

1.1.2 OSC Staff Notice 11-760 - Report on Mutual Fund Sales Practices under Part 5 of NI 81-105 Mutual Fund Sales Practices

**Ontario Securities Commission
Staff Notice 11-760
Report on Mutual Fund Sales Practices
under Part 5 of National Instrument 81-105
- Mutual Fund Sales Practices**

Executive Summary

Introduction

In the fall of 2006, OSC staff conducted a focused review of the marketing and educational practices of fund managers under Part 5 of National Instrument 81-105 *Mutual Fund Sales Practices* (NI 81-105). This report summarizes our findings and provides guidance to industry participants on complying with these requirements.

Background

NI 81-105 regulates the sales practices of industry participants in connection with the distribution of publicly offered securities of mutual funds. This includes the manager and the principal distributor of the mutual fund, as well as dealers and their sales representatives.

The intention of NI 81-105 is to reduce conflicts between the interests of investors and those of dealers, their sales representatives and managers. NI 81-105 came into force in May 1998 in response to the concern that certain sales practices and compensation arrangements common in the industry at the time could be perceived as inducing dealers and their sales representatives to sell mutual fund securities based on the incentives they were receiving, rather than on what was suitable for, and in the best interests of, investors.

By prohibiting certain sales practices and compensation arrangements, NI 81-105 establishes a minimum standard of conduct for industry participants to follow in their sales practices.

We last reviewed industry sales practices under NI 81-105 in October 1998 as part of a national compliance review. In our view, sufficient time had passed to warrant a review of Part 5 of NI 81-105, which deals with the following marketing and educational practices:

- cooperative marketing practices (section 5.1)
- mutual fund sponsored conferences (section 5.2)
- third party sponsored educational events (section 5.3)
- industry association sponsored events (section 5.4)

- participating dealer sponsored events (section 5.5) and
- promotional items and business promotion activities (section 5.6)

Purpose of the review

The goals of the review were to:

- confirm our understanding of how managers are interpreting and complying with Part 5 of NI 81-105
- review and assess managers' policies, procedures and practices relating to sales practices
- assess whether additional guidance to industry participants is necessary and
- determine whether NI 81-105 is meeting our objectives, or whether amendments are necessary

Scope of the review

We reviewed a sample of 20 managers with assets under management totaling \$306 billion as at July 31, 2006. The managers varied in size from \$6 million to \$67 billion in assets under management.

The review teams consisted of staff from the Compliance team of the Capital Markets Branch and staff from the Investment Funds Branch. We conducted onsite reviews of the managers included in the sample during the period from September to December 2006. We reviewed samples of documentation dating from August 1, 2005 to July 31, 2006 that related to events sponsored by managers.

Each manager that we reviewed received a report in February 2007, which set out the specific deficiencies staff noted during their reviews. The managers were required to respond in writing to staff within 30 days of receiving the report and explain how they were going to correct the deficiencies.

Key findings

Overall, the managers we reviewed substantially complied with Part 5 of NI 81-105. While the deficiency reports sent to each manager identified areas for improvement, none of the deficiencies warranted enforcement action.

We identified the following three areas of deficiency that were common to the managers in the sample:

1. Primary purpose test

Meeting the primary purpose test under Part 5 is essential to managers deciding to accept or reject a cooperative marketing request.

Primary purpose tests were not met because broader topics such as financial planning or investing in securities were included in the sales communications, investor conferences or seminars organized under section 5.1. In addition, significant time was spent on practice management sessions, motivational speakers, award ceremonies, sessions on general business operations or recreational activities for conferences or events organized under sections 5.2 to sections 5.6.

2. Policies and procedures

Policies and procedures for sales practices were inadequate because there was not enough detail to ensure compliance with Part 5. For example, policies and procedures simply repeated the provisions of NI 81-105 and did not provide guidelines or processes to assist managers in reviewing and approving requests and reimbursing expenses.

In some instances, the managers had detailed policies and procedures in place but they did not consistently adhere to them.

Additionally, some managers' policies and procedures under Part 5 did not appropriately capture events hosted or attended by dealers and sales representatives who distribute both mutual fund securities and non-mutual fund securities, such as segregated funds and closed-end funds.

3. Monitoring promotional items and business promotion activities

Managers did not adequately monitor promotional items and business promotion activities. They did not have adequate processes in place to:

- monitor the total dollar amount of benefits given to individual sales representatives as promotional items or in promotion activities or
- track the frequency with which these benefits were provided to individual sales representatives.

Specific deficiencies relating to each section of Part 5 of NI 81-105 are described below under *Detailed findings*.

Conclusion

We recognize that managers engage in a variety of sales practices and must use their judgment when applying the principles set out in NI 81-105, in particular under Part 5. To meet their standard of care under securities legislation, we expect managers to develop policies and procedures specific to their businesses and to apply them consistently to their sales practices.

In particular, we expect managers to maintain documentation to support decisions to provide sponsorship under Part 5. See Appendix A for a list of guidelines managers may want to consider including in their policies and procedures manual.

We believe the spirit and intent of NI 81-105 remain relevant today and strike the right balance between protecting investors, and fostering fair and efficient capital markets. As a result, we are not proposing any amendments to NI 81-105 at this time.

We will, however, continue to review cooperative marketing and other sales practices as part of our regular reviews of fund managers. We expect industry participants to look to the guidance included in this report in meeting the requirements under Part 5 of NI 81-105.

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Detailed findings

The following pages describe the deficiencies we observed for each section of Part 5 and our guidance for managers to meet the requirements. In many cases, the specific guidance noted under a section will also apply to other sections of Part 5.

Section 5.1 Cooperative marketing practices

Section 5.1 permits managers to pay the costs of sales communications, investor conferences and seminars that dealers organize and present to investors, within certain parameters.

Deficiencies

We observed the following deficiencies:

- **Primary purpose.** Sales communications and investor conferences and seminars did not meet the primary purpose of promoting or providing educational information concerning a mutual fund, a mutual fund family or mutual funds generally. Instead, the sales communications and seminars dealt with the broader topic of investing generally.
- **Documentation.** There was inadequate supporting documentation to demonstrate:
 - that sales communications and investor conferences and seminars met the primary purpose test
 - that the manager reviewed requests from dealers for financial support
 - that manager sponsorship of investor conferences and seminars was disclosed to the attendees in writing
 - that the 50% contribution limit on mutual fund organizations was met when more than one manager paid direct costs
 - who managers made payments to
- **Payments.** Managers paid for items that dealers used for client appreciation purposes, for example, golf tournaments, tickets to sporting events, books on investing and gift certificates.

Managers made cooperative payments directly to sales representatives instead of to dealers.

- **Policies and procedures.** In some instances, events were not identified and tracked under the appropriate section of Part 5. In other instances, the review process for sponsorship requests was handled solely by the manager's sales department with no independent oversight by, for example, the manager's compliance department.

Managers did not follow the guidelines in their policies and procedures for paying for cooperative marketing under section 5.1.

- **Disclosure.** Sales communications did not disclose manager sponsorship.

Guidance

We expect managers to consider the following:

Primary purpose

The primary purpose for sales communications, investor seminars and conferences in section 5.1 is more limited in scope than in other sections of Part 5 and may not include topics on financial planning or investing in securities. Managers require exemptive relief if they want to sponsor seminars or conferences on broader topics under this section.

We expect managers to have internal policies and procedures to evaluate the content of sales communications and investor conferences or seminars under this section. Managers may want to consider developing an internal percentage benchmark to assess whether the primary purpose test is met. For example, if the amount of time spent on permitted topics at an investor seminar or conference exceeds a certain percentage, the event meets the primary purpose requirement.

If the investor seminar or conference is a lunch or dinner presentation, looking solely at the time allotted to the educational portion of the event may not be an appropriate way to evaluate whether the primary purpose test is met. In this instance, we expect managers to consider the whole event, including:

- the content of the presentations
- the cost of meals or refreshments and
- any other costs

Managers may want to consider setting an internal dollar amount per person per event as a general guideline for sponsoring lunch or dinner seminars and conferences. If the costs appear excessive compared to the purpose of the event, the objective of the event may be viewed as client appreciation, which is not permitted by section 5.1.

Documentation

We expect managers to maintain documentation to support their decisions on providing sponsorship. We expect the documentation to include:

- a copy of the written communication identifying the manager as a sponsor

- final copies of any advertisement, newsletter or transcripts for television or radio advertisements
- a final agenda that sets out the topics covered and the time allotted to each topic
- evidence that sponsorship by multiple managers in total did not exceed 50% of the direct costs and
- copies of all invoices and receipts

Payments

Paragraph 5.1(c) specifies that the participating dealer—not the sales representative—must provide the manager with invoices and receipts associated with the event. Section 5.1 also requires managers to make reimbursement cheques payable to dealers, not to sales representatives.

Disclosure

Paragraph 5.1(e) specifies that attendees of investor seminars and conferences must be informed in writing of the manager's sponsorship. We do not consider verbally introducing the manager as a sponsor at the investor seminar or conference to fulfill this requirement.

If the manager has not been identified in the invitation to the seminar or conference as a sponsor, we expect the manager to be clearly identified in writing as a sponsor on items such as signs, posters and banners.

We consider using the fund company's logo instead of the manager's full legal name on a sales communication to satisfy the disclosure requirement in paragraph 5.1(e) if:

- the logo is easily identifiable and
- it is clear that the manager is sponsoring the event

The following are acceptable disclosure statements:

- "paid in part by XXX"
- "sponsored in part by XXX"
- "a portion of the costs has been paid by XXX" and
- "brought to you by XXX"
(where XXX is the fund manager's full legal name or its logo)

Section 5.2 Mutual fund sponsored conferences

Section 5.2 permits managers to organize educational conferences or seminars for sales representatives of dealers, subject to certain conditions.

Deficiencies

We observed the following deficiencies:

- **Primary purpose.** Conferences and seminars did not meet the primary purpose test because significant parts of the conference were devoted to topics not permitted in paragraph 5.2(a) or to recreational activities.
- **Documentation.** There was a lack of documentation to support how the conferences and seminars met the primary purpose test.
- **Policies and procedures.** Managers did not follow their policies and procedures for assessing whether a conference or seminar met the requirements of section 5.2.
- **Payments.** Managers paid expenses that sales representatives incurred to attend the conference, such as arrival and departure ground transportation costs, and personal incidental expenses.
- **Participants.** Managers influenced which sales representatives attended the conference. Clients were invited to conferences and seminars with their sales representative.

Guidance

We expect managers to consider the following:

Primary purpose

Conferences or seminars for sales representatives of dealers may include organized recreational activities and free time, including entertainment in the evenings. However, the primary purpose of the conference or seminar must be to provide educational information as described in paragraph 5.2(a).

We do not consider it appropriate for events under section 5.6 to be combined with events under section 5.2.

When determining primary purpose, we expect managers to consider the whole event including:

- the content of the presentations
- how much of the business day is spent on permitted educational topics (allowing for reasonable breaks, meals and time to travel between activities)
- the cost of meals or refreshments and

- any other costs

We expect the time spent on permitted educational topics to be proportionate to the time spent on other topics or activities, such as practice management, recreational activities or entertainment. If the organized recreational activities and free time appear excessive, the overall objective of the event may be viewed as business promotion, which is not permitted by section 5.2.

We consider topics that help sales representatives meet their obligations as registrants to be permissible educational information under section 5.2. An example is “how to ensure compliance with securities legislation”. Topics that relate to practice management are not permissible.

We expect managers to have internal policies and procedures to evaluate the content of conferences or seminars and ensure compliance under section 5.2. This can include:

- comparing the conference or seminar agenda to an internal percentage benchmark to assess whether the primary purpose test will be met and
- reviewing agenda items by topic and the amount of time allotted to each topic

In addition, managers should consider having people who are not involved in organizing the events review them.

Documentation

We expect managers to maintain documentation that supports their decisions to provide sponsorship under this section. We expect the documentation to include:

- the budget for the event
- a final agenda that sets out the topics covered and the time allotted to each topic
- a final list of the attendees
- evidence that:
 - the conference or seminar complies with section 5.2
 - the manager’s internal guidelines for the section have been met and
- copies of all invoices and receipts

Payments

We expect managers to maintain a budget for all conferences and seminars, and to ensure that the costs incurred are directly attributable to the conference or seminar.

Participants

Paragraph 5.2(b) specifies that the selection of sales representatives be made exclusively by the dealer. Managers may contact sales representatives directly only if they have the permission of the dealer and they invite all of the dealer's sales representatives.

We view the invitation and attendance of clients of sales representatives to conferences or seminars as client appreciation, which is not permitted by section 5.2.

Section 5.3 Third party sponsored educational events

Section 5.3 permits managers to pay the registration fees for sales representatives attending conferences, seminars or courses offered by organizations that are not members of the mutual fund organization or the dealer, within certain parameters.

Deficiencies

We observed the following deficiencies:

- **Primary purpose.** Courses did not meet the primary purpose test. While there were educational components dealing with financial planning and investing, the course content focused primarily on topics not permitted in paragraph 5.3(a).
- **Policies and procedures.** Managers did not follow their policies and procedures. For example, managers did not comply with their internal policies to reimburse only 50% of the total cost of a course, but reimbursed the full amount.
- **Documentation.** We noted a lack of documentation that supported the managers' assessment that the conferences, seminars and courses met the primary purpose test, and the managers' pre-approval decisions and reimbursement of expenses.

In addition, managers relied on the dealer to confirm that the events met the requirements of section 5.3 or to maintain all documentation which, by itself, is not sufficient.

- **Payments.** Managers reimbursed sales representatives for items other than the registration fee for the conference, seminar or course, such as dinners and course material.

Guidance

We expect managers to consider the following:

Primary purpose

It is the manager's responsibility to assess whether the primary purpose test is met under section 5.3. We expect managers to have internal policies and procedures to evaluate the content of a third party conference, seminar or course under this section.

When determining primary purpose, we expect managers to consider the whole event including:

- the content of the presentations and
- how much of the business day is spent on permitted educational topics (allowing for reasonable breaks, meals and time to travel between activities)

Certain organizations, such as the Canadian Securities Institute and the Investment Funds Institute of Canada, offer courses that normally meet the primary purpose test in paragraph 5.3(a). However, due to the variety of courses that may be offered, we expect managers to review the content of each conference, seminar and course before providing sponsorship.

Documentation

We do not consider a manager's standard of care under securities legislation to be satisfied by relying solely on third party certifications that the regulatory requirements under Part 5 have been met. We expect managers to carry out their own due diligence to determine compliance with this section and NI 81-105.

Payments

Section 5.3 permits managers to pay only the registration fees. Accordingly, managers should review invoices carefully to ensure they are paying only for expenses covered under this section.

Section 5.4 Industry association sponsored events

Section 5.4 permits managers to pay to a trade or industry association the costs or expenses incurred relating to a conference, seminar or course organized by them, subject to certain conditions.

Deficiencies

We observed the following deficiencies:

- **Primary purpose.** Managers did not adequately review the content of the conference, seminar or course to determine primary purpose.
- **Documentation.** We noted a lack of documentation that supported how the conference, seminar or course met the primary purpose test, and how the manager assessed the total direct costs of the conference, seminar or course to ensure compliance with the sponsorship limit in paragraph 5.4(2)(b). In some cases there was no documentation relating to the event, for example, there were no invoices for the costs of the conference.
- **Payments.** Managers paid more than 10 per cent of the total direct costs of the conference.

Guidance

We expect managers to consider the following:

Primary purpose

When determining primary purpose, we expect managers to consider the whole event including:

- the content of the presentations
- how much of the business day is spent on permitted educational topics (allowing for reasonable breaks, meals and time spent traveling between activities)
- the cost of meals or refreshments and
- any other costs

Managers may want to consider reviewing agenda items by topic and the amount of time allotted to each topic.

It is the manager's responsibility to ensure that the industry association sponsoring the event has obtained exemptive relief to receive cooperative support under section 5.4.

Documentation

We expect managers to maintain documentation that supports their decisions to provide sponsorship and their compliance with this section. In particular, we expect managers to have records that they have not paid more than 10% of the total direct costs of the event as set out in paragraph 5.4(2)(b).

Section 5.5 Participating dealer sponsored events

Section 5.5 permits managers to pay the costs of conferences and seminars organized and presented by dealers (that are not investor conferences or seminars referred to in section 5.1), within certain parameters.

Deficiencies

We observed the following deficiencies:

- **Primary purpose.** Conferences and seminars did not meet the primary purpose of providing educational information about financial planning, investing in securities, mutual fund industry matters, the managers' mutual funds or mutual funds generally because significant portions of the content of the events were devoted to topics not captured in paragraph 5.5(a) or significant parts of the day were devoted to recreational activities.

Managers did not adequately review the content of the conference or seminar to determine primary purpose. For example, a manager reviewed only the content of the

sessions that its staff presented, but did not look into the content of the other sessions presented at a multi-day conference.

Managers did not follow their policies and procedures for determining primary purpose when processing requests from affiliated dealers.

- **Documentation.** There was inadequate documentation to support managers' pre-approval decision and its reimbursement of expenses. Managers sponsored events that did not meet the primary purpose test under their policies and procedures, with no documentation to demonstrate why the decision was made.
- **Processes.** Managers did not implement procedures to handle requests for pre-approval in a timely manner.
- **Payments.** Managers paid more than 10% of the total direct costs of the conference or seminar.

Guidance

We expect managers to consider the following:

Primary purpose

Conferences or seminars may include organized recreational activities and free time, including entertainment in the evenings. However, to meet the primary purpose test in section 5.5, the overall purpose of the conference or seminar must be to provide educational information described in paragraph 5.5(a).

When determining primary purpose, we expect managers to consider the whole event, including:

- the content of the presentations
- how much of the business day is spent on permitted educational topics (allowing for reasonable breaks, meals and time to travel between activities)
- the cost of meals or refreshments and
- any other costs

Documentation

We expect managers to maintain documentation to support their decisions to provide sponsorship under this section. We expect the documentation to include:

- a final agenda that sets out the topics covered and the time allotted to each topic

- records that:
 - the conference or seminar complied with section 5.5
 - the manager's internal policies and procedures for its pre-approval and final consideration and approval were met
 - the manager's total sponsorship did not exceed 10% of the direct costs
 - sponsorship by multiple managers in total did not exceed 66% of the direct costs
- the total costs of the event and the amount paid by the manager and
- copies of all invoices and receipts

We do not consider a manager's standard of care under securities legislation to be satisfied by relying solely on third party certifications that the regulatory requirements under Part 5 have been met. We expect managers to carry out their own due diligence to ensure compliance with section 5.5 and NI 81-105.

Payments

Section 5.5 permits a manager to pay the direct costs incurred by the dealer in organizing and presenting the conference or seminar. Direct costs do not include the travel, accommodation or personal incidental expenses of attendees.

We recognize conferences and seminars often take many months to organize, and the details of the events, such as agenda items, estimated costs, the total number of sponsors and the amount of their contributions, may change. However, we expect managers to review a final agenda that sets out the topics covered and the time allotted to each topic, costs, list of sponsors, etc. when determining whether to reimburse the dealer under this section.

Section 5.6 Promotional items and business promotion activities

Section 5.6 permits managers to provide to sales representatives non-monetary benefits of a promotional nature if the benefits are not too extensive or frequent, and subject to certain conditions.

Deficiencies

We observed the following deficiencies:

- **Policies and procedures.** Managers did not have adequate guidelines for the frequency and extent of promotional items and business promotion activities they provided to sales representatives or adequate processes to effectively monitor them. For example, promotional items and promotion activities provided to sales representatives were often tracked separately.

Managers did not follow the dollar thresholds and frequency limits in their policies and procedures. For example, managers exceeded their quarterly and annual dollar limits per sales representative.

- **Non-monetary benefits.** The non-monetary benefits provided to individual sales representatives were too frequent or too excessive.

Guidance

We expect managers to consider the following:

Policies and procedures

We expect managers to have internal processes and monitoring procedures to assess whether the requirements of this section will be met. Among other things, managers should consider including the following items in their policies and procedures:

- an annual dollar limit that can be spent on a per sales representative basis, for example, \$1,000
- frequency limits for benefits on a quarterly and annual basis and
- internal guidelines for dollar amounts for different types of promotional items and events, such as trinkets, sports events, concerts, etc.

Participants

We view the attendance of clients of sales representatives at promotional activities intended for sales representatives as client appreciation, which is not permitted by section 5.6.

Appendix A

Managers may want to consider including the following items in their policies and procedures manual on sales practices to help them comply with Part 5 of NI 81-105:

Section 5.1 Cooperative marketing practices

- guidelines for ensuring the primary purpose test is met
- procedures for:
 - ensuring that no more than 50% of the total direct costs are paid by all mutual fund organizations in total
 - obtaining receipts for expenditures incurred by the dealer
 - ensuring the manager's sponsorship is disclosed in writing
- processes to ensure managers make payments to dealers, not to sales representatives

Section 5.2 Mutual fund sponsored conferences

- guidelines for:
 - ensuring the primary purpose test is met
 - ensuring the manager does not influence the selection of sales representatives of dealers
 - appropriate costs associated with an event
- permitted locations to hold conferences and seminars
- processes to ensure the manager does not pay for travel, accommodation or personal incidental expenses of sales representatives attending an event

Section 5.3 Third party sponsored educational events

- guidelines for ensuring:
 - the primary purpose test is met
 - the manager does not influence the selection of sales representatives of dealers
- procedures for obtaining receipts for registration fees
- permitted locations for conferences and seminars

Section 5.4 Industry association sponsored events

- guidelines for ensuring:
 - the primary purpose test is met
 - the manager does not influence the selection of sales representatives of dealers
- procedures for ensuring that no more than 10% of the total direct costs are paid by all members of a mutual fund family in aggregate
- permitted locations for conferences and seminars

Section 5.5 Participating dealer sponsored events

- guidelines for ensuring:
 - the primary purpose test is met
 - the manager does not influence the selection of sales representatives of dealers
- procedures for ensuring:
 - no more than 10% of the total direct costs are paid by all members of a mutual fund family in total
 - no more than 66% of the total direct costs are paid by all members of sponsoring mutual fund families in total
- permitted locations to hold conferences and seminars

Section 5.6 Promotional items and business promotion activities

- guidelines for assessing the frequency and extent of promotional items and promotion activities
- processes for monitoring the non-monetary benefits that individual sales representatives receive