

# OSC LEVIES FINES WITH RESPECT TO IMPROPER PERFORMANCE FEES

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## Introduction

On February 19, 2019, the Ontario Securities Commission (“**OSC**”) [issued an Order](#) approving the [settlement agreement](#) reached between OSC staff, AlphaNorth Asset Management (“**AlphaNorth**”) and Steven Douglas Palmer, the CEO and Ultimate Designated Person of AlphaNorth (“**Palmer**”).

## Background

AlphaNorth is the investment fund manager of two publicly offered mutual funds (each a “**Fund**” and collectively, the “**Funds**”) that are subject to National Instrument 81-102 – *Investment Funds* (“**NI 81-102**”).

Each Fund pays AlphaNorth a performance fee (the “**Performance Fee**”) if its performance, relative to its applicable benchmark, exceed a high-water mark (the “**High-Water Mark**”). Between June 2016 and March 2017 (the “**Material Time**”), AlphaNorth (1) re-designated the shares of a Fund held by certain investors based on their date of acquisition, with the net effect of lowering the High-Water Mark for all shares acquired after a certain date; and (2) lowered the High-Water Mark for all investors holding shares of a certain series of a Fund. As a result of these actions, AlphaNorth received an aggregate amount of \$64,574 in Performance Fees from the Funds that it wouldn’t have received otherwise.

In the settlement agreement, AlphaNorth agreed that it has breached:

1. Sections 56 and 57 of the *Securities Act (Ontario)* - *Failure to file a prospectus amendment* – the simplified prospectus of the Funds was not amended to reflect the noted changes until April 26, 2017 despite the fact that the High-Water Marks were changed approximately a year earlier, resulting in incomplete and misleading investor disclosure
2. *Paragraph 5.1(1)(a) of NI 81-102* – *Failure to obtain unitholder approval* – lowering the High-Water Mark resulted in a change in the basis of the calculation of a fee charged to the investment fund that results in an increase in charges to the fund or its unitholders, thereby requiring unitholder approval
3. *Subsection 4.4(a) of National Instrument 81-106 – Investment Fund Continuous Disclosure* – *failure to*

*disclose the lowering of the High-Water Mark in the Funds' Management Report of Fund Performance ("MRFP") – the interim MRFP and annual MRFP filed during the Material Time failed to provide disclosure about the lowering of the High-Water Mark*

4. *Section 5.1 of National Instrument 81-107 – Independent Review Committee – failure to refer the lowering of the High-Water Mark to the Independent Review Committee ("IRC") of the Funds – the lowering of the High-Water Mark presented a conflict of interest to AlphaNorth which was not referred to the IRC of the Funds*
5. *Section 116 of the Securities Act (Ontario) – Failure to exercise the degree of care, diligence, and skill that a reasonably prudent person would exercise in the circumstances – the totality of AlphaNorth's action did not satisfy the standard of care imposed on investment fund managers*
6. *Section 11.1 of National Instrument 31-103 – Registration Requirements, Exemptions and Ongoing Registrant Obligations – Inadequate internal control and compliance systems – AlphaNorth's internal compliance system was not adequate given what transpired*

In addition, Palmer, as the Ultimate Designated Person of AlphaNorth, was held responsible for AlphaNorth's failures.

The penalties assessed against AlphaNorth and Palmer for the failures noted above were as follows:

1. An administrative penalty of \$147,000 against AlphaNorth
2. An administrative penalty of \$100,000 against Palmer
3. A cost order of \$10,000 against AlphaNorth
4. A reprimand of both AlphaNorth and Palmer

Investment Fund Managers that are considering making changes to any of their performance fees should take note of the AlphaNorth example and proceed cautiously. While this case dealt with publicly offered investment funds, some of the findings (particularly with respect to the overarching standard of care of investment fund manager and required internal controls) would also apply to privately offered investment funds.

Please contact a member of McMillan's Investment Funds and Asset Management Group if you have any questions with respect to any of the above information.

by Jason Chertin, Hari Marcovici and Meghan Schwan, Articling Student

### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

The logo for mcmillan, featuring the word in a lowercase, sans-serif font. The 'm' and 'c' are in a dark red color, while the 'm', 'i', 'l', 'l', 'a', and 'n' are in a light blue color. The logo is positioned in the upper left corner of a banner image.

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