



Outreach Session for Investment Fund Managers

Merzana Martinakis, Senior Accountant,
Investment Fund Manager Team

Estella Tong, Senior Accountant,
Investment Fund Manager Team

June 24, 2014 (webinar)

June 26, 2014 (in-person meeting)

Disclaimer

The presentation is provided for general information purposes only and does not constitute legal or accounting advice.

Information has been summarized and paraphrased for presentation purposes and the examples have been provided for illustration purposes only.

Information in this presentation reflects securities legislation and other relevant standards that are in effect as of the date of the presentation.

The contents of this presentation should not be modified without the express written permission of the presenters.

Agenda

Part 1

- Investment Fund Manager (IFM) team - Who we are

Part 2

- IFM compliance deficiencies
 - NI 81-105 - Mutual Fund Sales Practices
 - Expenses charged to funds and allocation of fund expenses
 - Oversight of service providers
 - Issues related to IFM organizational structures

Part 3

- NI 31-103 – Proposed IFM related amendments

Part 4

- Investment Funds and Structured Products Branch – regulatory updates
 - CSA Mutual Fund Fees Review
 - Stage 3 of the CSA Point of Sale Disclosure Project

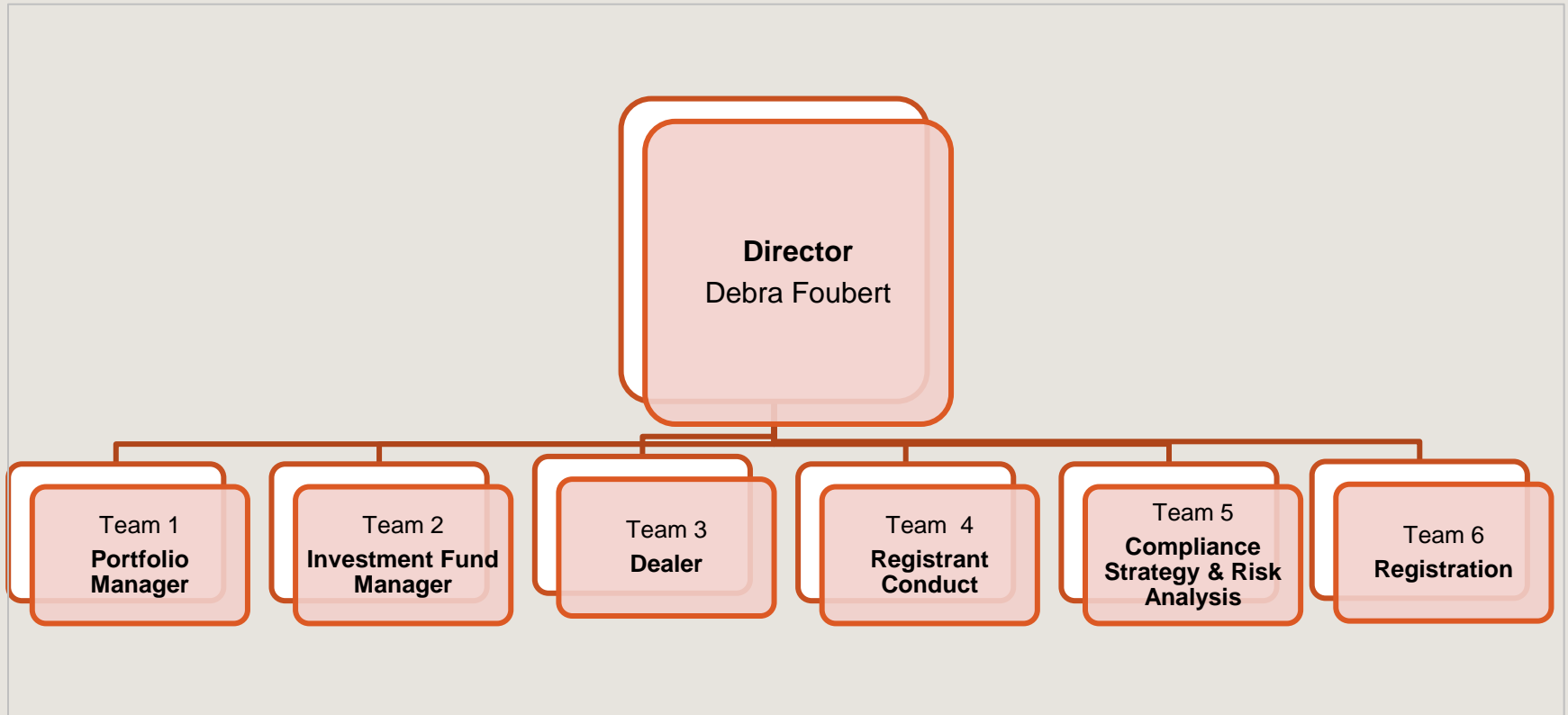


Part 1 - IFM Team – Who we are

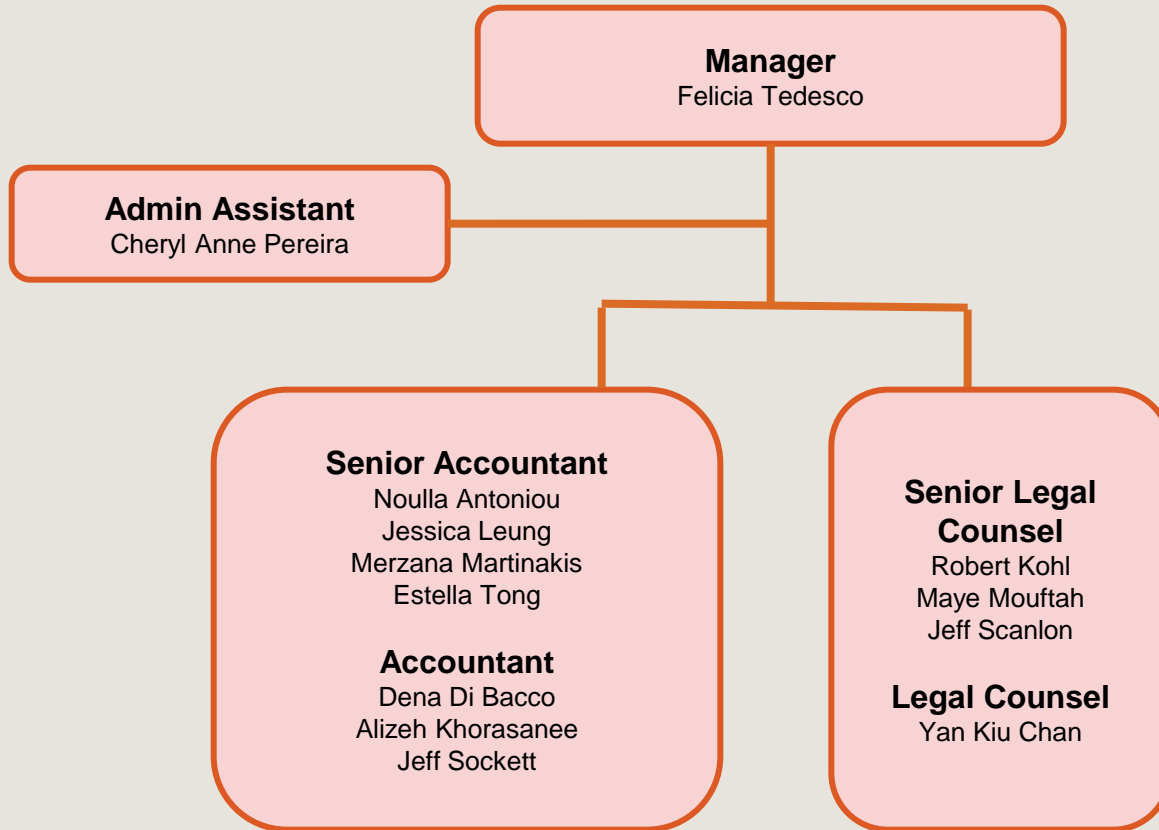
Who we are

- We are part of the Compliance and Registrant Regulation Branch at the OSC
- Our branch is responsible for registration of firms and individuals
- Our team is dedicated to investment fund managers
- We consider exemptive relief applications
- We lead and participate in policy initiatives
- We conduct compliance reviews

Overview of CRR Branch



Overview of IFM team





Part 2 - IFM compliance deficiencies

IFM compliance deficiencies

Common IFM deficiencies

- Sales practices under NI 81-105
- Expenses charged to funds
- Allocation of fund expenses
- Oversight of service providers

Other IFM deficiencies

- IFM organizational structures:
 - Payment of management fees to unregistered entities
 - IFM registration issues
 - Participation fees



NI 81-105 – Mutual Fund Sales Practices

NI 81-105 – Mutual Fund Sales Practices

Primary purpose

- The main challenges for assessing primary purpose relate to the following:
 - Content – provision of educational information
 - permitted topics vs. non-permitted topics
 - Time - % of time spent on permitted vs. non-permitted topics

NI 81-105 – Mutual Fund Sales Practices

Assessing Primary Purpose – Content & Time example

Time	Activity	Total Time	Registration, meals & breaks	Compliant content	Non compliant content	Free time activity
8:30 – 9:00 am	Breakfast & Welcome	30 minutes	30 minutes			
9:00 – 9:30 am	Opening remarks	30 minutes		30 minutes		
9:30 – 10:00 am	Chief Investment Officer, XYZ Investments Inc.	30 minutes		30 minutes		
10:00 – 10:30 am	Break	30 minutes	30 minutes			
10:30 – 11:30 am	Mutual funds in today's environment, Joe Smith, PM, XYZ Investments Inc.	60 minutes		60 minutes		
11:30 – 12:30 pm	How to grow your clientele	60 minutes			60 minutes	
12:30 – 1:30 pm	Lunch	60 minutes	60 minutes			
1:30 – 3:30 pm	Breakout sessions – all geared to mutual funds	120 minutes		120 minutes		
3:30 – 4:30 pm	Free time	60 minutes				60 minutes
TOTAL TIME		480 minutes	120 minutes	240 minutes	60 minutes	60 minutes

NI 81-105 – Mutual Fund Sales Practices

Assessing Primary Purpose – Content & Time example

Time Assessment	Total Time
Total time for all categories	480 minutes
Total time for registration, meals & breaks	120 minutes
Total time for analysis	360 minutes
Total time for compliant content	240 minutes
Compliant content as a % of total time for analysis	67%
Total time for non-compliant content & free time activity	60 minutes + 60 minutes = 120 minutes
Non-compliant and free time activity as a % of total time for analysis	33%

Conclusion: Conference meets primary purpose based on content and time

NI 81-105 – Mutual Fund Sales Practices

Reasonability of costs

- The two major findings relating to reasonability of costs were:
 1. Inadequate process to ensure that the provision of non-monetary benefits were not extravagant and were consistent with the spirit of Part 5 of NI 81-105
 - Inadequate process and factors considered to determine reasonability of costs
 2. The payment of prohibited expenses
 - transportation costs
 - accommodation costs
 - personal incidental expenses

NI 81-105 – Mutual Fund Sales Practices

Reasonability of Costs example

Q: The details of a mutual fund sponsored conference (section 5.2 of NI 81-105) are as follows:

Attending representatives: 100

Duration: 3 days

Location : Phoenix, AZ

The dinner costs* are as follows:

- 1) Day 1: \$25,000 – dinner at the hotel**
- 2) Day 2: \$30,000 – dinner at a golf course**
- 3) Day 3: \$85,000 – dinner on an island requiring rental of boats for transportation**

***dinner cost includes transportation to dinner (if required), set up, decoration, entertainment, staffing, and other ancillary costs**

The entertainment cost s are as follows:

- 1) Day 1: \$25,000 – golf or spa**
- 2) Day 2: \$25,000 – golf or spa**
- 3) Day 3: \$60,000 – golf or spa**

Total cost of the conference is \$325,000

When assessing the reasonability of the costs of this conference, can we conclude that the dinner and entertainment costs are reasonable?

NI 81-105 – Mutual Fund Sales Practices

Reasonability of Costs example

Dinner assessment						
	Day 1	Day 2	Day 3	Total	Comments	Compliant?
In total	\$25,000	\$30,000	\$85,000	\$140,000	May appear excessive – need to analyze on different levels	Maybe – further analysis required
Per rep	\$250	\$300	\$850	\$1,400	Day 1 and 2 seem reasonable; Day 3 appears extravagant based on cost & location; Day 2 & 3 are offside transportation prohibition	Yes – Days 1 & 2 for cost No – Day 3 re cost No – Day 2 & 3 for transportation to dinner
% of total event costs	\$25,000/ \$325,000 = 8%	\$30,000/ \$325,000 = 9%	\$85,000/ \$325,000 = 26%	\$140,000/ \$325,000 = 43%	Same conclusion as above – transportation costs to dinner are strictly prohibited	Yes – Days 1 & 2 for cost No – Day 3 re cost No – Day 2 & 3 for transportation to dinner

Conclusion: The dinner costs for day 3 are not reasonable having regard to the purpose of the conference. The payment of transportation costs are prohibited.

NI 81-105 – Mutual Fund Sales Practices

Reasonability of Costs example

Entertainment assessment						
	Day 1	Day 2	Day 3	Total	Comments	Compliant?
In total	\$25,000	\$25,000	\$60,000	\$110,000	May appear excessive – need to analyze on different levels	Maybe – further analysis required
Per rep	\$250	\$250	\$600	\$1,100	Day 1, 2 seem reasonable taking into account the cost of a round of golf or a spa visit in Ontario and section 7.3 of NI 81-105CP; Day 3 is extravagant in comparison	Yes – Day 1 & 2 No – Day 3
% of total event costs	\$25,000/ \$325,000 = 8%	\$25,000/ \$325,000 = 8%	\$60,000/ \$325,000 = 18%	\$110,000/ \$325,000 = 34%	Same conclusion as above	Yes – Day 1 & 2 No – Day 3

Conclusion: The entertainment costs for day 3 are not reasonable having regard to the purpose of the conference.

In summary: The IFM is compliant based on content and time (refer to slide 13). The IFM is not compliant based on the provision of transportation to dinner, the reasonability of some dinner costs and some entertainment costs; the cost of dinner and the entertainment on day 3 and the transportation to dinner on day 2 and 3 must be changed to ensure the entire conference is on side with section 5.2 of NI 81-105.



Expenses charged to funds & allocation of fund expenses

IFM Expenses vs. Fund Expenses

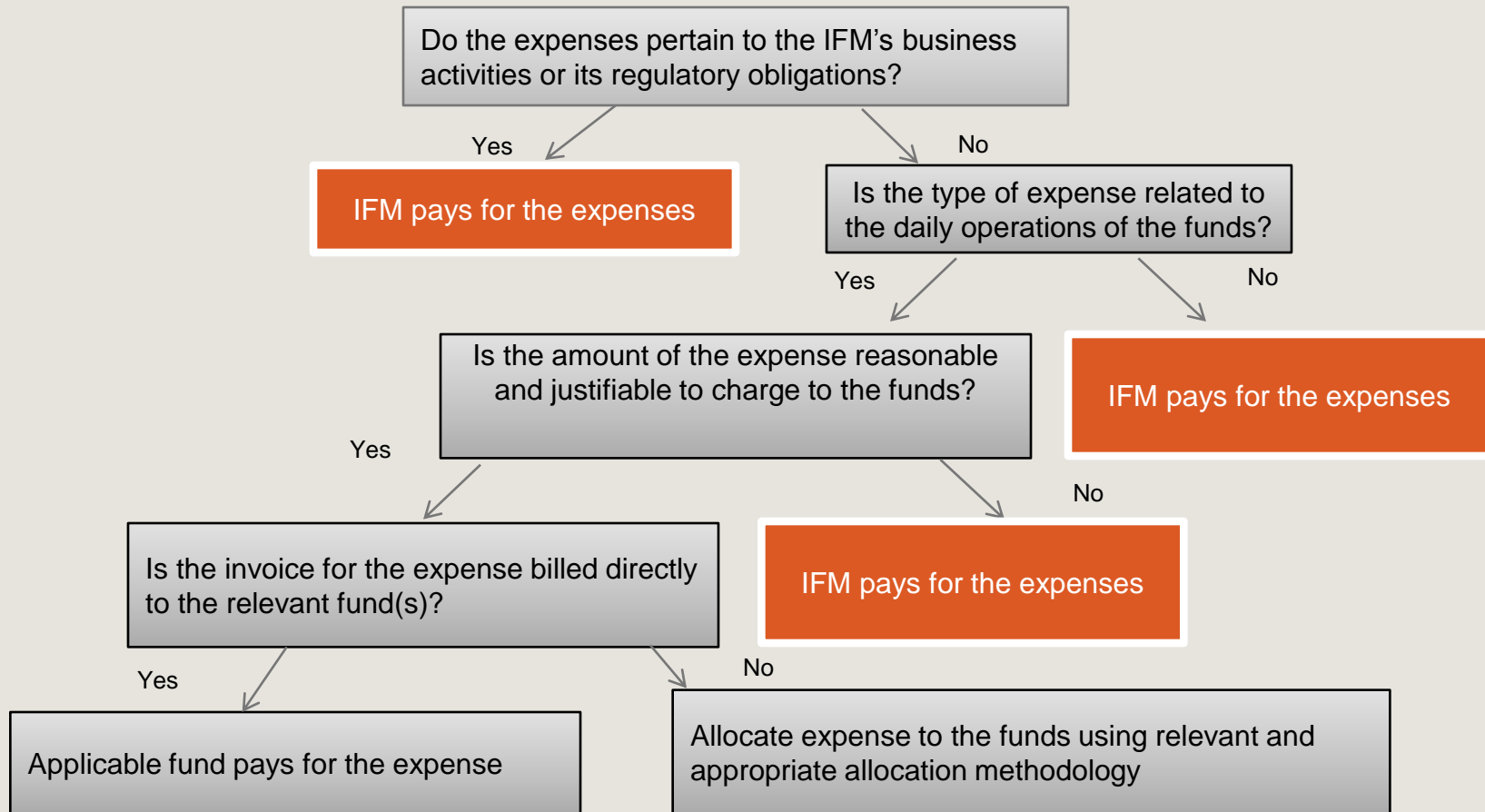
IFM expenses

- Expenses related to the operations and conduct of an IFM should be borne by the IFM and **should not** be allocated to the funds. These include:
 - maintaining proper registration for the firm, the UDP and the CCO
 - developing a system of compliance and controls, along with on-going monitoring and supervision
 - ensuring compliance with securities law and meeting regulatory obligations
 - establishing the firm's infrastructure and hiring qualified personnel
 - entering into agreements with service providers
 - establishing a distribution network & providing dealers with required information
 - promoting the investment funds

Expenses of an investment fund

- Only expenses that are related to the daily operation of the investment funds should be allocated to the investment funds

IFM Expenses vs. Fund Expenses



IFM Expenses vs. Fund Expenses

Nature of expense	IFM Expense	Fund Expense
Salaries and benefits of staff fully dedicated to providing services to the fund		✓
Salaries and benefits of compliance/ HR staff	✓	
System changes to enhance back office services for funds		✓
System changes to enhance portfolio management system	No. PM is already compensated through an advisory fee paid from the management fee.	No. PM is already compensated through an advisory fee paid from the management fee.
System changes to produce CRM 2 required information	✓	

Allocation of Fund Expenses

- **Direct expenses:** expenses that are directly linked to the funds. In most cases the invoices are provided on a fund-by-fund basis e.g. audit fees, custodial fees, legal fees.
- **Indirect expenses:** expenses that are not charged on a fund-by-fund basis e.g. fees paid to service providers for outsourced functions or expenses incurred for functions performed in-house and other overhead expenses.
 - The IFM will need to allocate these costs to the funds using an appropriate cost driver.

Type of Expense	Allocation methodology used/ cost driver
Fund accounting	Assets under management
Trust accounting	Assets under management
Transfer agency	Number of securityholders
Securityholder reporting	Number of securityholders
Legal expenses	<ul style="list-style-type: none">• Per fund if specific to a fund• Assets under management if applicable to all funds

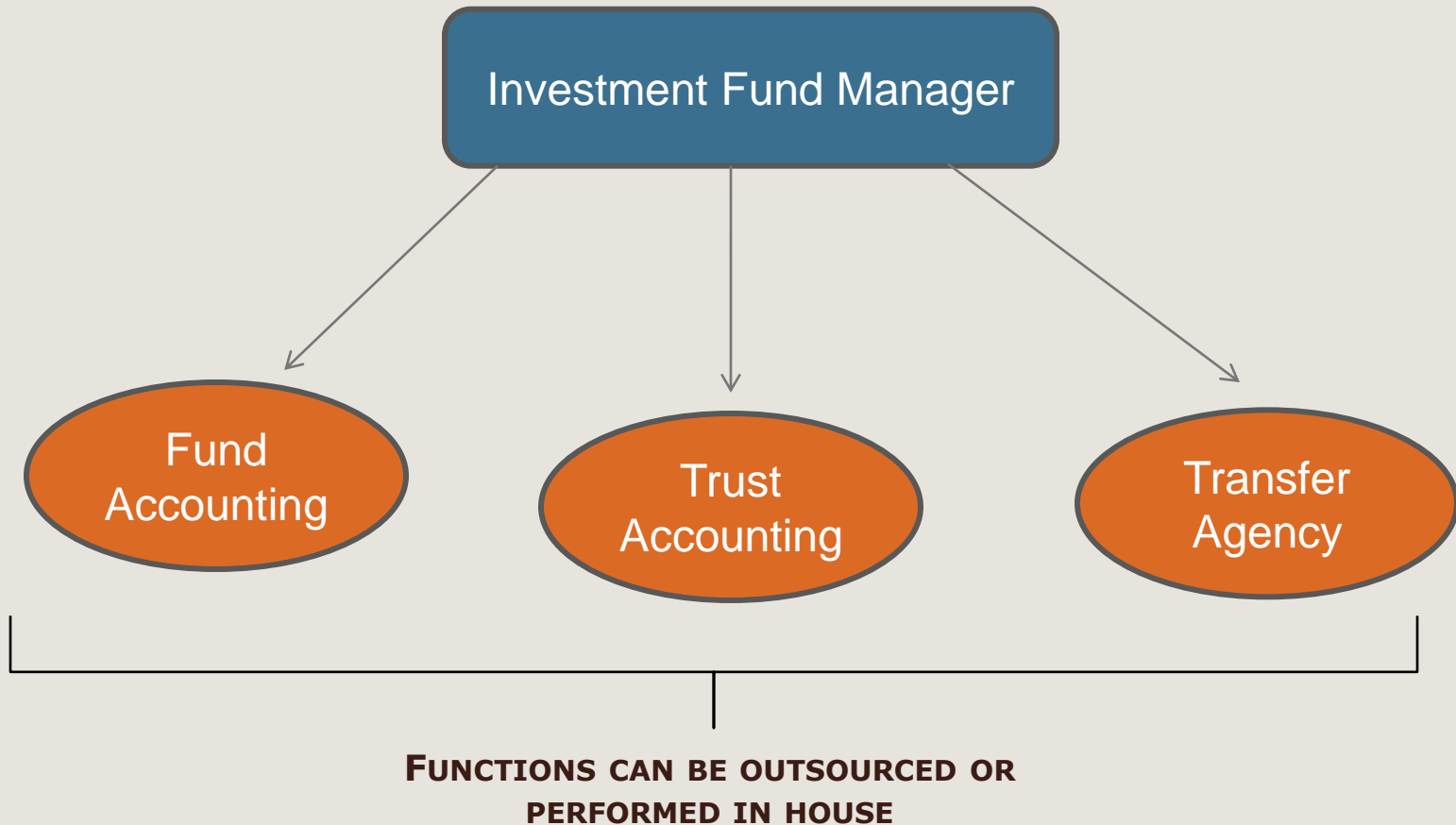
Other points to consider

- Disclosure in offering documents:
 - Disclosure made in the offering documents on fees and expenses should be clear and contain an appropriate level of detail
 - IFMs should avoid using general or collective terms such as “administration costs” or “operating costs” to describe a group of expenses
- Independent review committee (IRC):
 - IRC approval should be obtained for the types of expenses charged as well as for the allocation methodology used
 - IRC approval should be obtained for expenses paid to an affiliate
 - Provide adequate level of detail to the IRC to allow the IRC to make an informed decision
 - Ensure that IRC is aware of all updates and changes relating to expenses charged to the funds and allocation methodology used



Oversight of service providers

Major IFM Operational Functions



Outsourcing of IFM functions to service providers

Use of service providers

- Additional guidance under Part 11 of the Companion Policy to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103CP**)
- Key aspects of the oversight process to ensure compliance with securities legislation
- Third party service providers vs. affiliated entities:
 - An affiliate that is part of the same global conglomerate providing transfer agency, trust accounting and fund accounting services to investment fund
 - What is the expectation regarding oversight of the affiliate by the IFM?

Outsourcing of IFM functions to service providers

Function	Service provider responsibility	Examples of oversight:
Transfer Agency	<ul style="list-style-type: none">- Process subscription and redemption requests	<ul style="list-style-type: none">- Review unitholder reconciliation report for timely and accurate processing of transactions- Review of fund unit position reconciliations- Review of non-financial changes to unitholders

Outsourcing of IFM functions to service providers

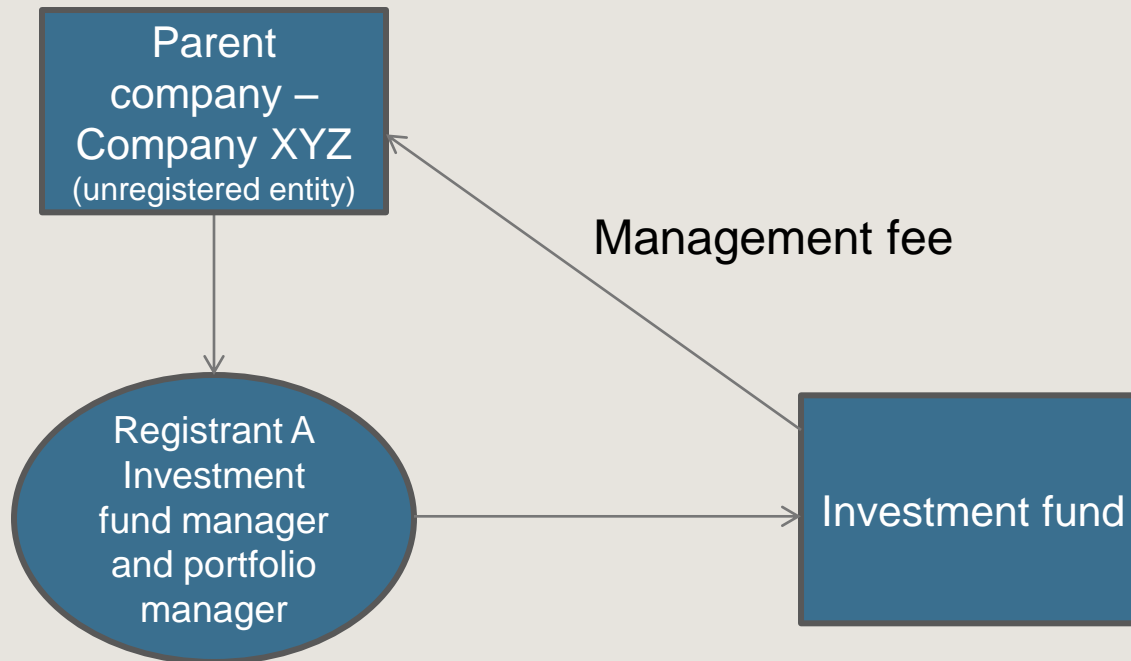
Function	Service provider responsibility	Examples of oversight:
Trust Accounting	<ul style="list-style-type: none">- Reconcile money flowing in/out of fund trust account with transfer agent activity	<ul style="list-style-type: none">- Review reconciliation of each fund's trust account to ensure:<ul style="list-style-type: none">• no commingling• proper interest distribution• ensure only valid transactions take place
Fund Accounting	<ul style="list-style-type: none">- Perform net asset value (NAV) calculation including pricing of individual securities, processing of corporate actions, reconciling cash and security positions held by the fund with custodial records	<ul style="list-style-type: none">- Review NAV reporting package detailing all components of the NAV calculation to ensure:<ul style="list-style-type: none">• timely review of cash and fund security positions• proper reconciliation of fund positions to custodial report• accurate pricing of securities including review and approval of manually-priced securities• complete and accurate processing of corporate actions• rectify NAV errors as required• re-calculate on a sample basis management fees, other fund expenses and NAV



Issues related to IFM organizational structures

IFM organizational structures

- Payment of management fees to unregistered entities
 - Registration implications:
 - Who is the IFM? Who directs the business, operations or affairs of the fund?
 - Participation fee implications:
 - Participation fee does not capture all revenue attributed to registerable activities



IFM organizational structures

Disclosure regarding an unregistered entity performing IFM duties and responsibilities

- Examples of financial statement disclosure:
 - Pursuant to the terms of agreements, the fund pays management and advisory fees to Company XYZ, Registrant A's parent company.
 - Company XYZ then pays a fee to Registrant A for services rendered on behalf of the investment fund.
- Examples of disclosure in management agreements and offering documents
 - Company XYZ is:
 - responsible entering into agreements on behalf of the fund
 - allocated an amount of income and the performance bonus allocation
 - acts as transfer agent and registrar
 - calculates the value of each portfolio's assets



Part 3 – NI 31-103 – Proposed IFM related amendments

Proposed IFM related amendments

Proposed on-going amendments to NI 31-103:

- CSA published proposed amendments to NI 31-103 in December 2013
- CSA proposed amendment impacting IFMs:
 - Section 12.14(2)(c) – Net Asset Value (**NAV**) adjustment
 - Introduction of new Form 31-103F4 *Net Asset Value Adjustments*
 - The intention of the change is to provide additional details on the cause of the NAV adjustment



Part 4 – Investment Funds and Structured Products Branch regulatory updates



CSA Mutual Fund Fees Review: Regulatory Update

Chantal Mainville, Senior Legal Counsel
Investment Funds and Structured Products Branch

CSA Discussion Paper 81-407

Mutual Fund Fees

- Published for comment December 13, 2012;
- Goal was to:
 - Discuss investor protection and fairness issues we think arise from mutual fund fee structure
 - Set out a range of potential regulatory options to address issues identified
 - Use paper as a platform to begin a discussion of the issues and possible solutions

Regulatory Issues Arising from Mutual Fund Fee Structure in Canada

- Lack of investor understanding and control of advisor compensation
- Potential conflicts of interests at both the mutual fund manufacturer and advisor levels
- Lack of alignment of advisor compensation and services
- Lack of low-cost options for DIY investors

Potential options proposed in 81-407

- Prescribe advisor services to be provided in exchange for trailing commissions
- Offer low-cost fund series for DIY investors
- Charge/disclose trailing commission component as separate asset-based fee
- Cap commissions
- Implement best interest duty for advisors
- Ban conflicted advisor remuneration

Status Report on Consultation

- On December 17, 2013, published CSA Staff Notice 81-323 providing status report on mutual fund fees consultation
- Identified key themes emerging from comment process and subsequent in-person consultations
- Themes split between industry and investor viewpoints.

Key themes from industry stakeholders

- There is no evidence of investor harm that warrants a change to the mutual fund fee structure in Canada
- A ban on embedded compensation will:
 - Reduce access to advice for small retail investors
 - Eliminate choice in how investors may pay for advice, and
 - Create an unlevel playing field among competing products and opportunities for regulatory arbitrage
- Should observe and assess the impact of domestic and international reforms before moving ahead with further proposals.

Key themes from investor stakeholders

- Embedded advisor compensation causes a misalignment of interests which impacts investor outcomes and should be banned
- Investors should at a minimum have the true choice to not pay embedded commissions
- Need to apply a best interest duty to advisors
- Need to increase advisor proficiency and regulate the use of titles

Next Steps: Research

- CSA will obtain *quantitative* information to inform its policy decision
- Issued RFP on April 7, 2014 inviting proposals for two independent pieces of research to evaluate the extent, if any, to which:
 - i. Sales and trailing commissions influence fund sales
 - ii. The use of fee-based vs. commission-based compensation changes the nature of advice and investment outcomes over the long term.

Timing

- Conduct research: summer and fall 2014
- Staff notice setting out key findings and status will be published by early 2015
- Recommendation on policy direction submitted to CSA Chairs early 2015.



Stage 3 of the CSA Point of Sale (POS) Disclosure Project: Regulatory Update

Stephen Paglia, Senior Legal Counsel
Investment Funds and Structured Products Branch

Project Background

- Purpose:
 - provide investors with more meaningful information about a mutual fund at a time that is most relevant to their investment decision
- Fund Facts:
 - in plain language, no more than two pages double-sided and highlights key information that is important to investors.

Staged Approach to Implementation

- June 18, 2010 notice outlined the CSA's decision to proceed with a staged implementation.
- Stage 1 (completed) – mandates the production, filing and posting of the Fund Facts to a website.
- Stage 2 (completed) – allows delivery of the Fund Facts to satisfy current prospectus delivery requirements.
 - Fund Facts required to be delivered as of June 13, 2014
- Stage 3 (under way)

Stage 3 of Point of Sale Project

- Three concurrent work streams:
 - proposed amendments aimed at implementing pre-sale delivery of the Fund Facts,
 - the development of a CSA mutual fund risk classification methodology
 - the development of a summary disclosure document for exchange-traded mutual funds (ETFs)

Pre-Sale Delivery

Type of account	Type of trade	Type of fund	Time of delivery		
			Initial purchase	Subsequent purchase	Annually
2009 Proposal					
Full service	Adviser recommended	All funds other than money market funds	Before or at point of sale	No delivery	Investor will be given option to receive annually Fund Facts for all funds
		Money market funds	Before or at point of sale OR With trade confirmation		
	Investor initiated	All funds			
Order execution only	All trades	All funds	With trade confirmation		
Current Proposal					
Full Service	All trades	All funds	Before a dealer accepts an instruction for the purchase of a security of a mutual fund OR Within 2 days of purchase in limited circumstances subject to conditions	No delivery unless a more recent version of the Fund Facts has been filed	Not applicable
Order execution only	All trades	All funds			

Current Pre-Sale Delivery Proposal

Proposed pre-sale delivery requirements simplified

- for all mutual fund securities purchases, Fund Facts is required to be delivered or sent to purchaser before a dealer accepts instruction

Limited exceptions to pre-sale delivery

- where pre-sale delivery impracticable
- for pre-authorized purchase plans

Exceptions to Pre-Sale Delivery

- **Where Pre-Sale Delivery Impracticable**
 - the purchaser indicates that mutual fund purchase has to be completed immediately or within a specified time
 - it is not reasonably practicable for dealer to complete pre-sale delivery of the Fund Facts
 - the dealer informs the purchaser of:
 1. existence and purpose of the Fund Facts, and
 2. dealer's obligation of pre-sale delivery of Fund Facts
 - the dealer provides a verbal overview of the Fund Facts, including investor rights
 - the purchaser consents to receiving the Fund Facts after entering into the purchase
 - the Fund Facts is required to be delivered or sent to the purchaser within 2 days of purchase
 - no standing instructions for post-sale delivery

Exceptions to Pre-Sale Delivery

- **For Pre-Authorized Purchase Plans**

- the Fund Facts is not required to be delivered for subsequent purchases of a mutual fund
- the dealer must provide initial and subsequent annual notices to the purchaser with the following information:
 - how to access and request the Fund Facts
 - purchaser does not have a right to withdrawal
- purchaser has right of action for rescission or for damages if there is a misrepresentation in the prospectus or Fund Facts

Risk Rating Methodology

- CSA Notice 81-324 and Request for Comment – *Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts*
 - Published December 12, 2013
 - Developed in response to stakeholder concerns regarding lack of standardized risk disclosure
- Proposal sets out a proposed risk classification methodology for use by mutual fund managers in the Fund Facts.
 - Methodology based on 10-year standard deviation
 - 6 category risk scale ranging from low to very high
 - Intended to provide a consistent and comparable basis for measuring the risk of different mutual funds
- Comment period ended on March 12, 2014

Summary Disclosure Document for ETFs

- CSA granted exemptive relief orders in August 2013 introducing an alternative delivery regime for ETFs
 - Requires delivery of a summary disclosure document with the trade confirmation for all ETF purchases as of September 2013
- Exemptive relief orders cover all ETF manufacturers and bank-owned dealers, which account for approximately 80% of ETF trades
- CSA currently developing and testing a summary disclosure document similar to Fund Facts for ETFs called ETF Facts
- Will publish proposals to implement ETF Facts and codify alternative delivery regime introduced through exemptive relief orders

Next Steps

- Pre-sale Delivery of Fund Facts
 - Publication of final rules Fall 2014
 - Final implementation date to be determined
- Risk Classification Methodology
 - Publication for comment early 2015
- ETF Facts
 - Publication for Comment late 2014



References

References & web links

- IFM Common deficiencies
 - [OSC Staff Notice 33-742 – 2013 OSC Annual Summary Report for Dealers, Advisers and Investment Fund Managers](#)
 - [OSC Staff Notice 33-738 - 2012 OSC Annual Summary Report for Dealers, Advisers and Investment Fund Managers](#)
 - [OSC Staff Notice 33-743 \(to insert website hyperlink once published\) - *Guidance on sales practices, expense allocation and other relevant areas developed from the results of the targeted review of large investment fund managers*](#) (OSC Staff Notice 33-743)
 - Mutual Fund Sales Practices
 - Assessing primary purpose
 - [Part 5 of National Instrument 81-105 Mutual Fund Sales Practices](#) (NI 81-105)
 - Part I – Sales Practices *Assessing primary purpose* section i) and ii) [of OSC Staff Notice 33-743](#)
 - [OSC Staff Notice 11-760 – Report on Mutual Fund Sales Practices Under Part 5 of National Instrument 81-105 Mutual Fund Sales Practices](#) (OSC Staff Notice 11-760)
-

References & web links

- Mutual Fund Sales Practices
 - Assessing reasonability of costs
 - Section 7.1 and 7.3 of the [Companion Policy to NI 81-105](#) (NI 81-105CP)
 - Part I – Sales Practices *Reasonability of Costs*, section i) and ii) of [OSC Staff Notice 33-743](#)
 - [OSC Staff Notice 11-760](#)
 - Promotional items and business promotion activities
 - Definitions included in [Part 1 of NI 81-105](#)
 - [Part 5 of NI 81-105](#)
 - Section 7.3 and 7.6 of [NI 81-105CP](#)
 - Part I – Sales Practices *Reasonability of Costs*, section i) and ii) of [OSC Staff Notice 33-743](#)
 - [OSC Staff Notice 11-760](#)

References & web links

- Expenses charged to funds & allocation of fund expenses
 - [Part II of OSC Staff Notice 33-743](#)
 - [OSC Staff Notice 11-760](#)
- Outsourcing of service providers
 - [Part 11 of NI 31-103CP](#)
 - [Part V of OSC Staff Notice 33-743](#)
- IFM organizational structure
 - [Section 7.3 of NI 31-103CP](#)
 - [Section 2.8 of the Companion Policy to OSC Rule 13-502 Fees](#)
- Proposed NAV Form 31-103F4 *Net Asset Value Adjustments*
 - [Proposed Amendments to NI 31-103 and related rules and forms](#) published December 5, 2013



Questions



RegistrantOutreach@osc.gov.on.ca