

HEDGE FUNDS & STRUCTURED PRODUCTS BULLETIN

November 2007

OSC ISSUES STAFF NOTICE 33-729 PROVIDING GUIDANCE ON SIGNIFICANT DEFICIENCIES IN MARKETING PRACTICES OF INVESTMENT COUNSEL/PORTFOLIO MANAGERS

INTRODUCTION

On November 9, 2007 the Ontario Securities Commission (the “OSC”) issued Staff Notice 33-729 - *Marketing Practices of Investment Counsel/Portfolio Managers* (the “Staff Notice”)¹ detailing the results of a focused review conducted of the marketing practices of certain firms registered as advisers in the category of investment counsel/portfolio manager (“ICPM”). The Staff Notice outlines various questionable marketing practices identified by the OSC and contains several “suggested practices” which will serve as important guidelines for the preparation and use of marketing materials by ICPMs.

BACKGROUND

For the purposes of its review, the OSC gathered information from 50 ICPMs and reviewed 21 ICPMs in depth. Brochures, offering documents, advertisements, client presentations and websites were all examined with three main objectives in mind: (i) to broaden the OSC’s understanding of the marketing practices of ICPMs, (ii) to assess ICPMs’ compliance with Ontario securities laws, and (iii) to identify any regulatory gaps.

In the course of its review, the OSC compliance team paid special attention to marketing materials used by ICPMs in connection with the offering of hedge funds, pooled funds and other investment funds that are not qualified pursuant to a prospectus (“non-prospectus qualified investment funds”). Non-prospectus qualified investment funds are not subject to the specific requirements regarding marketing practices contained in National Instrument 81-102 – *Mutual Funds* (“NI 81-102”). However, the OSC considers that as part of the general requirement for all registered ICPMs to deal fairly, honestly and in good faith with their clients under section 1.2 of OSC Rule 31-505 – *Conditions of Registration*, registrants are under a duty not to engage in potentially misleading marketing practices. The Staff Notice indicates that the requirements set forth in Part 15 of NI 81-102 and in Part 13 of the associated Companion Policy provide “best-practice standards” that can be applied to the marketing of all types of investment funds.

DEFICIENCIES AND SUGGESTED PRACTICES

Use of Hypothetical Performance Data

According to the Staff Notice, many of the ICPMs reviewed do not use data from actual client portfolios to present the performance of their investment funds or accounts in marketing materials. Instead, a variety of simulated or hypothetical performance results are utilized.

For example, some ICPMs were found to be applying a particular investment strategy to a historical period of time to measure what results *would have theoretically been achieved* in the past (“back-tested performance data”). Some funds-of-funds made use of back-tested performance data by calculating hypothetical performance data based on the historical performance of the underlying funds that the investment manager *would have* invested in had the fund-of-funds been in existence at the time.

¹ (2007) 30 O.S.C.B. 9213, online at: http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part3/sn_20071109_33-729_marketing-practices.pdf.

The principal issue with the use of back-tested performance data is the temptation to use the benefit of hindsight and adjust investment strategies to create impressive historical returns that may mislead or confuse potential investors. These dangers are compounded by the fact that many marketing documents neither disclose the assumptions and calculation methodologies used to produce the back-tested performance data, nor adequately point out the risks and limitations of such data.

The Staff Notice indicates that the use of back-tested performance data may be acceptable only in very limited circumstances. For example, back-tested performance data may be used where a newly created investment fund will follow the same investment strategy as an existing fund run by the same ICPM. If utilized, any back-tested performance data must be calculated fairly (e.g. adjusted for all applicable fees), be clearly identified as back-tested data and the dangers and limitations associated with the use of such data must be clearly and prominently disclosed in the marketing materials.

The Staff Notice also expressed concerns relating to the use of “model portfolios” to calculate fund performance for marketing purposes. The returns of model portfolios may differ significantly from those of actual portfolios since trading costs are typically not deducted from returns, unrealistic trading prices may be used and the model portfolio may assume that cash is always fully invested.

OSC Suggested Practice

Wherever possible, the actual performance of client portfolios or investment funds should be used for the preparation and presentation of performance data. In the event that hypothetical performance data is used, it should be clearly labelled as such, and the potential dangers and limitations of such data should be clearly and prominently disclosed.

Linking Performance of Different Funds/Portfolios

According to the Staff Notice, certain ICPMs who manage several different investment funds or investment strategies have used the performance of one fund or strategy in the marketing materials of another. For example, the historical performance data of an investment fund with a long track record may have been presented as the performance data of a fund with only a short history. The two funds may also have been otherwise linked or presented in a misleading manner by virtue of appearing in the same table or graph. This may lead investors to believe that a fund has a much longer track record than is actually the case. It may also be confusing because the performance of the two funds may not be comparable across time periods and may not even rely on the same calculation method.

OSC Suggested Practice

Performance data of an investment fund and/or investment strategy should be displayed separately from that of other existing funds and clearly labelled, so that they can be easily distinguished by investors.

Use of Performance Composites

Another problematic practice identified in the Staff Notice is the inappropriate calculation of performance composites. Composites are aggregate calculations of the performance of several client portfolios or funds using a similar investment strategy. Performance Composites run the risk of presenting misleading results by not including all relevant client portfolios (a practice known as “cherry-picking”) or by excluding the performance of terminated (usually poorly performing) portfolios. The OSC also detected the use of inappropriate calculation methodologies in some circumstances, such as the use of average returns instead of asset-weighted returns, unsatisfactory policies and procedures in the construction of composites and inadequate disclosure regarding the performance composites displayed.

OSC Suggested Practice

Performance composites should include all client portfolios relevant to a particular investment strategy and should be calculated based on the asset-weighted returns of the client portfolios. Marketing documents should

also disclose all aspects necessary for the reader to understand the composite returns, including whether such returns are net of fees, what currency is used for calculation, whether there are minimum asset levels and whether any sub-adviser was used.

Use of Benchmarks

The use of benchmarks to compare the returns of an investment strategy also has its pitfalls. Such comparisons may be misleading to investors where the benchmarks are not actually comparable to the fund or investment strategy, where the benchmark is not widely recognized or available, or where the comparison is not made on the same basis (such as the use of different currencies or total versus excess returns). The OSC also noted instances of inadequate disclosure concerning the comparison to the benchmark and deficient record-keeping by ICPMs in respect of benchmarks.

OSC Suggested Practice

Benchmarks that have a connection to the investment strategy in question may be used. In some circumstances, widely known and followed benchmarks, such as the S&P/TSX Composite Index, may be used even where the investment strategy has a different composition. In any case, any marketing materials which incorporate benchmark comparisons must include all information necessary to allow an investor to understand the relevance of a benchmark and to draw a fair comparison.

Exaggerated and Unsubstantiated Claims

The Staff Notice indicates that any statements in marketing materials that cannot be substantiated with evidence should not be made. These would include statements that an individual is a “recognized expert” in a field or claims as to “superior performance” of a fund (if such statements cannot be verified). The Staff Notice also pointed to the prohibition in the *Securities Act* (Ontario) against giving an undertaking as to the future value or price of a security and against unregistered persons holding themselves out as being registered.

OSC Suggested Practice

Only statements about performance, skills, education, experience and services that are verifiable should be included in marketing materials and ICPMs should retain the supporting documentation for any such claims. Alternatively, where such claims are made, the marketing materials may provide reference to easily accessible sources that allow investors to verify such statements.

Lack of Appropriate Policies and Procedures and Incorrect Information

The OSC Staff Notice indicates that many of the ICPMs reviewed either did not have appropriate policies and procedures in place that addressed marketing activities or that the policies and procedures which were in place did not reflect the specific marketing practices being undertaken by the ICPM.

Many of the ICPMs reviewed by the OSC also had incorrect or outdated information in their marketing materials.

OSC Suggested Practice

ICPMs should develop and enforce written policies and procedures that are designed to fit their particular marketing activities. The policies should provide guidance on the preparation, review and approval of all marketing materials with a view to preventing false or misleading statements. In particular, the policies and procedures should address the preparation of performance data, the use of performance composites and the selection of benchmarks. The policies and procedures should also provide for an independent review and approval of marketing materials to help eliminate errors.

IMPACT OF STAFF NOTICE ON ICPMS AND PRIVATELY OFFERED INVESTMENT FUNDS

Following the completion of its review, the OSC sent compliance deficiency reports to all affected ICPMs who have 30 days to respond to the issues raised. The OSC intends to follow up with these ICPMs to ensure that compliance with Ontario securities laws can be achieved within a reasonable time.

The Staff Notice is relevant to any ICPMs who undertake marketing activities. Compliance staff have made it clear that they intend to rely on the suggested practices set forth in the Staff Notice as guidelines to assess and monitor the compliance of marketing practices in the future. The Staff Notice lays out what is expected of registered firms in the preparation and use of marketing materials. As such, the Staff Notice will become an important source of information for ICPMs and managers of non-prospectus qualified investment funds seeking to understand their obligations under Ontario securities law with respect to marketing practices.

Although not specifically referenced in the Staff Notice, it is also possible that any marketing materials distributed to potential investors in connection with an offering of securities of a non-prospectus qualified investment fund could be considered to constitute (or form part of) an offering memorandum for the purposes of Ontario securities laws. As such, any “misrepresentations” (which include both an untrue statement of a material fact and the omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it is made) contained in such marketing materials could give rise to a right for investors to commence an action under section 130.1 of the *Securities Act* (Ontario) against the issuer seeking damages or rescission of their purchase of the securities.

ICPMs and managers of non-prospectus qualified investment funds should ensure that appropriate policies and procedures are in place which address marketing-related matters and that these policies and procedures are reviewed and updated on a regular basis. In addition ICPMs and managers of non-prospectus qualified investment funds should consider consulting with their professional advisors prior to publishing, posting or distributing any marketing materials.

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The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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