of policies and procedures regarding best execution, CIM made representations to Mutual Fund investors regarding its overall best execution obligation.
29. CIM made the following statements in the Annual Information Forms ("AIFs") for the Mutual Funds during the Relevant Period:

"The purchase and sale of portfolio securities will be arranged through registered brokers or dealers selected on the basis of [CIM's] assessment of the ability of the broker or dealer to execute transactions promptly and on favourable terms, and the quality and value of services provided to the Fund ...

Brokerage fees will be paid at the most favourable rates available to the Fund ...

[CIM] may also choose to execute a portion of the Funds' portfolio transactions with Caldwell Securities Ltd. (the Funds' principal distributor) on terms as favourable or more favourable to the Funds as those executed through other brokers and dealers." [emphasis added]

30. For many Mutual Fund trades, brokerage fees were not paid at the most favourable rates available to the Mutual Funds or on terms as favourable or more favourable to the Mutual Funds as those executed through other brokers and dealers.
31. Also, during the Relevant Period, the Income Fund executed all (and not a portion as stated in the AIFs) of its trades through CSL contrary to the representation in the AIFs to the Income Fund investors.
32. The statements made in the AIFs regarding brokerage fees being paid on the most favourable rates available to the Funds and the statement that the Income Fund may choose to execute a portion of its trades through CSL were misleading and/or untrue.

### **CIM's Misleading Statements Regarding Best Execution to SMA Clients**

33. CIM's SMA clients signed an Investment Management Agreement ("IMA") with CIM as the PM. The IMA provided that unless the client specifies otherwise, CIM intends to execute transactions through CSL and that:

“[CIM] shall at all times ensure that the prices charged, and services provided, by CSL are competitive... [CIM] shall secure best execution and the most favourable net transaction price for the Account having regard to various relevant factors including the size and type of the transaction, the nature and character of the markets for the relevant security, the execution experience, integrity, financial responsibility and commission rates charged by available brokers and dealers, as well as supplemental services and information which may be provided by some brokers and dealers to the Advisor in relation to investment decision-making services and order execution services ...

... the objective of securing the most favourable net transaction price for the Account does not obligate the Advisor to obtain the lowest net price. The Advisor is therefore authorized, to the extent permitted by applicable law, to commit the Account to pay a broker or dealer who furnishes investment decision-making and/or order execution services to the Advisor a commission for effecting a transaction which is higher than the commission that another broker or dealer would have charged for effecting such transactions provided the Advisor determines in good faith that the excess commission is reasonable in relation to the value of such investment decision-making and/or order execution services viewed in terms of the particular transaction or the Advisor's overall responsibilities with respect to the discretionary accounts managed by it”

34. SMA clients were also advised in the relationship disclosure document that when CIM used its discretion to trade securities in SMAs that CIM must seek to achieve the best possible result having regard to the price of the security, speed of execution, quality of execution and total transaction cost.
35. Contrary to the representations to SMA clients about seeking to achieve best execution and that CIM would determine in good faith that the excess commissions were reasonable, CIM was unable to provide Staff with evidence that CIM: (i) ensured that the prices charged and services provided by CSL were competitive; (ii) took into account and evaluated various relevant factors in deciding to use CSL as a dealer; and/or (iii) determined in good faith that excess commissions were reasonable in relation to the value of such investment decision-making and/or order execution services viewed in terms of the particular transaction.

#### **Review of Equity Trades in the Mutual Funds and SMAs**

36. Companion Policy 23-101 (“23-101CP”) provides that one must consider a number of factors when considering whether the best execution obligation of an adviser has been met, including price, speed of execution, certainty of execution and the overall cost of the transaction. The overall cost of the transaction includes all costs associated with executing a trade that are passed on to a client, and includes the commission fees charged by a dealer for execution of orders.
37. Further, 23-101CP states that the “reasonable efforts” test does not require achieving best execution for each and every order when acting for a client. 23-101CP states that in making reasonable efforts to achieve best execution, the adviser should consider a number of factors, including assessing a client’s portfolio objectives, selecting appropriate dealers and marketplaces and monitoring the results on an ongoing basis.
38. Staff reviewed trades for the Mutual Funds and SMA clients during the Relevant Period to understand CIM’s trading process and the effect of CIM’s lack of detailed policies and procedures regarding best execution.

**(i) Balanced Fund**

39. During the Relevant Period, the Balanced Fund executed approximately 66% of its equity trades with unaffiliated dealers at an average commission rate of \$0.05 per share, which included compensation to the dealers for research provided to CIM. During the same period, approximately 34% of the Balanced Fund's equity trades were executed through CSL at an average commission rate of \$0.16 per share, which did not include research to CIM.
40. A review of CIM's trading blotter revealed instances where the same security was traded for the Balanced Fund at CSL and at unaffiliated dealers for significantly different commission rates. Some examples of varying commissions, in which the CSL commission rates were higher by multiples of 4.4 to 13.4 when compared to commission rates from unaffiliated dealers for similar trades, are set out below:

| Security         | Account       | B/S | Date traded | Quantity | Dealer | Commission/<br>share | Multiple over<br>unaffiliated<br>dealer |
|------------------|---------------|-----|-------------|----------|--------|----------------------|---|
| Bank Nova Scotia | Balanced Fund | B   | 2014-01-30  | 4400     | CIBC   | \$0.05               |   |
| Bank Nova Scotia | Balanced Fund | B   | 2014-01-31  | 2000     | CSL    | \$0.30               | 6x                                      |
| Fedex Corp       | Balanced Fund | S   | 2013-10-21  | 4500     | Cowen  | \$0.05               |   |
| Fedex Corp       | Balanced Fund | S   | 2013-11-06  | 4500     | CSL    | \$0.67               | 13.4x                                   |
| Timken Co        | Balanced Fund | S   | 2013-01-25  | 1400     | BMO    | \$0.05               |   |
| Timken Co        | Balanced Fund | S   | 2013-02-05  | 1000     | CSL    | \$0.55               | 11x                                     |
| Verizon Comms    | Balanced Fund | S   | 2015-09-22  | 10000    | Cowen  | \$0.05               |   |
| Verizon Comms    | Balanced Fund | S   | 2015-10-09  | 19000    | CSL    | \$0.22               | 4.4x                                    |

41. Based on Staff's review of the Balanced Fund trades, during the Relevant Period, many trades executed through CSL were not done at the most favourable rates available.

42. Many Balanced Fund trades executed through CSL were not done on terms as favourable or more favourable as trades through unaffiliated dealers.
43. Again, CIM was unable to provide Staff with any evidence that it took steps to satisfy itself that, despite the excess rates charged by CSL, Balanced Fund equity trades executed through CSL were done on terms as favourable or more favourable as trades through unaffiliated dealers.

**(ii) Income Fund**

44. Some of the securities traded for the Income Fund through CSL were also traded for the Balanced Fund through unaffiliated dealers at significantly lower commission rates. Some comparative examples of the same security traded in the Income Fund through CSL, and in the Balanced Fund through unaffiliated dealers for significantly lower commission rates are set out below:

| Security         | Account       | B/S | Date traded | Quantity | Dealer | Commission/<br>share | Multiple over<br>unaffiliated dealer |
|------------------|---------------|-----|-------------|----------|--------|----------------------|--------------------------------------|
| Bank Nova Scotia | Balanced Fund | B   | 2013-12-16  | 4500     | CIBC   | \$0.05               |                                      |
| Bank Nova Scotia | Income Fund   | S   | 2015-11-17  | 2000     | CSL    | \$0.30               | 6x                                   |
| BCE              | Balanced Fund | S   | 2013-01-09  | 8000     | BMO    | \$0.05               |                                      |
| BCE              | Income Fund   | S   | 2016-04-15  | 3000     | CSL    | \$0.30               | 6x                                   |
| Onex             | Balanced Fund | B   | 2013-06-04  | 3000     | CIBC   | \$0.05               |                                      |
| Onex             | Income Fund   | S   | 2016-02-26  | 2000     | CSL    | \$0.42               | 8x                                   |

45. Based on Staff's review of the Income Fund trades, during the Relevant Period, many trades executed through CSL were not done at the most favourable rates available.

46. Many Income Fund trades executed through CSL were not done on terms as favourable or more favourable as trades through unaffiliated dealers.
47. Again, CIM was unable to provide Staff with any evidence that it took steps to satisfy itself that, despite the excess rates charged by CSL, Balanced Fund equity trades executed through CSL were done on terms as favourable or more favourable as trades through unaffiliated dealers.

**(iii) SMA Clients**

48. CIM had three main categories of SMA clients paying commissions during the Relevant Period: (i) clients who were to pay 1.25% of gross dollar value of trades (“1.25% SMAs”); (ii) clients who were to pay 1.0% of gross dollar value of trades (“1% SMAs”); and (iii) clients who were to pay \$0.10 per share for Canadian shares and 1.25% of gross dollar value for USD trades (“Insurance SMAs”).
49. During the Relevant Period, CSL executed trades on behalf of CIM’s SMA clients. The average commission rates for SMA clients were: (i) \$0.22 per share for 1.25% SMAs; (ii) \$0.19 per share for 1% SMAs; and (iii) \$0.09 per share for Insurance SMAs.
50. Although CIM told clients that CIM shall secure best execution “having regard to various relevant factors including ... commission rates charged by available brokers and dealers”, CIM was unable to provide Staff with any evidence, including written policies and procedures, that CIM took steps to secure best execution of equity trades for its SMA clients. Rather, CIM automatically used CSL for trades for SMAs and did not check with other dealers to see if trades could be executed on more advantageous terms.

**Review of Bond Trades in the Mutual Funds and SMAs**

51. All bond trades for the Mutual Funds and the majority of bond trades for the SMA clients were executed through CSL. Most of these bond trades were in liquid Government of Ontario, Government of Canada and Crown corporation bonds.
52. During the Relevant Period, CSL did not carry any bonds in its inventory. CSL would buy or sell bonds for CIM by buying or selling the bonds from or to another investment dealer and adding an additional spread or CSL Mark-Up.

53. From a review of CIM’s trading blotter, Staff learned there was a significant change in the amount of the CSL Mark-Up for the Mutual Funds towards the end of the Relevant Period. Starting on August 1, 2016, CIM and one of its PMs reached an agreement by which the CSL Mark-Up was reduced to \$0.01 per \$100 worth of bonds traded for the Mutual Funds (the “One Penny Practice”). The chart below sets out sample bond trades before and after the One Penny Practice.

| Trade Date    | Account Name  | B/S | Quantity  | Bond                         | Spread/<br>\$100 | Total Spread    | Net Amount  | Before or After One Penny Practice |
|---------------|---------------|-----|-----------|------------------------------|------------------|-----------------|-------------|------------------------------------|
| Mar 20, 2013  | Balanced Fund | B   | 2,000,000 | ON Prov 2.1% 08Sep18         | \$0.175          | <b>\$3,500</b>  | \$2,017,856 | Before                             |
| Nov 15, 2016  | Balanced Fund | B   | 2,000,000 | CDA Govt 1.5% 01Jun26        | \$0.01           | <b>\$200</b>    | \$2,012,973 | After                              |
| Apr 22, 2015  | Balanced Fund | B   | 4,000,000 | CDA Govt HSG Tr 1.2% 15Jun20 | \$0.15           | <b>\$6,000</b>  | \$3,989,797 | Before                             |
| Sept 7, 2016  | Balanced Fund | B   | 4,000,000 | CDA Govt 1.5% 01Jun23        | \$0.01           | <b>\$400</b>    | \$4,212,932 | After                              |
| Feb 26, 2013  | Income Fund   | S   | 4,375,000 | ON Prov 2.85% 02Jun23        | (\$0.23)         | <b>\$10,063</b> | \$4,384,403 | Before                             |
| Sept 27, 2016 | Income Fund   | S   | 4,300,000 | CDA Govt 1.5% 01Jun26        | (\$0.01)         | <b>\$430</b>    | \$4,533,157 | After                              |
| Jun 3, 2014   | Income Fund   | B   | 5,000,000 | ON Prov 2.1% 08Sep19         | \$0.18           | <b>\$9,000</b>  | \$5,024,603 | Before                             |
| Sept 7, 2016  | Income Fund   | B   | 5,000,000 | CDA Govt 1.5% 01 Jun 23      | \$0.01           | <b>\$500</b>    | \$5,266,164 | After                              |

54. During the Relevant Period, there were no CIM policies and procedures explaining: (i) how the CSL Mark-Up was determined; (ii) why a particular CSL Mark-Up was charged on a particular trade; and/or (iii) how or whether the interposition of CSL between unaffiliated dealers and CIM for client bond trades met CIM’s best execution obligation.
55. CIM did not do any regular comparisons, analyses or reviews to assess whether CIM was providing best execution on bond trades for the Mutual Funds and SMA clients.
56. CIM’s failure to commit the One Penny Practice to writing is further evidence of CIM’s inadequate policies and procedures concerning best execution during the Relevant Period.

57. On several occasions during the Relevant Period, CIM sourced the bond price directly from an unaffiliated dealer and a CSL Mark-Up was still charged to the CIM client notwithstanding that a CSL trader was not directly involved.
58. In summary, many bond trades for the Mutual Funds and the SMA clients were not done on the most advantageous execution terms reasonably available under the circumstances.

### **CIM's Failure to Establish a System of Controls and Supervision**

59. CIM had an obligation as a registered firm to have a system of adequate internal controls and supervision to ensure compliance with securities laws and to manage the risks associated with its business in accordance with prudent business practices.
60. The following demonstrate CIM's inadequate internal controls and supervision as part of a compliance system regarding its best execution obligation during the Relevant Period:
  - a. CIM's lack of detailed written policies and procedures regarding its best execution obligation;
  - b. The lack of policies and procedures setting out how the CSL Mark-Up on bond trades for CIM clients was determined;
  - c. The lack of documentation evidencing the practice for pricing bond mark-ups, for the Mutual Funds at \$0.01 per \$100 worth of bonds as implemented by CIM on August 1, 2016;
  - d. The conflicting descriptions of CIM's best execution obligation in the Compliance Manuals;
  - e. The conflicting information provided to Staff about CIM's process during the Relevant Period for executing bond trades;
  - f. CIM's failure to evaluate whether best execution had been achieved for client trades; and
  - g. CIM's failure to provide sufficient information or perform analysis to support its certifications to the IRC, as detailed below.
61. CIM's failure to have adequate policies and procedures regarding best execution breached section 11.1 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("NI 31-103").

## **CIM's Failure to Provide Sufficient Information to IRC**

62. As required by NI 81-107, CIM's IRC was established to deal with conflicts of interest which arose in the management of the Mutual Funds.
63. CIM's IRC had issued a series of semi-annual standing instructions to address the conflicts of interest created by CIM's brokerage arrangements with CSL. The IRC's standing instructions were in place from at least November 1, 2012 to October 31, 2016. Each of the standing instructions stated: "1. Brokerage arrangement with CSL must be executed at terms as favo[u]rable or more favo[u]rable than could be executed through another dealer".
64. For each of these semi-annual standing instructions, CIM provided a certification and an assessment to the IRC stating that there was a review of equity trades for the Mutual Funds and certifying that: "Equity trades were executed at terms as favo[u]rable or more favo[u]rable than could be executed through another dealer".
65. The representations made by CIM to the IRC that equity trades made through CSL for the Mutual Funds were executed at terms as favourable or more favourable than could be executed through another dealer were inaccurate and misleading.
66. CIM did not provide the IRC with all the information which it required to properly carry out its responsibilities under NI 81-107, including the IRC's responsibility to review and assess the adequacy and effectiveness of the standing instructions to address CIM's brokerage arrangement with CSL.

## **C. BREACHES OF ONTARIO SECURITIES LAW AND CONDUCT CONTRARY TO THE PUBLIC INTEREST**

67. Staff alleges the following breaches of Ontario securities law during the Relevant Period:
  - (a) CIM breached its best execution obligation under section 4.2 of NI 23-101 by placing most of its trades for execution through CSL, a related investment dealer, without having adequate policies and procedures or an adequate written process in place to ensure that CIM's best execution obligation was being met;

- (b) CIM had inadequate policies and procedures relating to its best execution obligation contrary to section 11.1 of NI 31-103; and
  - (c) One or more of the representations made by CIM to the IRC were inaccurate and misleading and CIM did not provide the IRC with sufficient information for the IRC to properly carry out its responsibilities and therefore CIM breached subsection 2.4(1)(a) of NI 81-107.
68. Staff alleges that the conduct set out above including the misleading and/or untrue statements to Mutual Fund investors and SMA clients referred to in paragraphs 28 to 35 amounted to unfair market practices and procedures as set out in subsections 1.1 and 2.1 of the Act and was conduct contrary to the public interest.
69. Staff reserves the right to amend these allegations and to make such further and other allegations as Staff may advise and the Commission may permit.

**DATED** this 12th day of June, 2018.