# Four Things You Need to Know About Compliance in Q4

**Bulletin**

November 5, 2014

**AUM Law** primarily serves the asset management sector, with specific expertise in the regulatory space. We focus on providing truly practical, forward-thinking advice and services.

We regularly advise fund managers and other clients on issues relating to each of the topics in this bulletin. We have recently assisted a number of clients in successfully addressing concerns raised by OSC staff. This bulletin is an overview only and it does not constitute legal advice. It is not intended to be a complete statement of the law or an opinion on any matter. No one should act upon the information in this document without a thorough examination of the law as applied to the facts of a specific situation.

Please contact a member of our Regulatory Compliance Group to ask a question, submit a comment or request more information about any topic in this bulletin. To unsubscribe or request a copy of one of our other recent bulletins, please contact communications@aumlaw.com.

**The Ontario Securities Commission's (OSC) Compliance and Registrant Regulation Branch published its Annual Summary Report in late September, highlighting its key policy initiatives, findings from its compliance reviews of registrants, and expectations and guidance for registered firms and individuals. The report (found here) is an excellent reference and self-assessment tool. We strongly recommend that you read it.**

**In addition, the following regulatory developments will be of interest to you in Q4:**

1. **Important Changes Coming to NI 31-103 in January 2015**
2. **Fund Manager Expense Allocation Practices Increasingly Under Scrutiny**
3. **Late Fee "Traps"**
4. **CRM-2: Additional Account Statements, Position Cost Information and Valuation of Securities**

## 1. Important Changes Coming to NI 31-103 in January 2015

### Background

On October 16, 2014, the Canadian Securities Administrators (the CSA) published in final form a number of important amendments to the rules, policies and forms that establish the regulatory framework for dealers, advisers and investment fund managers. Subject to the receipt of government approvals in certain jurisdictions, the amendments will come into force on January 11, 2015.

The amendments affect National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103), National Instrument 33-109 *Registration Information* (NI 33-109), National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards* (NI 52-107) and related companion policies and forms. The full details of the amendments can be found here.

The amendments are for the most part unchanged from the proposed amendments that were published for comment in December 2013.

We believe that many of the amendments will be welcomed by industry participants and represent a sensible attempt to address problems identified with the current regime, clarify ambiguous language and streamline existing requirements. However, the amendments do in some cases (as highlighted below) impose new restrictions on registered individuals and firms. Accordingly, industry participants should carefully review their existing policies and practices to ensure they remain compliant with the new requirements once the amendments come into force.

## Overview of Key Changes to Current Regime

**Some of the more notable changes to the current regime are as follows:**

- New guidance in section 1.3 *Fundamental concepts* of the Companion Policy to NI 31-103 (CP 31-103) to clarify the application of the "business trigger" for registration to start-up issuers as well as amended guidance applicable to venture capital and private equity firms
- An amendment to the proficiency requirements in Part 3 of NI 31-103 applicable to chief compliance officers of mutual fund dealers, scholarship plan dealers and exempt market dealers (EMDs) to require (for new applicants only) 12 months relevant securities industry experience in the 36 months before applying for registration
- New guidance in Part 3 of CP 31-103 in relation to experience that the CSA will consider to be relevant investment management experience
- An amendment to the restrictions in section 4.1 of NI 31-103 to clarify that the restrictions apply to activities with more than one registered firm in any jurisdiction in Canada (and not just in the local jurisdiction)
- New restrictions in Part 7 of NI 31-103 to restrict EMDs from engaging in "brokerage activities" (generally participating in secondary trading of listed securities that are not subject to resale restrictions) to address concerns the CSA has identified in connection with foreign broker-dealers engaging in brokerage activities through the EMD category. We invite you to read our AUMLaw Bulletin of November 5, 2014 which PMAC has made available online for broader discussion on this point.
- An amendment to the exemption in section 8.5 *Trades through or to a registered dealer* of NI 31-103 to expand the scope of this exemption (by deleting the word "solely") to allow certain "acts in furtherance of a trade" to be conducted by non-registrants (such as a "finder" or "referral agent") on an exempt basis, provided the non-registrant does not solicit or contact the purchaser in relation to the trade and the trade is ultimately made through an appropriately registered dealer
- New exemptions in section 8.5.1 *Trades through a registered dealer by a registered adviser* and 8.20.1 of NI 31-103 to permit incidental trading activities by a registered adviser as long as the trade is executed through an appropriately registered dealer
- Welcome changes to sections 11.9 *Registrant acquiring a registered firm's securities or assets* and 11.10 *Registered firm whose securities are acquired* of NI 31-103 to streamline the process by limiting the filing requirement as follows:
  - The filing requirement will generally apply only to the *initial* acquisition of a direct or indirect ownership interest, beneficial or otherwise, in 10% or more of the voting securities of a firm registered in Canada or (and this is new) in a foreign jurisdiction, and not subsequent acquisitions
  - The filing requirement will only need to be made with the principal regulator of the registered firm that is the acquirer and the principal regulator of the registered firm that is the target (as opposed to the current regime, which generally requires a filing be made and fees be paid in all jurisdictions in which the firm is registered
- Amendments to Part 12 *Financial condition* of NI 31-103 to clarify requirements applicable to subordination agreements, when an EMD is exempt from the requirement from financial statement delivery requirements and to introduce a new form, Form NI 31-103F4 *Net Asset Value Adjustments, as* required by section 12.14
- New exemption in section 13.17 *Exemptions from certain requirements for registered sub-advisers* to exempt a registered adviser who is acting as a sub-adviser to a registered adviser or registered dealer from certain client obligations in certain circumstances

**A detailed overview of these changes, and the changes to NI 33-109, NI 52-107, and related policies and forms, is found here.**

## Proposed Restriction on PM/EMD Participation in Prospectus Offerings

**The CSA Notice suggests that the CSA continues to be concerned about the scope of permitted activities for EMDs and indicates that the CSA may propose further restrictions on EMDs as part of a future initiative.**

**In particular, the CSA appears to be concerned about entities registered in the EMD category participating in prospectus distributions. This would include, for example, a situation where:**

- a firm that is registered as an investment fund manager (IFM), portfolio manager (PM) and EMD proposes to distribute securities of a public mutual fund to an accredited investor under the mutual fund prospectus (as opposed to relying on the accredited investor exemption, which would result in form and fee requirements under NI 45-106 *Prospectus and Registration Requirements* (NI 45-106)); and
- a firm that is registered as an EMD proposes to participate as a "selling group member"[1] in a prospectus offering of securities to an accredited investor, and wishes to distribute the securities under the prospectus (as opposed to relying on the accredited investor exemption, with the same results as above).

**In December 2013, the CSA proposed a change to Part 7 Categories of registration for firms of NI 31-103 that would have potentially limited the ability of an EMD or IFM/PM/EMD using its EMD license to participate as a "dealer" in a distribution of securities made under a prospectus. Specifically, the CSA proposed to delete the words "whether or not a prospectus was filed in respect of the distribution" from clause 7.1(2)(d)(i) of NI 31-103, which outlines the permitted activities of an EMD:**

> [7.1] (2) A person or company registered in the category of
> …
> (d) exempt market dealer may
> (i) act as a dealer by trading a security that is distributed under an exemption from the prospectus requirement~~, whether or not a prospectus was filed in respect of the distribution~~;

**We understand that the intent of this proposed change was to eliminate language that was considered to be ambiguous and to clarify that an EMD may participate as a "dealer" in a distribution of securities *made under an exemption* from the prospectus requirement, but not participate as a dealer in a distribution made under a prospectus.**

**The CSA received a number of comment letters strongly opposed to this proposed change, which letters argued, among other things, that this would be disruptive of existing market practices for issuers and EMDs in some jurisdictions and would restrict the ability of venture issuers to raise capital in the public markets.**

**The CSA Notice indicates that the CSA has decided not to proceed with this change at this time but suggests that additional restrictions on EMD participation in prospectus offerings may be introduced at a later date:**

> ***Exempt market dealer activities***
>
> *Participation in prospectus offerings [section 7.1]*
> The comments indicate that the words "whether or not a prospectus was filed in respect of the distribution" in subparagraph 7.1(2)(d)(i) and language in the Companion Policy may have been interpreted broadly by some market participants to allow exempt market dealers to be involved in prospectus offerings. As a general matter, we believe the appropriate dealer registration category for participating in prospectus offerings is the investment dealer category. We do not believe, as a matter of policy, that it makes sense to allow the exempt market dealer category to develop further into a competing platform for issuers that wish to make prospectus offerings. The CSA intends to examine further what activities an exempt market dealer should be permitted to conduct and may propose further amendments in the future. These further amendments may make a distinction between firms registered as both portfolio managers and exempt market dealers that may want to participate in prospectus offerings of investment funds, and other exempt market dealers. In the interim, we are not making any changes to subparagraph 7.1(2)(d)(i).

**We commend the CSA for carefully considering the comments that were raised on this issue and for taking additional time to consider the potential implications of this change. In the event further proposed amendments are published in this regard, AUM Law will provide comments in due course.**

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[1] The term "selling group member" refers to a dealer or other person who falls within the exception in clause (a) of the definition of "underwriter" in subsection 1(1) of the Securities Act (Ontario) (the OSA), namely, "a person or company whose interest in the transaction is limited to receiving the usual and customary distributor's or seller's commission payable by an underwriter or issuer", and corresponding provisions in the securities legislation of the other jurisdictions. We understand that OSC staff take the view that an EMD is not permitted to act as an "underwriter" in a prospectus distribution by virtue of s. 25(2) and 26(4) of the OSA and s. 7.1(2)(d)(iv) of NI 31-103.

## 2. Fund Manager Expense Allocation Practices Increasingly Under Scrutiny

Securities regulators in the United States and Canada have recently signalled through staff guidance, and in some cases compliance and enforcement actions, that they are increasingly concerned over perceived issues with fund manager expense allocation practices.

In the United States, a number of recent speeches[2] and enforcement actions[3] by Securities and Exchange Commission (SEC) staff have highlighted concerns over perceived inappropriate expense allocation and disclosure practices south of the border.

Similarly, staff of the Ontario Securities Commission (OSC staff) recently issued two notices that provide extensive guidance as to what constitutes (in the view of OSC staff) 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 recent developments, it is important that fund managers manage – and be 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 statutory duty to act honestly, in good faith and in the best interests of the fund,[4] and the fund manager's legislative duties to appropriately respond to conflicts.[5]

Similarly, it is important that the fund manager be able to demonstrate that the allocation of expenses as between the manager and the funds it manages, and as across multiple funds, is consistent with the terms of the management or trust agreement, the disclosure of such terms in the offering document (e.g., prospectus or offering memorandum) 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.

## 3. Late Fee "Traps"

As a registered firm, registered individual, and/or permitted individual, you have an ongoing obligation to notify the regulators of any updates or changes to your firm's or your individual circumstances. A failure to notify the regulators within the requisite timeframe can result in late fees being imposed. There are various ways to incur late fees, and they can add up quickly. In Ontario, late fees per violation can add up to $10,000 (i.e., the OSC charges $100 per day up to a maximum of $5,000 per year, going back two years). Multiple violations may mean multiple late fees.

Below are some common circumstances in which registrants may trigger late fees.

### Acquisition of Beneficial Ownership

**Registrant acquiring Registrant.** If your registered firm acquires beneficial ownership of (or direct/indirect control/direction over) another registered firm's securities or assets, you are required to give the regulator **30 days'**

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[2] See, for example, the January 2013 presentation by Bruce Karpati, *Chief, SEC Enforcement Division's Asset Management Unit, presentation,* Private Equity Enforcement Concerns, available at http://www.sec.gov.

[3] In the Matter of Lincolnshire Management, Inc. Investment Advisors Act of 1940 Release No. 3927 (September 22, 2014).

[4] See section 116 of the *Securities Act* (Ontario) (the OSA).

[5] See, e.g., section 13.4 of NI 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103) and Part 5 of NI 81-107 Independent Review Committee for Investment Funds (NI 81-107).

**prior written notice** if the acquisition would lead your firm to own more than 10% of any class or series of securities of the other firm. A failure to provide such notice within 30 days triggers late fees.

**Non-Registrant acquiring Registrant.** A registered firm is also required to give notice to the regulator as soon as it knows or has reason to believe that any person or entity is about to acquire or has acquired beneficial ownership of (or direct/indirect control/direction over) 10% or more of any class or series of voting shares of the registered firm. If the beneficial ownership of your registered firm changes, you are also required to update your F6 within 10 days of the effective change. Failure to do so triggers late fees.

For both of the cases above, where a registered individual or permitted individual acquires beneficial ownership, his or her F4 will need to be updated. Where the acquisition leads a new individual to become a permitted individual (i.e., more than 10% ownership), then an additional F4 for that individual will need to be submitted.

### Outside Business Activities (a.k.a. Other Business Activities or OBA)

*Are you an owner, director or officer of a holding company?*

*Are you a member of an advisory committee of an industry association?*

*Do you volunteer as a committee member for your child's amateur sports team?*

*Do you work with or volunteer with another type of a charitable, social or religious organization?*

*Are you otherwise an influential participant in an activity outside of your registered firm?*

If you answered yes to any of the above, have you disclosed your involvement to the OSC?

Registrants have an ongoing obligation to update the OSC of any updates or changes to individual Forms 33-109F4, which includes a section on OBA, **within 10 days** of the effective change.

You may be surprised by what kinds of activities may constitute an OBA. Despite its title, an OBA does not necessarily relate to business or employment. Regulators are taking a broad view of activities and positions, paid and unpaid, that must be disclosed. If you are involved with an organization outside of your firm and yield some level of influence within the organization, the OSC may take the view that you are engaging in an OBA.

To avoid potential late fees and regulatory entanglement, we recommend that you consider disclosing to the OSC each and every outside activity of registered individuals (e.g., CCOs, ARs and AARs) and permitted persons (e.g., shareholders, directors and officers).

### Other Changes That Require You to Notify the Regulators

- Changes in constating documents (e.g., articles of amendment)
- Changes to Form 33-109F4 *Registration of Individuals and Review of Permitted Individuals* (e.g., address, proficiency, OBA, subjection to regulatory/criminal/civil proceedings)
- Changes to Form 33-109F6 *Firm Registration* (e.g., address, insurance information, auditor, regulatory or legal action)
- Changes to Form 33-109F1 *Notice of Termination of Registered Individuals and Permitted Individuals* within 10 days
- Annual financial statements and interim financial reports

## 4. CRM-2: Additional Account Statements, Position Cost Information and Valuation of Securities

**The next phase of CRM-2 comes into force on July 15, 2015. The 2015 amendments require new information to be presented on monthly and quarterly account statements. The new information will be important in providing annual reports coming into force in July 2016.**

**We recommend that firms do the following before July 15, 2015:**

- Get ready for the transition! Ensure that systems are in place to comply with the rules and to ensure your account statements are accurate.
- Tune and test your account statement production process so that your statements contain the required information:
  - the party that holds or controls each security (e.g., the custodian)
  - whether any securities are covered by an investor protection fund (e.g., Canadian Investor Protection Fund)
  - whether any securities are subject to a deferred sales charge
  - the position cost of each security and the total position cost of all securities in the account (in the account statement or within 10 days); the position cost may be provided as original cost or book cost, and may be presented on an average cost or aggregate position; if the firm does not have the position cost information, there are options it can consider

**The 2015 amendments also crystallize the method of calculating the market value of securities:**

- Investment funds are valued as of the last net asset value (NAV).
- Publicly traded securities are valued using the last bid (long position) or last ask (short position) price.
- The regulators have also said closing price can be used if a firm believes it is more accurate.

**For private or illiquid securities that are difficult to value, the firm can estimate the market value if it has enough information (and if it discloses that it is an estimate) – or list the market value as "not determinable".**