PMs and IFMs – Select Issues

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Agenda: PM and IFM Requirements – Common Issues

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1. Investment Decisions by Non-registrants	2. Prohibited Inter-fund Trading
3. Self-dealing	4. Inadequate Know-Your-Product
5. Fair Allocation	6. Investment Objectives and Restrictions
7. Inadequate Oversight of Outsourced Functions	8. Inadequate Calculation of NAV
9. Inadequate Calculation of Fees	10. Inappropriate Clauses
11. Prohibited Lending Activities	12. Conflicts of Interest – Considerations

Duty of Care – s. 75.2 Securities Act

- All registrants must act fairly, honestly and in good faith
- PMs with discretionary authority and IFMs must also act in client’s best interest
- Fund’s interests considered to be consistent with investors interests as a whole
- IFMs must also exercise the degree of care, diligence and skill of a reasonably prudent person

Requirements of a Portfolio Manager and Investment Fund Manager

- Other requirements:
  - Specific requirements in NI 31-103
  - NI 23-101 – Trading Rules
  - NI 23-102 – Use of Client Brokerage Commissions
  - NI 24-101 – Institutional Trade Matching
  - NI 81-102 – Investment Funds
  - NI 81-105 – Mutual Fund Sales Practices
  - NI 81-106 – Investment Fund Continuous Disclosure
  - NI 81-107 – Independent Review Committee for Investment Funds

1. Investment Decisions by Non-Registrants

- Unregistered “Strategic Advisors” or “Senior Consultants”
- Delegation of KYC functions or investment decisions to unregistered individuals, or to unregistered referral agents
- Unregistered board of directors making investment decisions for investment fund
- Fundamental concepts about registerable activities – s. 1.3 of 31-103CP

Investment Decisions by Non-Registrants – What Can You Do?

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- Assess and document whether activities “trigger” registration
- IFM/PM may consider advice from experts
- But only registrants may advise or make investment decisions for clients
- If unsure, seek legal advice

2. Prohibited Inter-Fund Trading

- Portfolio trades between funds managed by the same PM
- This is prohibited by s.13.5 of NI 31-103
- Regardless of whether the trades were in line with the fund's investment objectives, in all instances this was a breach of securities law

3. Self-Dealing Restrictions

- Fund purchasing securities of issuer for which responsible person or associate is a partner, officer or director without disclosure and client consent
  - Responsible person means fund's PM and PM-related persons

- Portfolio trades between a fund or a managed account and the account of a responsible person or associate

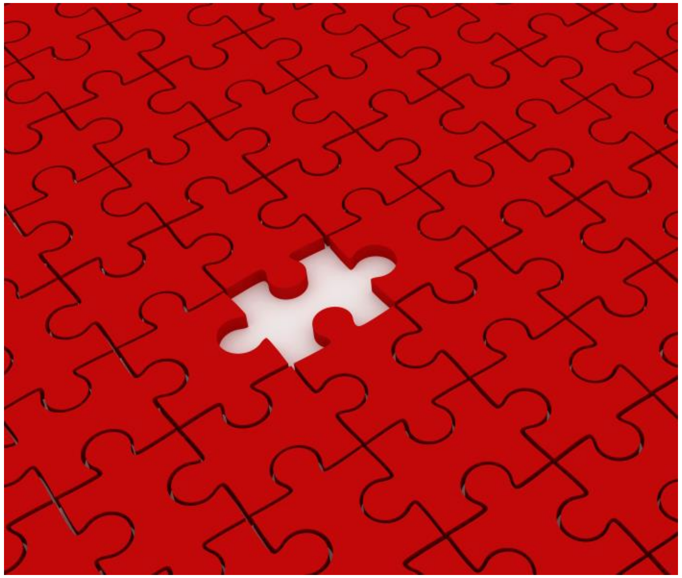
- Fund providing guarantee or loan to a responsible person or associate

Prohibited Inter-fund Trading and Self-dealing – What Can You Do?

- Implement process to prevent prohibited trading
- Train ARs – must know the restrictions
- Monitor trading activities
- Monitor changes to business activities of responsible persons
- For transactions permitted with written consent:
  - Independent committee review
  - Provide proper disclosure to investors
  - Obtain consent from all investors

4. Inadequate Know-Your-Product

- Inadequate evidence of KYP due diligence
- No or inadequate documentation
  - No approved list
  - Transferred-in legacy positions – no KYP for hold decisions
  - Due diligence not updated
- Must adequately document KYP and suitability



Inadequate Know-Your-Product – What Can You Do?

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- Implement detailed KYP/suitability procedures
- Adequately document KYP/suitability
- Adopt an “approved list”
- Consider relevant KYC and IPS information
- Ensure adequate oversight and review of trades
- Establish a system to identify and reject trades inconsistent with IPS

5. Fair Allocation – s.14.10 NI 31-103

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- Unfair allocations among clients
  - Allocations favoring underperforming portfolios to boost returns
  - Allocations favoring portfolios over-weighted in cash
  - Allocations favoring larger clients

- PMs must allocate fairly

- PMs with discretionary authority must consider their best interest obligation when allocating investments

Fair Allocation– What Can You Do?

- Implement fair allocation policy
- At a minimum, include methods to allocate
  - Price and commission for orders when trades are bunched/blocked
  - Block trades and IPOs among clients
  - Block trades and IPOs when orders partially filled – e.g., pro rata
  - Private securities
  - Disclose policy to clients (s.14.3 NI 31-103)
- Document allocation decisions demonstrating fairness

6. Investment Objectives and Restrictions

- PMs not complying with investment criteria

- Investing outside mandate, for example:
  - Buying promissory notes instead of cash equivalents
  - MIC investing in non-qualifying mortgages
  - Loans between funds managed by PM

- Restricted PMs investing outside of their registration category

- Misleading disclosure of investment criteria

Investment Objectives and Restrictions – What Can You Do?

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- Train ARs
- Monitor trades to ensure compliance
- Frequently review portfolios to assess compliance
- Ensure OMs/marketing materials are consistent with mandate
- Understand limitations/restrictions – e.g., non-permitted fund lending

7. Inadequate Oversight of Outsourced Functions

- Lack of oversight policies/procedures
- Inadequate oversight by IFMs in numerous areas:
  - Security holding valuations
  - Management fee calculations and other charges to investors
  - Reconciliation of records between fund and transfer agent
  - Net asset value calculations
  - Trust account transactions
  - Oversight over PMs meeting investment objectives
- PMs – Oversight issues
  - Algorithms and trading software
  - Client reporting

Inadequate Oversight of Outsourced Functions – What Can You Do?

- Implement oversight policies and procedures
- Tailor policies to outsourced activities
- Monitor outsourced activities
- Address exceptions as reported or identified
- Use escalation protocols for exceptions identified
- Train staff on oversight protocols

8. Inadequate Calculation of NAV

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- IFMs performing inadequate NAV calculations
- No, or delayed, recognition of impairments
- Inadequate valuation of illiquid assets
- Asset/liability adjustments not representative of fair value

8. Inadequate calculation of NAV (continued)

- Duty of Care – Incorrect NAV calculation unfair to investors
- New investors may overpay
- Redeeming investors may receive less/more than fair value
- Redemptions/dividends may breach corporate solvency tests

Inadequate calculation of NAV – What can you do?

- Implement calculation policies and procedures
- Consider upcoming IFRS changes – financial instruments
- Establish impairment recognition policy
- Document calculations
- Consider part 14 of NI 81-106 – required for reporting issuers
- Consider s. 14.11.1 of NI 31-103 – valuing illiquid securities
- Ensure corporate solvency tests are met (if applicable)
- Ensure governing document provisions relating to redemptions and distributions are met

9. Inadequate Calculation of Fees

- Inadequate calculation/payment of fees
  - Incorrect or non-verifiable entries in the calculation
  - Inappropriate methodology – not disclosed to clients or in management agreement
  - Unauthorized payments
- Duty of care applies to calculation and payment
- IFM/PM must manage conflicts of interest

Inadequate Calculation of Fees – What Can You Do?

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- Implement calculation policies and procedures
- Document calculations
- Review and verify fee calculations
- Disclose methodology to investors
- Manage conflicts of interest
  - Engage an independent auditor to verify
  - Engage third party to perform calculations

10. Inappropriate Clauses

- Disclaimers and clauses purporting to limit liability
- Non-arm's length circumstances – particular concern
- Examples
  - PMs with discretionary authority disclaiming their trust or fiduciary relationship
  - Funds indemnifying IFM/PM for its misdeeds

Inappropriate Clauses – What Can You Do?

- Review agreements, marketing materials and disclosure
- Remove inappropriate “hedge clauses”
- Independent committee review for non-arm’s length agreements
- Seek legal advice

11. Prohibited Lending Activities

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- Registered individuals lending to fund for general or long-term purposes
- Lending creates serious conflict of interest
- Section 13.12 of NI 31-103 prohibits registrant lending to clients
- Exception – IFM short-term loans to funds for redemptions or normal course expenses
- PMs prohibited from lending

11. Prohibited Lending Activities – What Can You Do?

- Set out restrictions in policies and procedures
- Train staff on restrictions
- IFMs – Establish permitted lending parameters
- Monitor firm lending activities on an ongoing basis
- Where permitted, ensure the terms of the loan are fair to the fund – still must manage conflict of interest

12. Conflicts of Interest – Considerations

- Example circumstances where conflicts may arise:
  - selecting investments
  - allocating investment opportunities
  - calculating management or performance fees
  - calculating net asset value
  - selecting external service providers – brokers, dealers, and custodians
  - non-arm's length services/transactions
  - proprietary trading by firm/employees
- Best interest obligation – Conflicts must be resolved in favour of client

Thank you!

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