



Effective Oversight of Service Providers and Modernization of Investment Fund Product Regulation - Alternative Funds

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Agenda

1. Effective Oversight of Service Providers

- Introduction
- Guiding principles of outsourcing
- Fund accounting
- Trust accounting
- Transfer agency
- Portfolio management
- Other service providers
- Use of an affiliated service provider
- Things to remember
- Resources

2. Modernization of Investment Fund Product Regulation



Effective oversight of service providers

Introduction

- Many registered firms choose to outsource certain functions to a service provider (an affiliated entity or a third party)
 - Under section 11.1 of NI 31-103, a registered firm must establish, maintain and apply policies and procedures that establish a system of controls and supervision to:
 - (a) provide reasonable assurance that the firm and its individuals comply with securities law, and
 - (b) manage its business risks in accordance with prudent business practices.
 - Registered firms are ultimately responsible and accountable for all functions that they outsource to service providers under securities laws
 - They must have a system of controls for monitoring service providers to meet their regulatory obligations
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Guiding Principles of Outsourcing

- Establish a clear outsourcing policy to guide the assessment as to whether and how functions should be outsourced
- Develop an outsourcing risk management program, considering:
 - the scope and importance of the outsourced function
 - potential impact in the event of a service provider failure
 - regulatory status of the service provider
 - how well your service provider controls and manages its own risks

Guiding Principles of Outsourcing – cont'd

- Develop selection criteria and conduct appropriate due diligence in selecting a service provider. Criteria include:
 - regulatory status
 - financial soundness
 - infrastructure resources
 - quality and knowledge of staff
 - contingency planning (disaster recovery plan, testing of backup)
 - cybersecurity measures
 - presence of internal audit function
 - availability of report on controls by external auditors

Guiding Principles of Outsourcing – cont'd

- Have a written contract in place that clearly describe all material aspects of the outsourcing arrangement; including the rights, responsibilities and expectations of all parties
- Require that the service provider protects confidential information of the firm and its clients
- Must take steps to:
 - effectively manage the risks of outsourcing, and
 - demonstrate effective oversight of service providers to fulfill the firm's regulatory obligations

Guiding Principles of Outsourcing – cont'd

- Document your oversight processes and procedures
- Clearly define metrics that will measure the service level, and specify what service levels are required
- Establish a process to identify and report instances of non-compliance or unsatisfactory performance to the service provider
- Ensure that the registered firm and its regulator(s) have access to books and records of service providers concerning outsourced activities

Commonly-outsourced functions

Investment fund managers (IFM) often outsource the following functions:

- Fund accounting
- Trust accounting
- Transfer agency

Other registrants including IFMs may also engage the following service providers:

- Portfolio manager
- Compliance consultant
- Legal counsel
- Accountant

Fund Accounting

Roles & responsibilities of the service provider:

- Calculate the net asset value (NAV) of investment funds, including:
 - pricing of investment holdings
 - accruing for fees and expenses
 - recording security transactions
 - recording capital gains and investment income
 - recording securityholder capital transactions
- Pay fees and expenses out of the fund's custodian account

Fund Accounting

Roles & responsibilities of the service provider (continued):

- Reconcile cash and security positions with custodial records
- Monitor and record corporate actions
- Reconcile the fund's units outstanding with the transfer agency's records
- Review changes in NAV for reasonability

Fund Accounting

Example

An IFM of a pooled fund outsources its fund accounting function to Company ABC. Details of the pooled fund are as follows:

- NAV for the pooled fund is struck monthly
- Expenses and income are accrued monthly
- Most expenses are paid quarterly
- Performance fee is accrued monthly and paid annually
- 30% of the pooled fund is invested in private or illiquid securities

Fund Accounting

Oversight procedures:

On a monthly basis:

- Review the NAV for reasonability – check the monthly change in NAV; compare the change in NAV to the change in benchmark to assess reasonability (e.g. follow up on NAV changes greater than the pre-set threshold)
 - Perform spot checks on the pricing of liquid securities held by the fund
 - Review and approve all manual price adjustments
 - Review and approve valuation of all private, illiquid or hard to value securities (e.g. look at last bid and ask, obtain broker quotes, any third party financing that may impact valuation)
 - Spot check or review to ensure that corporate actions and income are being properly accounted for
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Fund Accounting

Oversight procedures continued:

On a monthly basis (continued):

- Review the reasonableness of accruals for expenses, management fee and performance fee
- Obtain and review reporting from the service provider on the reconciliation of security positions to custodian records
- Reconcile total units/shares outstanding for the fund to transfer agent's records

Fund Accounting

Oversight procedures continued:

Quarterly oversight procedures:

- Review expense invoices before payment is made by the fund

On an annual basis:

- Recalculate the performance fee prior to payment
- Adjust accrued expenses based on actuals
- Assess service level satisfaction on the service provider (e.g. timeliness of responses to questions, delivery of reports)
- Obtain and review reports on controls at the service organization prepared by external auditors, if available

Fund Accounting

Additional considerations:

- Ensure that the service provider is kept up-to-date on your valuation policies
- Establish clear escalation protocol when issues arise in NAV calculation
- Ensure that the frequency of oversight procedures is sufficient based on how often the NAV is struck
- Maintain documented evidence of the registrant's oversight of the service provider

Trust Accounting

Roles & responsibilities of the service provider:

- Handle cash-in-transit relating to subscriptions and redemptions
- Reconcile money flow with fund's distribution channel and custodian account
- Reconcile general ledger against bank account, and follow up on longstanding unreconciled items
- Monitor and distribute interest income earned on the trust accounts to the appropriate parties
- Ensure only valid transactions are processed through the trust account
- Comply with applicable securities legislation

Trust Accounting

Examples of oversight procedures:

- Ensure that the trust account is compliant with the applicable legislation (e.g. a designated trust account in accordance with s14.6 of NI 31-103, and Part 11 of NI 81-102 if applicable)
- Review transactions on a sample basis to confirm that the trust account is in compliance
- Periodically review trust account reconciliations to ensure that they are done timely and properly, and any unusual or longstanding items are followed up promptly

Trust Accounting

Examples of oversight procedures (cont'd):

- Understand how interest income is allocated, and review the allocation if material
- Establish a clear escalation protocol when issues arise
- Obtain and review reports on controls at the service organization prepared by external auditors, if available

Transfer Agency

Roles and responsibilities of the service provider:

- Maintain a register of securityholders
- Process and record subscription and redemption requests
- Reconcile trades with distribution channels
- Process and record distributions to securityholders
- Process non-financial changes to unitholder accounts
- Monitor short-term trading of the fund
- Identify and monitor dormant accounts
- Mail out investor notices and communications
- Issue trade confirmations and account statements, if applicable
- Prepare tax reporting, if applicable

Transfer Agency

Example

An IFM/EMD of a pooled fund outsources the transfer agency function of the pooled fund to Company XYZ. Distribution details of the pooled fund are as follows:

- Subscriptions and redemptions occur on a monthly basis
- Third party dealers can send their trades through FundServ or to Company XYZ via mail or email
- The IFM/EMD also distributes the fund directly under its EMD registration
- The IFM/EMD has outsourced its client reporting obligations for trades where it is the registered dealer of record to Company XYZ

Transfer Agency

Oversight procedures:

On a monthly basis:

- Obtain and review report on non-financial changes made by the transfer agent to ensure that they are properly authorized
- Perform spot checks to ensure that securityholder records are updated for non-financial information (e.g. compare securityholder records to report on non-financial changes)
- Review reports on cancelled trades and trading errors to ensure that they were corrected in a timely manner
- Perform spot checks on trade confirms sent to clients for accuracy and completeness (e.g. ensure compliance with CRM2)

On a quarterly basis:

- Perform spot checks on client account statements for accuracy and completeness (e.g. ensure compliance with CRM2)
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Transfer Agency

Oversight procedures continued:

At least annually or on an ad-hoc basis as required:

- Review and understand controls at the transfer agent to ensure
 - trade information from various distribution channels is uploaded completely
 - all trades are processed accurately and in a timely manner
- Ensure that short-term trading is monitored in accordance with the fund's offering document
- Ensure that dormant accounts are dealt with adequately
- Ensure that trade confirms and client account statements have been updated for changes in securities legislation (for example new CRM2 requirements)

Portfolio Management

Roles and responsibilities of the service provider:

- Provide investment advice for the funds within the fund's investment mandate (including sub-advisory relationships)

Portfolio Management

Examples of oversight procedures:

- Review the portfolio manager's written policies and procedures on portfolio management and trading (e.g. personal trading, trade allocation, best execution, use of soft dollars)
- Obtain and review compliance certificates from the portfolio manager
 - the frequency of the compliance certificate should be appropriate based on the type of fund; some may require monthly certifications; for other funds a quarterly certification may be more appropriate

Portfolio Management

Examples of oversight procedures:

- Ensure that the portfolio manager updates its controls when there is a change in regulatory restriction or in the fund's investment guideline or restriction
- Perform periodic review on the fund's portfolio to ensure that the portfolio risks are within the intended risk profile of the fund, and that the portfolio is in compliance with the fund's investment guideline and any regulatory restrictions applicable to the fund

Other service providers

Compliance consultant and/or legal counsel

Roles and responsibilities of the service provider:

- Prepare regulatory filings (including but not limited to prospectuses, offering documents, Form 31-103F1 & F4 filings)
- Prepare compliance manual
- Review registrant's operations for non-compliance

Other service providers

Compliance consultant and/or legal counsel (continued)

Examples of oversight procedures:

- Review and approve all filings prepared by service provider prior to filing with regulator
- Review the compliance manual to ensure that it is tailored to the registrant's business

Other service providers

Accountants

Roles and responsibilities of the service provider:

- Prepare financial statements for the registered firm
- Calculate regulatory excess working capital

Examples of oversight procedures:

- Review and approve the financial statements
- Review and approve the excess working capital calculation
- Ensure that the frequency of the excess working capital calculation is appropriate

Use of an Affiliated Service Provider

- An IFM may use an affiliated service provider that is part of the global conglomerate to perform fund administrative functions
- May be appropriate to take a modified approach to oversee an affiliated service provider; factors to consider:
 - Ability of the registered firm to control or influence the actions of the affiliated service provider
 - Familiarity with the affiliated service provider's operations and controls
 - Alignment of interests with the affiliate

Use of an Affiliated Service Provider

- As a minimum:
 - maintain a service level agreement with the affiliate that clearly lists the roles and responsibilities
 - ensure that there is a formal line of reporting between the affiliate and the registrant
 - officers/directors of the affiliated service provider should attend and report to committees within the registrant's organization (including but not limited to Risk Management Committee and Valuation Committee)
 - develop a tailored approach to oversee the affiliated service provider

Things to remember

- Tailor your oversight procedures to your business and your outsourcing arrangement
- Remember that as the registered firm you are ultimately responsible and accountable for all the functions that you have outsourced to a service provider



Resources

Resources

Annual report

- OSC Staff Notice 33-742 – *Annual Summary Report for Dealers, Advisers and Investment Fund Managers*

http://www.osc.gov.on.ca/documents/en/Securities-Category3/sn_20131107_33-742_annual-rpt-dealers.pdf

Topical Guide for Registrants

- Reference guide designed to assist registrants and other stakeholders to locate topical guidance regarding compliance and registrant regulation matters

http://www.osc.gov.on.ca/en/Dealers_topical-guide-for-registrants.htm

Staff notices

- 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*

http://www.osc.gov.on.ca/documents/en/Securities-Category3-Comments/sn_20140619_33-743_guide-sales-expense.pdf



Modernization of Investment Fund Product Regulation – Alternative Funds

Outline

- **Project Background**
- **Recap of Alternative Fund Proposals**
 - Proposed Repeal of NI 81-104
 - Proposed NI 81-102 Amendments
 - Financial Statement Disclosure
 - Form of Prospectus/POS Disclosure
 - NI 81-104 Proficiency Requirements – Mutual fund dealers
- **Comments Received/Next Steps**

Project Background

- Alternative Funds proposal is the Final Stage of Investment Fund Modernization Project
- Prior steps in the project involved codification of routine exemptive relief for mutual funds, and integration of non-redeemable investment funds into NI 81-102 regime with core investment restrictions and operational requirements and are now fully in force
- Proposals were published for 90 day comment period on September 22, 2016 – included several consultation questions concerning aspects of the proposals

Proposed Repeal of NI 81-104

- NI 81-104 to be repealed and applicable provisions adopted within NI 81-102 to form the backbone of Alternative Funds Framework
- Repeal furthers the Phase 2 goal of consolidating operational requirements/investment restrictions for all investment funds within NI 81-102

Proposed NI 81-102 Amendments

Investment Restrictions

Concentration Limits

Type of Fund	Current Restriction	Proposed Change
Commodity Pool/Alternative Funds	<ul style="list-style-type: none">• 10% of NAV at time of purchase	<ul style="list-style-type: none">• 20% of NAV at time of purchase
NRIF	<ul style="list-style-type: none">• No restriction	<ul style="list-style-type: none">• 20% of NAV at time of purchase
Conventional mutual funds	<ul style="list-style-type: none">• 10% of NAV at time of purchase	<ul style="list-style-type: none">• No change

Proposed NI 81-102 Amendments (Cont'd)

Investment Restrictions

Investment in Physical Commodities

Type of Fund	Current Restriction	Proposed Change
Commodity Pool/Alternative Funds	<ul style="list-style-type: none">• None	<ul style="list-style-type: none">• No change
NRIF	<ul style="list-style-type: none">• None	<ul style="list-style-type: none">• No change
Conventional mutual funds	<ul style="list-style-type: none">• Gold only, up to 10% of NAV at time of purchase	<ul style="list-style-type: none">• Gold, Silver, Platinum, Palladium (directly) or other commodities (through derivatives) – combined 10% of NAV at purchase• Exception for precious metals funds – 100% in gold, silver, Platinum or Palladium

Proposed NI 81-102 Amendments (Cont'd)

Investment Restrictions

Illiquid Assets

Type of Fund	Current Restriction	Proposed Change
Commodity Pool/Alternative Funds	<ul style="list-style-type: none">10% of NAV at purchase, 15% hard cap	<ul style="list-style-type: none">No change
NRIF	<ul style="list-style-type: none">No restriction	<ul style="list-style-type: none">20% of NAV at purchase, 25% hard cap
Conventional mutual funds	<ul style="list-style-type: none">10% of NAV at purchase, 15% hard cap	<ul style="list-style-type: none">No change

Proposed NI 81-102 Amendments (Cont'd)

Investment Restrictions

Fund of Fund

Type of Fund	Current Restriction	Proposed Change
Commodity Pool/Alternative Funds	<ul style="list-style-type: none"> Only in mutual funds subject to NI 81-102 and that file an SP 	<ul style="list-style-type: none"> Any investment fund that is a reporting issuer subject to NI 81-102
NRIF	<ul style="list-style-type: none"> Any investment fund that is a reporting issuer subject to NI 81-102 	<ul style="list-style-type: none"> No change
Conventional mutual funds	<ul style="list-style-type: none"> Only in mutual funds subject to NI 81-102 and that file an SP 	<ul style="list-style-type: none"> Up to 10% in alternative funds/NRIFs that are subject to NI 81-102 Any other mutual fund that is subject to NI 81-102 and is reporting issuer in a jurisdiction

Proposed NI 81-102 Amendments (Cont'd)

Investment Restrictions

Cash Borrowing

Type of Fund	Current Restriction	Proposed Change
Commodity Pool/Alternative Funds	<ul style="list-style-type: none">• Not permitted	<ul style="list-style-type: none">• Can borrow up to 50% of NAV, subject to conditions
NRIF	<ul style="list-style-type: none">• No restrictions	<ul style="list-style-type: none">• Can borrow up to 50% of NAV, subject to conditions
Conventional mutual funds	<ul style="list-style-type: none">• Not permitted	<ul style="list-style-type: none">• No change

Proposed NI 81-102 Amendments (Cont'd)

Investment Restrictions

Short Selling

Type of Fund	Current Restriction	Proposed Change
Commodity Pool/Alternative Funds	<ul style="list-style-type: none">• Up to 20% of NAV• No more than 10% of an issuer• 150% cash cover• Proceeds for cash only	<ul style="list-style-type: none">• Up to 50% of NAV• No cash cover• No prohibition on using proceeds to buy long• Subject to combined cap with cash borrowing of 50%
NRIF	<ul style="list-style-type: none">• No restrictions	<ul style="list-style-type: none">• Same as alternative funds
Conventional mutual funds	<ul style="list-style-type: none">• Same as commodity pools	<ul style="list-style-type: none">• No change

Proposed NI 81-102 Amendments (Cont'd)

Investment Restrictions

Derivatives

Type of Fund	Current Restrictions	Proposed Change
Commodity Pool/Alternative Funds	<ul style="list-style-type: none"> Counterparty debt rating requirements Exempt from counterparty exposure limits 	<ul style="list-style-type: none"> Exempt from counterparty debt rating requirements Subject to counterparty exposure limits Codification of routine “Cleared OTC Swaps” Relief
NRIF	<ul style="list-style-type: none"> Exempt from counterparty rating requirements and exposure limits 	<ul style="list-style-type: none"> Subject to counterparty exposure limits
Conventional mutual funds	<ul style="list-style-type: none"> Subject to counterparty debt rating requirements Subject to counterparty exposure requirements 	<ul style="list-style-type: none"> Codification of routine “Cleared OTC Swaps” relief

Proposed NI 81-102 Amendments (Cont'd)

Investment Restrictions

Leverage

Type of Fund	Current Restrictions	Proposed Change
Commodity Pool/Alternative Funds	<ul style="list-style-type: none">• No direct leverage• Only permitted synthetically through derivatives - No limit (in theory)	<ul style="list-style-type: none">• 3 times NAV• Sum of notional exposure from: cash borrowing, short-selling, derivatives
NRIF	<ul style="list-style-type: none">• No restrictions	<ul style="list-style-type: none">• Same as alternative funds
Conventional mutual funds	<ul style="list-style-type: none">• Not permitted, directly or synthetically	<ul style="list-style-type: none">• No change

Proposed NI 81-102 Amendments (Cont'd)

New Funds

Seed Capital/Organizational Costs

Type of Fund	Current Restrictions	Proposed Change
Commodity Pool/Alternative Funds	<ul style="list-style-type: none">• Manager to pay start-up costs• Min. \$50,000 seed capital – must remain in fund at all times	<ul style="list-style-type: none">• To be subject to same requirements as conventional mutual funds
NRIF	<ul style="list-style-type: none">• Fund can pay start-up costs• No seed Capital requirements	<ul style="list-style-type: none">• No change
Conventional mutual funds	<ul style="list-style-type: none">• Manager to pay start-up costs• Min, \$150,000 seed capital – cannot be withdrawn until \$500,000 in outside investment	<ul style="list-style-type: none">• No change

Financial Statement Disclosure

Leverage Disclosure

Type of Fund	Current Requirements	Proposed Change
Commodity Pool/Alternative Funds	<ul style="list-style-type: none">• Must disclose min. and max. leverage during reporting period• based on fund's own methodology for leverage calculation	<ul style="list-style-type: none">• Min. and max. leverage to be calculated based on new NI 81-102 requirements• Disclosure to also be provided in the MRFP
NRIF	<ul style="list-style-type: none">• No specific requirements	<ul style="list-style-type: none">• Same requirements as for alternative funds
Conventional mutual funds	<ul style="list-style-type: none">• Not applicable	<ul style="list-style-type: none">• No change

Form of Prospectus/POS Disclosure

Type of Fund	Current Requirements	Proposed Change
Commodity Pool/Alternative Funds	<ul style="list-style-type: none"> • Must use Form 41-101F2 “long form” prospectus • Delivery within 2 days of trade 	<ul style="list-style-type: none"> • Exchange traded alternative funds to keep using long form, plus ETF Facts • Non-exchange traded Alternative Funds to use NI 81-101 Forms, to include alternative fund-specific disclosure • POS delivery for Fund Facts
NRIF	<ul style="list-style-type: none"> • Same as above 	<ul style="list-style-type: none"> • No change
Conventional mutual funds	<ul style="list-style-type: none"> • Must use NI 81-101 Forms (SP, AIF, Fund Facts) • POS Delivery for Fund Facts 	<ul style="list-style-type: none"> • No change

NI 81-104 Proficiency Requirements - Mutual fund dealers

- NI 81-104 includes specific proficiency requirements for mutual fund dealers selling commodity pools (no special requirements for IIROC registrants)
- Requires mutual fund dealers to have one of: CSC, CFA or Derivatives Fundamentals Course
- Proposals would remove this requirement as part of NI 81-104 repeal
- CSA to work with the MFDA to develop updated proficiency requirements for alternative funds to replace those in NI 81-104

Comments Received/Next Steps

- Comment Period ended December 22, 2016 – 41 comment letters received
- Letters from variety of commenters: fund managers, dealers, investor advocates, service providers, prime brokers, law firms
- Industry generally supportive; investor advocates more cautious
- Most comments received focused on provisions concerning borrowing, short selling, leverage, derivatives use, and disclosure. Substantive comments also received on other aspects of proposals.
- CSA Working Group to consider comments and determine which if any changes to recommend making to the proposals and whether changes require a second publication and comment period.



Questions

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