May Flowers

Bulletin

May 29, 2015

"You are as welcome as the flowers in May," wrote playwright Charles Macklin. Likewise, we hope you welcome our May bulletin apprising you of the newest regulatory developments:

1. New Regulatory Notices
2. Beware and Prepare: Cybersecurity and the OSC
3. Recent SEC Developments
4. 81-102 Funds: Rehypothecation of Securities
5. Comments on OSC Statement of Priorities
6. Changes to Registered Firms or Individuals' Information

In addition to these topics, new "start-up" crowdfunding exemptions have been adopted in some Canadian jurisdictions. We will be providing these updates next week as part of our *In a Nutshell* series.

1. New Regulatory Notices

The Canadian Securities Administrators (CSA) and the Ontario Securities Commission (OSC) recently published a notice that includes helpful guidance for issuers, dealers and other market participants that distribute securities on a prospectus-exempt basis.

- CSA Staff Notice 45-304 (Revised) – *Notice of Local Exemptions Related to NI 45-106 Prospectus Exemptions and NI 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations*
- OSC Staff Notice 45-709 (Revised) – *Tips for Filing Reports of Exempt Distribution*

Although these notices do not contain new information, they are useful quick reference guides that you may wish to keep at hand.

2. Beware and Prepare: Cybersecurity and the OSC

During recent compliance audits, the OSC has been inquiring into registrants' cybersecurity practices. We expect that cybersecurity will be an area of regulatory focus in the coming months. Also, did you know that the financial industry is the number one target industry for cyber criminals (source: Deloitte)?

To help you stay ahead of cybersecurity risks, strengthen your systems to manage these risks appropriately, and have your answers ready when the regulators call (and simply for good business practice), we have outlined some considerations and questions:

- Education of staff on recognizing and avoiding cybersecurity threats to the firm, and protecting confidential information
- Understanding service provider cybersecurity risks and how they are addressed
- Structured governance procedures over cybersecurity risk controls
- Encryption policies and procedures for computers and devices
- Sources of guidance and best practices (e.g., industry associations and recognized information security organizations) that firms follow

- Business interruption contingency plans in the event that a cyber attack damages a firm's critical infrastructure
- Policies and procedures for accepting instructions to withdraw or transfer funds via electronic means
- Types of IT safeguards that firms employ

In addition to preparing you for a compliance audit, being able to identify and manage your firm's cybersecurity risks is critical to safeguarding confidential information (such as your clients' personal and financial information) and protecting your firm's reputation.

3. Recent SEC Developments

From time to time, AUM Law reports on regulatory developments south of the border, since developments in the United States typically provide an early indication of trends and issues that may be of concern to Canadian securities regulators.

Recent Trends in Expense Allocation

In the United States, Securities and Exchange Commission (SEC) staff have recently highlighted, in a number of enforcement actions, perceived inappropriate expense allocation and disclosure practices by investment fund managers.

For example, in late April 2015, the SEC announced charges against a hedge fund advisory firm and two executives relating to alleged improper allocations of fund assets to pay operating expenses, including office rent, employee salaries and benefits, and similar expenses, without clear authorization from fund investors and without accurate and complete disclosures that fund assets were being used for these purposes. The SEC also charged an accountant who conducted the outside audit of the financial statements that were sent to investors.

To settle the charges, the firm agreed to pay disgorgement amounts, penalties and interest of approximately $700,000. In addition, the two executives agreed to be barred from the securities industry for one year; the executive who acted as general counsel agreed to a one-year suspension from practising as an attorney on behalf of any SEC-regulated entity; and the accountant agreed to pay a penalty of $75,000 and consented to an order suspending him from practising as an accountant on behalf of any SEC-regulated entity for three years. The firm and the three individuals settled the charges without admitting or denying the SEC's findings. See the SEC release in *Re Alpha Titans LLC, Timothy McCormack and Kelly Kaeser* dated April 29, 2015.

This case followed an earlier settlement in September 2014 where the SEC announced that it had charged an advisory firm with breach of fiduciary duty to two private equity funds for allegedly improperly allocating expenses between the two funds (e.g., by allocating an expense to one fund even though the expense had primarily benefitted the other fund).

The firm settled the charges without admitting or denying the SEC's findings by paying disgorgement amounts, penalties and interest of more than $2.3 million. See the SEC release in *Re Lincolnshire Management, Inc.* dated September 22, 2014.

In Ontario, OSC staff issued two notices in the spring of 2014 that provide extensive guidance on what constitutes (in staff's view) inappropriate allocation and disclosure practices:

- OSC Staff Notice 81-724 Report on Staff's Continuous Disclosure Review of the Fees and Expenses Disclosure by Investment Funds, dated May 8, 2014
- OSC Staff Notice 33-743 Guidance on sales practices, expense allocation and other relevant areas developed from the results of the targeted review of large investment fund managers, dated June 19, 2014

In light of these developments, it is important that fund managers manage – and are seen to manage – the conflicts of interest that may arise with expense allocation practices, in a manner that is consistent with the fund manager's duties to act honestly, in good faith and in the best interests of the fund, and to appropriately respond to conflicts.

Similarly, it is important that the fund manager be able to demonstrate that the allocation of expenses as between the manager and the funds, and as across multiple funds, is consistent with the clear terms of the management or trust agreement, the disclosure of such terms in the offering document or investment management agreement provided to investors, and the fund manager's written policies and procedures in relation to expense allocation.

A failure to effectively manage these potential conflicts or to ensure that the practices are consistent with these documents may result in significant compliance or enforcement consequences and/or potential civil litigation consequences for the fund manager and its principals.

AUM Law has recently worked with a number of investment fund manager clients to assist in enhancing the disclosure in their agreements and offering documents, and to resolve comments raised by OSC staff in connection with perceived concerns over expense allocation practices. Please contact a member of our Regulatory Compliance Group if you have questions about this area.

4. 81-102 Funds: Rehypothecation of Securities

The April 2015 *Investment Funds Practitioner*, published by staff of the OSC's Investment Funds and Structured Products Branch, included an interesting reminder about public investment funds governed by National Instrument 81-102 *Investment Funds* (NI 81-102).

In response to an inquiry, staff confirmed that portfolio assets deposited by an investment fund as collateral with a counterparty in connection with a specified derivatives transaction (as otherwise permitted by NI 81-102) may not be rehypothecated (i.e., pledged or otherwise encumbered) by the counterparty. Staff's view is that the ability to deposit portfolio assets as collateral in connection with a particular specified derivatives transaction is a limited carve-out from the general rule that all of a fund's portfolio assets must be held by its custodian. Since the counterparty in essence replaces the custodian in safeguarding the assets, the fund would be subject to risks not otherwise permitted by NI 81-102 if the assets could then be rehypotecated by the counterparty.

The take-away from the note is that fund managers must ensure that their over-the-counter derivatives documentation does not permit the counterparty to use the collateral, other than for the completion of the original specified derivatives transaction.

5. Comments on OSC Statement of Priorities

Last month, the OSC released its most recent draft of its statement of priorities for its upcoming fiscal year. Among other pressing issues, the OSC has identified the following as priorities:

- Evaluation of the best interest duty
- Reforms to improve the advisor/client relationship under National Instrument 31-103 *Registrant Requirements, Exemptions and Ongoing Registrant Obligations*
- Finalizing the analysis of advisor compensation practices

The OSC is accepting comments on its draft until June 1, 2015.

6. Changes to Registered Firms or Individuals' Information

As we have previously reminded our subscribers, registered firms have ongoing obligations under securities legislation to inform the OSC of certain changes to a firm or a registered individual's information. Failure to notify the OSC **within 10 calendar days** of most of these changes can lead to a **$100 late fee per day** up to a maximum of **$5,000 per year**, going back **two years** (**$10,000**):

Changes to Firm	Changes to Registered and Permitted Individuals	Changes to Operations
• Operations (e.g., organizational structure, officers and directors) • Ownership or anticipated acquisition of securities of another entity • Insurance, auditors and constating documents (e.g., articles of amendment)	• Individual Forms 33-109F4 • Outside activities*	• Offering of new products/business lines

*The OSC has been imposing late filing fees for failure to disclose all outside activities of individuals (i.e., directors, officers, trustees, shareholders and other roles). If you are unsure what is considered an outside activity, please contact us for further analysis and potential filing.

Here is a copy of Appendix A of Companion Policy to National Instrument 33-109, summarizing the notice requirements, time periods and forms required to notify regulators of changes to a firm or individual's registration information.