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**MR-0062**  
May 24, 2007

## **MEMBER REGULATION NOTICE**

### **EXEMPT SECURITIES OF NON-ARM'S LENGTH ISSUERS**

This Notice is intended to clarify the obligations of Members and Approved Persons with respect to securities sold pursuant to exemptions under applicable securities legislation ("exempt securities") in which a Member or Approved Person of a Member has a direct or indirect interest.

#### **Background**

Where Members or Approved Persons have a significant direct or indirect interest in securities or other products being sold to clients through the Member there is a material conflict of interest that, under MFDA Rule 2.1.4, must be addressed by the exercise of responsible business judgment influenced only by the best interests of the client.

Provincial securities legislation allows for the sale of securities of a related party by way of prospectus, provided that certain mandatory disclosure is provided to the client by the issuer and the dealer.

With respect to the sale of exempt securities of a related party, there are additional factors that must be considered and disclosure alone will not be sufficient to address the conflict in accordance with the standard defined in MFDA Rule 2.1.4.

#### **Conflict of Interest Concerns Regarding Exempt Securities**

Exempt securities are not sold by way of prospectus. As such, they are not reviewed by any securities commission prior to issue and are not subject to the same types of controls and disclosures as securities sold by prospectus. Therefore, with respect to exempt securities of non-arm's length issuers, even where there is disclosure of the inherent conflict to clients, it is the view of MFDA staff that there will be few circumstances where Members or Approved Persons would be able to demonstrate that the conflict has been adequately dealt with through the exercise of responsible business judgment influenced only by the best interests of the client.

This view is consistent with that of some of the securities commissions. Section 6 of BC Interpretation Note 33-701 directs that registered dealers must not, in reliance on an exemption, sell securities issued by or held by an associated or connected party of the registrant. This is to ensure that conflicts of interest are limited and dealers are better able to fulfill their obligation to act fairly, honestly and in the best interests of the client. Under section 3 of Saskatchewan Local Instrument 33-502, dealers and their sellers are prohibited from trading in exempt securities if any seller of the registered dealer is a promoter of the issuer of the exempt security. A “promoter” is defined in the Saskatchewan *Securities Act* to include a person or company that takes part in founding, organizing or substantially reorganizing the business of an issuer. Both of these local instruments recognize the extent of the conflict that exists in the sale of exempt securities of non-arm’s length issuers and prohibit such sales.

MFDA staff has become aware of situations where clients of MFDA Members have been sold exempt securities of non-arm’s length issuers such as:

- Shares or debentures in corporations owned by Members or Approved Persons;
- Promissory notes issued by entities related or connected to Members or Approved Persons;
- Securities guaranteed directly by the Member;
- Investments in limited partnerships where Approved Persons act as general partner or manager; and
- Other ventures such as investments in land developments, factoring corporations and mortgage investments.

Some of these examples involved intermediary corporations owned by the Approved Person or members of the Approved Person’s immediate family.

MFDA staff is of the opinion that the practice of selling exempt securities of issuers in these and similar situations cannot generally be done in accordance with the requirements of MFDA Rule 2.1.4. Exceptions to this general rule may apply to:

- Exempt securities that are issued or guaranteed by an appropriately regulated financial institution such as a Schedule I or II chartered bank, credit union or trust company; and
- Securities managed by related investment counsel/portfolio managers.

In any event, where a Member elects to sell exempt securities of any type, MFDA staff expects that the product will be reviewed and approved in an objective manner by the Member prior to approval for sale, in accordance with the obligations outlined in MFDA Member Regulation Notice MR-0048.

We also remind Members and Approved Persons that transactions with respect to such securities cannot be structured as referral arrangements to avoid conflict concerns. The use of a referral structure does not address the conflict issue and, in any case, all securities related business must be carried out for the account of the Member and through the facilities of the Member. For more information on this last point, Members and Approved Persons may refer to MFDA Member Regulation Notice MR-0043.

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