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In this issue of the Registrant newsletter, we provide a basic primer on the prospectus exemptions available to managers of exempt and proprietary pooled funds. We present some findings from a 2010 marketing sweep that the BCSC participated in with other provincial regulators. We also discuss some compliance tips based on an overview of the 2010 Examinations Report Card.

Lastly, you'll meet Nirwair Sanghera of the Examinations Branch and we say goodbye to Gayle Carlson, who recently retired from the BCSC.

In the news...

- A BCSC panel imposed a record \$47 million penalty against Sung Wan (Sean) Kim and banned him permanently from the BC markets. Kim is the principal of Cirplus Futures Inc., a firm formerly registered as an exchange contracts dealer in BC. The BCSC's Senior Examiner, Janice Leung, provided testimony during the hearing against Kim. Further details are available at the [BCSC's website](#).
- The BCSC and ASC released their oversight reports of the TSX Venture Exchange (TSX-V). BC and Alberta jointly regulate the TSX-V. Additional details are at the [BCSC's website](#).
- The TMX Group Inc. and London Stock Exchange Group PLC announced merger plans to bring together the leading stock exchanges in Canada and the UK, which are respectively, the 11th and 10th largest exchanges in the world. Together, the new merged stock exchange organization will become the world's leading resource-oriented exchange with a value of over \$6 billion.

Meet Nirwair Sanghera



Nirwair is a Securities Examiner, responsible for examining portfolio managers, exempt market dealers, investment fund managers and restricted dealers. He recently spent two years in Enforcement as an Investigator, where he was investigating abuse and misconduct in the capital markets and taking action against wrongdoers.

Nirwair is a Certified General Accountant and a Member of the Association of Accounting Technicians (UK organization, similar to the CGA in Canada). Prior to joining the BCSC, Nirwair worked as a Senior Accountant for a big five accounting firm.

A primer on prospectus exemptions

By Edwin Leong

Sophisticated investor, accredited investor, offering memorandums, minimum investment amounts, friends and family, business associates, employee exemptions...we throw around many terms when discussing the prospectus exemptions available, but sometimes registrants get those terms get confused and mixed up.

Background to the exempt market and the requirements

Normally, an issuer, whether it's a company wanting to raise capital or a fund wanting to sell units, must file a prospectus to a securities regulator for review and receipting before it can sell shares or units to the public. This can be a lengthy and expensive process, so securities regulators provide exemptions from the prospectus requirement to raise capital more quickly and efficiently without compromising investor protection.

Although most people understand the nature of public offerings and selling shares on stock exchanges, the exempt market is a substantial part of British Columbia's capital market. Based on 2010 filings of exempt distribution reports, issuers from within and external to BC raised \$8.5 billion from BC investors. Additionally, BC-based issuers raised another \$7.7 billion outside of BC, resulting in an exempt market worth over \$16 billion.

The capital raising exemptions are in [National Instrument 45-106 Prospectus and Registration Exemptions](#) (NI 45-106). For this article, we will focus the discussion on exempt funds distributing units to investors under the exemptions from the requirement to file a prospectus.

Commonly used exemptions by exempt funds

Registrants offering their own exempt or proprietary pooled funds directly to investors, without using managed accounts, will typically use the following exemptions in NI 45-106:

1. Accredited investor – section 2.3
2. Family, friends and business associates – section 2.5
3. Offering memorandum (OM) – section 2.9
4. Minimum amount investment – section 2.10
5. Additional investment in investment funds – section 2.19

6. Employee, executive officer, director and consultant – section 2.24

Most of these exemptions are self-explanatory, but we have seen some confusion and mixing up of some of these exemptions in marketing and advertising materials. For example, an information sheet for an exempt fund may stipulate that the fund is offered via an OM, but go on to stipulate a minimum investment amount and require that investors be qualified as accredited investors.

In our example, the information sheet has mixed up provisions from three separate exemptions instead of clearly outlining the exemptions the fund is using to distribute the units. A potential investor may think that he or she must qualify as an accredited investor, must invest a minimum amount of capital in the fund, and will receive an OM, which has statutory protections and civil remedies that, in fact, may not be available to the investor if he or she really purchased under another exemption.

Issuers of exempt products need to understand that the exemptions are discrete and standalone.

Minimum amount

The fund manager has the discretion to stipulate whatever minimum investment amount it deems appropriate and that amount can be less or more than \$150,000. However, for the section 2.10 exemption to apply, the investor must invest, at one time, at least \$150,000 even if the fund manager's minimum investment amount is less. The the investor does not need to be qualified as an accredited investor, as this is a separate exemption. No offering document or information disclosure is required for the minimum amount exemption.

Accredited investor

If the fund distributes to an accredited investor under section 2.3 of NI 45-106, the fund manager must qualify the investor with one of the definitions of an accredited investor in NI 45-106. Typically, a fund manager does this with a subscription agreement, which will list out the accredited investor definitions and the investor will note which definition applies. No offering document or information disclosure is required for the accredited investor exemption and no minimum amount need be invested either.

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No *sophisticated investor* exemption

While some of the exemptions may infer that the investor is *sophisticated* or experienced, fund managers should note that the current exemptions no longer refer to *sophisticated investor* and the term has not been in use since 2002 when the BCSC overhauled the exemptions regime.

The offering memorandum exemption

Some funds seek to broaden the investor base beyond accredited investors and those with the ability to invest \$150,000 at one time. The OM exemption under section 2.9 of NI 45-106 provides exempt funds with the ability to broaden the investor base; however, the fund must:

- Draft an OM and provide a copy to each investor that the fund distributes units to – the OM must follow [Form 45-106F2 Offering Memorandum for Non-qualifying Issues](#) (note that due to the changeover to IFRS, if the fund's financial year begins on or after January 1, 2011, there is [a new version of the OM form](#))
- Provide a [Form 45-106F4 Risk Acknowledgement](#) to every investor that the fund distributes units to using the OM exemption

A key difference between the OM exemption and the accredited investor and minimum amount exemptions is that the OM provides the investor with statutory rights to civil remedies if the OM contains a misrepresentation. These statutory rights are not available to investors that purchase units through other exemptions available in NI 45-106, as the instrument does not require the fund manager to provide any formal disclosure document to these investors.

We have seen some fund managers draft OMs, following Form 45-106F2, but not use the OM exemption to distribute units of the fund. The fund manager provides the OM merely as information to prospective investors. However, exempt fund managers should ensure that they excise all references to the statutory rights from the OM document, to make clear to the investors that the statutory rights contained in the OM will not apply to investors that purchase via other exemptions in NI 45-106.

Exempt fund managers should consider whether they really need a Form 45-106F2 OM for information purposes if they do not intend to use section 2.9 of NI 45-106 to distribute the units. While producing an information document is a best practice, fund managers

may want to avoid calling the information document an OM, which will help to reduce confusion with the investors.

Managed accounts

The exemptions discussed above are relevant for portfolio managers who only manage funds and directly distribute the units to investors. However, portfolio managers who offer advisory services to private clients and have discretionary management of individual, segregated client accounts may be able to use the exemption available under section 8.6 of NI 31-103, if they use proprietary pooled funds to manage their clients' assets.

Traditionally, segregated, managed client accounts hold individual stocks and bonds; however, some portfolio managers find it easier and more efficient to use proprietary pooled funds to obtain the appropriate asset allocation to meet the clients' investment objectives.

Using the exemption under section 8.6 means that the portfolio manager is the principal and accredited investor of the pooled funds, not the client. The portfolio manager would then distribute the units of the pooled funds to the client accounts based on the agreed asset mix and investment objectives.

The portfolio manager is required to file a distribution report and pay fees on an annual basis (see next section).

Reporting requirement

Depending on the exemption, the fund may have a reporting requirement and a fee payment to the securities regulator when the fund makes distributions. Fund managers should review section 6.1 of NI 45-106 for the exemptions that require a [Form 45-106F1 Report of Exempt Distribution](#) filing. In British Columbia, issuers can use the [BCSC's e-Services](#) feature of the website to submit a report.

Normally, a fund manager must file a report of exempt distribution and submit a fee payment within 10 days of a distribution. However, some exemptions allow the fund manager to file a report and make a fee payment once a year. The annual filing provision is in section 6.2(2) of NI 45-106 and the following exemptions qualify for this annual filing:

- Section 2.3 accredited investor
- Section 2.10 minimum amount
- Section 2.19 additional investment in investment funds

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The annual filing deadline is within 30 days of the financial year-end of the fund. For example, if an exempt fund has a year-end date of December 31 and only distributes units using the three exemptions listed above, for any distributions in 2011, the fund must file a report and pay the fee by January 30, 2012.

Other exemptions, such as the OM exemption, require filing a distribution report and a fee payment within 10 days of the distribution.

Suitability

No matter which exemption an exempt fund uses to distribute units of the fund, registrants who distribute the units have an obligation to know-your-client (KYC) and assess the suitability of the fund for the investor.

A subscription agreement is a common method of formalizing the purchase and sale contract between the exempt fund and the investor, but it does not replace the KYC obligation. We expect registrants who distribute exempt fund to complete a KYC form and suitability review for every new investor. Distributors can be fund managers or related parties registered as EMDs, portfolio managers or third party dealers.

Conclusion

The exempt regime is a cost-effective way to distribute units of exempt funds, but fund managers need to understand which exemptions are most appropriate for their investors.

Issuers that raise capital improperly can face regulatory action, such as:

- a cease trade order against any new distributions
- having to offer a right of rescission to investors
- reputational damage to the firm and its related parties

Fund managers should review the exemptions separately and not combine them with each other, as each exemption is only appropriate for specific classes of investors.

Edwin Leong has been with the Examinations Branch since 2006.

Saying goodbye to Gayle Carlson



Gayle Carlson – photo courtesy of Karin Armstrong

After 32 years of service (incredibly, all with the BCSC), Gayle Carlson retired on January 28, 2011. Gayle started her long career with the BCSC in the Records Department, where she spent her first three years. However, Gayle is most closely associated with the Registration Branch.

Registrants that have been in the business for a while have likely dealt with Gayle at some point on registration matters, as Gayle was a Registration Clerk for five years and Registration Supervisor for 14 years.

From 2000 to her retirement in 2011, Gayle was the BCSC's National Registration Database (NRD) Coordinator. She was a member of the NRD working group since its inception and was the go-to person at the BCSC for NRD. Being the NRD Coordinator meant that Gayle was no longer involved in the day-to-day business of registering firms and individuals, however, Gayle continued to work with and assist registrants when NRD became the means for registering firms and individuals.

We wish Gayle all the best as she rides off into the sunset to enjoy her much-deserved retirement.

Findings from the 2010 Marketing Sweep

By Edwin Leong

In the summer and fall of 2010, the BCSC participated in a national marketing sweep with six other provincial regulators. From an initial marketing survey sent to 14 BC firms, we selected five for limited scope field exams, concentrating on the marketing activities of the firms with an additional five firms selected for desk review.

The CSA will publish a Staff Notice in the summer of 2011 to summarize the national findings and provide valuable guidance on marketing practices. In this article, we share five findings and deficiencies from our review of the BC firms.

The five findings are:

1. Minimal or no policies and procedures for performance presentation
2. Overly promotional and unsubstantiated language
3. Presenting inappropriate hypothetical performance data
4. Inappropriately linking previous firm performance with new firm performance
5. Poor disclosures

#1 Poor policies and procedures

Policies and procedures has been our top general deficiency for many years, so it is no surprise that we found poor policies and procedures for performance presentation. Most of the firms reviewed have policies and procedures that deal with marketing activities and the review and approval of advertising materials. However, most of the firms have poor policies dealing specifically with performance presentation.

A registered firm that is going to present performance should have policies and procedures for:

1. properly calculating performance
2. constructing composites
3. selecting benchmarks for comparing to the composites
4. disclosing relevant information to the client

#2 Overly promotional and unsubstantiated language

Many firms use promotional language in their marketing materials. We have seen examples, such as *proven performance*, *superior performance*, and *precedent setting*. This kind of language will put your firm in a positive light, which is, of course, the point of marketing.

Many of you are experienced investment managers and you are proud of the performance you have achieved over the years. Many of you firmly believe that your record justifies the promotional language you use. However, we have seen that some firms using this kind of language are not providing clarification or support to substantiate how the firm's performance is proven or superior.

Without substantiating the claim, the description ends up being an opinion instead of a statement supported by facts. Firms must follow the principles of fair representation and full disclosure when advertising and must not present performance or performance-related information that is false or misleading. Information can also be misleading if it is old and dated.

Information can also be misleading if it is old and dated.

#3 Presenting hypothetical performance

Some firms present hypothetical performance figures (also known as pro-forma, back-tested, and model figures).

There are challenges inherent with hypothetical performance data, including:

- difficulty verifying the numbers
- poor disclosures
- figures that can be subject to manipulation
- poor assumptions, such as excluding trading costs from the hypothetical numbers versus a real portfolio

Poor labelling and poor disclosures can mislead a prospective investor to believe that the hypothetical performance is the firm's actual performance, or that the firm or fund's performance record is longer than it really is.

#4 Linking past and current firm performance

In a couple of our files, we have seen portfolio managers (PM) link their performance at a previous firm with the performance record at the PM's current firm.

There is a notion that the PM's performance at the previous firm belongs to the PM and the PM can transfer the record to the new firm for presentation if there is adequate disclosure. However, performance belongs to the firm, not to the individual and a PM wanting to present past firm performance must have adequate records to support the presentation along with detailed disclosures for the presentation.

#5 Poor disclosures

Our emphasis on disclosures comes down to fair dealing with your clients, which is in section 14 of [the Securities Rules](#). There is also Part 14 of [National Instrument 31-103 Registration Requirements and Exemptions](#), which requires a registered firm to deliver to a client all the information that a reasonable investor would consider important about the client's relationship with the registrant.

Disclosure must be meaningful. Disclosure is not required just for the sake of saying you made disclosure. The disclosure's quality will determine if it is meaningful. For example, while portfolio managers are intimately familiar with terms such as standard deviation, alpha, beta, the Sharpe Ratio, and the rest of the technical jargon from the industry; do your clients actually know what these terms mean? Do they provide any value to non-industry people if you use them in your disclosures without explaining what they are and what they measure?

Global Investment Performance Standards (GIPS)

GIPS from the CFA Institute are best practices for performance presentation. GIPS provides guidance on how hypothetical and past firm performance can be presented directly or as supplemental information, as part of a GIPS compliant presentation. We encourage registrants to review GIPS and incorporate the principles in the firm's policies and procedures. Visit the [GIPS Standards website](#) for information and guidance.

Building a fortress compliance program

By Michael Sorbo

In our recent [2010 Report Card](#), we identified common deficiencies that show registrants are still having difficulties establishing strong compliance programs. Specifically, firms are not always delivering what they promise with:

- strong compliance officer presence
- compliance outcomes
- operational and internal controls
- capital monitoring practices
- documenting know-your-client and suitability processes
- adequate workflows for advertising policies & procedures

The financial crisis created many challenges and, in some cases, new, previously unidentified risks became known that emphasized the need for firms to manage their operations ethically, with adequate controls, and with an appropriate amount of capital.

Not all compliance programs are identical, nor should they be. However, in a period of crisis and regulatory change we strongly encourage firms to self-assess and manage their risks. Where necessary, firms should self-correct their strategies, get their processes and procedures properly documented, and cross-train their staff.

In our report card, we provide several tips to help firms focus on and be proactive in learning new regulatory requirements. We provide these from our observations of successful portfolio management firms we review in our compliance exams. We think some of these principles are critical for helping all firms develop a stronger client focus.

Regularly review your compliance programs

We encourage firms to conduct annual reviews or stress tests on specific parts of their compliance programs to determine if the controls and procedures are effective. In the review, it is easier to break up the firm's program into manageable parts and assess each separately to determine if they need revision and if controls are effective. If the firm concludes they are no longer effective, the firm can revise the policies and procedures accordingly.

Know the current regulations

While we understand that [National Instrument 31-103 Registration Requirements and Exemptions](#) set out many new requirements and changes from previous rules, we expect firms to be proactive in learning the new regulatory requirements and to update programs and practices accordingly.

Learn your lessons from past examinations

All examinations include a review of how past deficiencies were resolved, and whether the firms followed through with its plans. In some recent reviews, we found some firms have been too casual about ensuring that prior deficiencies were resolved.

We refer repeat deficiencies to our Compliance and Enforcement branches for consideration. Failure to correct past deficiencies or failure to maintain corrections made some time ago, are significant deficiencies and indicate a poor culture of compliance.

Update your management procedures

Advising firms and dealers face numerous risks. Many of firms have a variety of business segments and manage them on a line-of-business basis, as determined by the products and services provided. Firms may also face risks generated by affiliated firms such as business partners, brokers, and custodians. A formal risk management program can help mitigate the risks and improve overall compliance.

Incomplete client information

While many firms indicate that they know their clients well, compliance officers may not regularly analyze the quality of client documentation or the currency of investment policy statements to ensure that the firm treats the clients fairly. Other good practices include recording important client decisions and monitoring advice provided by the various business areas.

In closing, do not stop with these principles; look at current practices and behaviors to ensure that the firm is in alignment with the clients' goals and objectives.

For [our complete report](#), see the "[Compliance toolkit](#)" section of the BCSC website.

Michael Sorbo is the Manager, Examinations.

Resources for Registrants

- [National Instrument 31-103 Registration Requirements and Exemptions](#)
- [BCSC Compliance Toolkit](#) – a resource for compliance
- [CSA Registration Database](#) – registration type and status of individuals and firms
- [BCSC Disciplined Persons List](#) – individuals that have been sanctioned by the BCSC
- [BCSC Q & A's for Dealers and Advisers](#) – questions and answers for registrants
- [BC Securities Act, Regulations and Rules](#) – the securities legislation
- [Policies and Instruments](#) – policies and instruments in effect in BC
- [Registration Forms](#) – forms specific to dealers and advisers
- [BCSC Weekly Report](#) – weekly updates on new policies, news releases and orders
- [InvestRight](#) – investor education by the BCSC

Other resources:

- [BC Statutes](#) and [Federal Statutes](#)
- [AIMA Canada](#) – The Alternative Investment Management Association
- [Canadian Securities Administrators](#)
- [Canadian Securities Institute](#)
- [CFA Institute](#)
 - [CFA Professional Conduct](#)
 - [CFA Standards of Practice Handbook](#) (PDF download)
 - [CFA Vancouver](#)
- [FINRA Financial Industry Regulatory Authority](#) - Compliance tools
- [Managed Funds Association](#) – reports on sound practices
- [OSC Compliance resources](#)
- [Society for Corporate Compliance and Ethics](#)
- [Canadian Centre for Ethics and Corporate Policy](#)
- [US Securities and Exchange Commission](#)
 - [Information for Newly-Registered Investment Advisers](#)

The Registrant

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