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Maximizing the Fee: Royal Bank of Canada Affiliate Pays $30+ Million for Client Abuse

Article By:

Peter D. Hutcheon

On Thursday, March 3, 2022, the U.S. Securities and Exchange Commission ("SEC") announced that City National Rochdale, LLC ("CNR"), a Delaware statutory trust sponsoring proprietary mutual funds and serving as their investment adviser, agreed to pay $30,361,803 to settle charges brought by the SEC that the trust had failed to disclose conflicts of interest that defrauded current and prospective clients. CNR is an affiliate of City National Bank of Los Angeles, California, and in turn, City National Bank ("CNB") is a wholly-owned subsidiary of the Royal Bank of Canada ("RBC").

What had CNR done wrong? From 2016 to 2019, it violated the Investment Advisers Act of 1940 and applicable SEC regulations thereunder in three separate ways: i) CNR invested client monies in its proprietary mutual funds (rather than comparable independent funds), without disclosing that CNR earned additional advisory fees from investments in its proprietary funds as well as generating servicing fees for CNR affiliates; ii) CNR failed to offer clients the opportunity to invest in comparable mutual funds not operated by CNR; and iii) CNR failed to offer clients lower cost shares in its proprietary funds, shares which are of a class that does not charge marketing and distribution fees (so called 12b-1 fees).

As a result of these activities, CNR and its affiliates earned $22,013,613. The SEC settlement required CNR to disgorge the $22 million, plus prejudgment interest of $2,848,191, and pay a civil penalty of $5,500,000, for a total of $30,361,803.

City National Bank

Consider the motivation of an institution like CNB and its affiliated entities. Yes, they made more money in the short run, but then CNR had to give it back along with an additional $8.3 million in interest and penalties. More significant, perhaps, is the damage to their reputation. CNB regularly advertises on television's financial channels with presentations featuring satisfied customers extolling CNB's understanding of and support for their businesses. That is a picture quite at odds with the documented treatment by CNR of its clients. One wonders what the disclosure of CNR's failures may have on CNR's and CNB's market perception.

CNB began life in 1954 in Beverly Hills, when it opened its first branch. It was founded by "a small group of Beverly Hills entrepreneurs," according to the CNB website, "to create an alternative banking experience for the booming Hollywood film industry and post-war real estate market." Indeed, when it opened a Sunset Boulevard branch in 1959, Donna Reed cut the ribbon. By the 1960's, CNB had become known as "The Bank to the Stars," and it worked with the FBI to advance ransom money to Frank Sinatra to free his kidnapped son. CNB continued to grow and expand in California and nationally. Then in 2015, it was acquired by RBC. Consider how the local, specific community focus of CNB evolved over the years to become a significant regional bank with a particular history.

Royal Bank of Canada

Next one might ask why RBC would want to acquire a bank like CNB, focused on Southern California, but with operations in Nevada, New York, Atlanta, Nashville, and beyond. The answer rests in Canada's Bank Act and the decisions of the Canadian government to restrict the ability of Canada's banks to grow in Canada. There are 5 large Canadian banks, and the 2 largest, Toronto Dominion Bank and RBC, are among the 25 largest banks in the world.

Constrained at home, the large Canadian banks have turned to international expansion, especially in various American capital markets, both banking and investment banking. I have written about Toronto Dominion Bank and its U.S. subsidiary, TD Bank, in my October 6, 2020 Blog "Commerce, Culture, and Compliance," in which I discuss the Consumer Finance Protection Board's enforcement action against TD Bank for imposing inappropriate fees, resulting in a $25 million civil penalty and the establishment of a $97 million repayment fund.

RBC was founded over 150 years ago (1864) and has paid dividends to its shareholders every year since 1870. It is the second largest Canadian bank (Toronto Dominion is the largest) and has assets of $1.7 trillion (Canadian). In 1998, the Bank of Montreal sought to merge with RBC at the same time the Canadian Imperial Bank of Commerce sought to merge with Toronto Dominion. Canadian authorities prevented both mergers. Thereafter the largest Canadian banks focused their growth plans elsewhere, particularly in the U.S., with the possible exception of the Bank of Nova Scotia (Scotia Bank), which looked instead primarily to Latin America. RBC acquired Dain Rauscher Wessels, an investment banking firm located in Minneapolis, Minnesota, in 2000, and from there built a major investment banking business, especially in municipal securities and in mergers and acquisitions.

RBC Capital Markets

RBC Capital Markets, RBC's investment banking arm, has been particularly active in takeover undertakings. In 2011 it served as the advisor to the Board of Directors of Rural/Metro of Scottsdale Arizona in connection with a buyout proposed by the firm Warburg Pincus. What RBC Capital Markets did not disclose was that it was simultaneously trying to persuade Warburg Pincus to obtain financing for the buyout from RBC. Not surprisingly, the Delaware Courts (both Chancery in 2014 and the Supreme Court in 2015) found that behavior objectionable, as it put profit ahead of obligations to its advisory client. Perhaps it is not surprising that at the end of 2015 (November to be precise) RBC acquired CNB as it sought another venue to maximize profits.

The CNR's failure to deal fairly with investment clients after it became an RBC affiliate suggests that concern for earnings trumped good judgment. It has often been said that responsible corporate behavior flows from leadership at the top. Hopefully, that will eventually prove to be the case for CNR. One also may wonder how much the Canadian constraints on domestic growth force preoccupation with profit in other places. Governmental efforts to regulate capitalism do not always work as intended.

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