

**IN THE MATTER OF
ALPHANORTH ASSET MANAGEMENT
AND STEVEN DOUGLAS PALMER**

STATEMENT OF ALLEGATIONS

(Subsection 127(1) and Section 127.1
of the *Securities Act*, RSO 1990, c S.5)

A. ORDER SOUGHT

1. Staff of the Enforcement Branch (**Enforcement Staff**) of the Ontario Securities Commission (the **Commission**) request that the Commission make an order pursuant to subsection 127(1) and section 127.1 of the *Securities Act*, RSO 1990, c S.5 (the **Act**) to approve the settlement agreement dated February 13, 2019 between AlphaNorth Asset Management (**AlphaNorth**), Steven Douglas Palmer (**Palmer**) (collectively, the **Respondents**) and Enforcement Staff.

B. FACTS

Enforcement Staff make the following allegations of fact:

OVERVIEW

2. Compliance with Ontario securities laws is critical for all investment fund managers to ensure robust protection to investors from unfair or improper practices and to foster fair and efficient capital markets and confidence in capital markets. Specifically, rules providing for shareholder approval and conflict mitigation are fundamental to fair markets and investor protection. Fund managers must ensure full compliance with these rules before instituting changes to fees, including by referring potential conflicts to the Independent Review Committee (**IRC**). More practically, responsible management of retail investment funds requires adequate financial resources for compliance programs and compliance staff, and internal and external professional advice where necessary.
3. In this matter, AlphaNorth and Palmer, AlphaNorth's Chief Executive Officer (**CEO**) and ultimate designated person (**UDP**), failed in their obligations to ensure changes to fee

structures of mutual funds were undertaken properly and to have adequate internal controls and compliance systems.

4. As detailed below, between June 2016 and April 2017 in the case of AlphaNorth Growth Fund (the **Growth Fund**), and between June 2016 and March 2017 in the case of AlphaNorth Resource Fund (the **Resource Fund**) (together, the **Funds**) (respectively, the **Material Time**), AlphaNorth implemented certain changes to set a lower High-Water Mark (as defined below) in respect of the performance fee to be paid to AlphaNorth by:
 - i. the Growth Fund in respect of series A shares of the Growth Fund (the **Growth Fund Series A Shares**) acquired after June 1, 2016; and
 - ii. the Resource Fund in respect of the series B shares of the Resource Fund (the **Resource Fund Series B Shares**).
5. In setting the lower High-Water Mark in respect of the performance fee payable by both Funds, AlphaNorth did not complete the necessary regulatory steps. AlphaNorth should have but did not refer these proposed changes to the IRC of the Funds or provide timely disclosures. In addition, AlphaNorth should have brought the lower High-Water Marks to meetings of holders of the Growth Fund Series A Shares (**Growth Fund Series A Shareholders**) and Resource Fund Series B Shares (**Resource Fund Series B Shareholders**) to allow the shareholders to consider whether to approve these changes. As a result, during the Material Time, AlphaNorth charged and collected performance fees that it was not eligible to receive.
6. Consequently, AlphaNorth failed to meet the prescribed standard of care under paragraph 116(b) of the Act, which requires an investment fund manager (**IFM**) to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances. AlphaNorth also failed to comply with NI 81-102¹, NI 81-106² and NI 81-107.³

¹ National Instrument 81-102 *Investment Funds* (**NI 81-102**)

² National Instrument 81-106 *Investment Fund Continuous Disclosure* (**NI 81-106**)

³ National Instrument 81-107 *Independent Review Committee for Investment Funds* (**NI 81-107**)

7. In addition, AlphaNorth also failed to maintain adequate internal controls and compliance systems sufficient to provide reasonable assurance that it and each individual acting on its behalf complied with securities legislation, and to manage the risks associated with its business in accordance with prudent business practices, contrary to NI 31-103.⁴
8. Palmer authorized and permitted the non-compliance engaged in by AlphaNorth, and is deemed by section 129.2 of the Act to have not complied with Ontario securities law. He also failed to meet his obligations as AlphaNorth's UDP.
9. The Growth Fund, in respect of Growth Fund Series A Shares, was improperly charged, in the aggregate, approximately \$22,735 (inclusive of HST), and the Resource Fund, in respect of Resource Fund Series B Shares was improperly charged, in the aggregate, approximately \$42,839 (inclusive of HST) because of the failures identified above. In total, the amount charged inappropriately was \$65,574 (inclusive of HST).

THE RESPONDENTS

10. AlphaNorth is a general partnership formed under the laws of the Province of Ontario on August 16, 2007, with its head office in Toronto, Ontario. It is registered with the Commission as an IFM, portfolio manager and exempt market dealer. The Commission is AlphaNorth's principal regulator.
11. Palmer is a founding partner of AlphaNorth and the President and CEO of AlphaNorth, and is registered with the Commission as AlphaNorth's UDP among other categories. He is also a director of the Mutual Fund Corporation (defined below).
12. As at June 30, 2017 (close to the Material Time), the assets under management (**AUM**) for the Growth Fund and the Resource Fund were \$2,696,522 and \$2,887,538, respectively. As at June 30, 2018, the Growth Fund and the Resource Fund had AUM of \$3,083,652 and \$1,721,126, respectively.

⁴ National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**)

13. AlphaNorth is the IFM and the portfolio manager of the Funds.

THE FUNDS

14. The Funds are each a class of shares of AlphaNorth Mutual Funds Limited (the **Mutual Fund Corporation**), incorporated under the laws of Ontario on April 29, 2011 pursuant to its articles of incorporation.
15. The Funds' securities are offered to investors in various series, and certain of those series are in continuous distribution pursuant to a simplified prospectus and related documents prepared in accordance with National Instrument 81-101 *Mutual Fund Prospectus Disclosure*. The Funds are subject to, among other laws and regulations, NI 81-101, NI 81-102, NI 81-106 and NI 81-107. This legislation is designed, in part, to ensure that the investments of the Funds are diversified, transparent and relatively liquid, to ensure appropriate disclosure to new and existing investors, and to ensure the proper administration of the Funds and management of the IFM's conflicts of interest.
16. Among other fees and expenses, each Fund pays a quarterly performance fee to AlphaNorth, if the percentage gain in the net asset value (NAV) per share of the Fund over the preceding quarter or quarters since a performance fee was last paid to AlphaNorth, exceeds the percentage gain or loss of the applicable benchmark for the Fund over the same period and provided that the NAV per share of the Fund (including distributions) is greater than all previous NAVs per share of the Fund at the end of each previous fiscal quarter in which a performance fee was paid (the **High-Water Mark**). The performance fee will be equal to this excess return per share multiplied by the number of shares outstanding at the end of the quarter, multiplied by 20%.
17. The High-Water Mark in respect of each series of each Fund prior to the Material Time was \$10 per share, and neither Fund had paid a performance fee to AlphaNorth since its inception several years earlier.

IMPROPER RE-SETTING OF THE HIGH-WATER MARK FOR THE GROWTH FUND

18. During the Material Time, AlphaNorth charged and collected a performance fee for the Growth Fund Series A Shares, based on a High-Water Mark of \$1.845, which represented the NAV per Growth Fund Series A Share as of May 31, 2016, rather than \$10 which was disclosed in the prospectus. This affected investors who acquired Growth Fund Series A Shares on and after June 1, 2016, until the prospectus amendment (referred to below) was filed on April 26, 2017.
19. The Growth Fund paid AlphaNorth a performance fee in respect of the Growth Fund Series A Shares for the third and fourth quarters of 2016, and accrued performance fees for the first quarter of 2017 based on the High-Water Mark of \$1.845, which impacted NAV for the Growth Fund Series A Shares during the Material Time. AlphaNorth received approximately \$22,735 (inclusive of HST) in performance fees for those periods.
20. On August 25, 2016, AlphaNorth sent investors in Growth Fund Series A Shares who held those securities on June 1, 2016, a notice explaining that all Growth Fund Series A Shares acquired before June 1, 2016 were to be re-designated as series D shares of the Growth Fund (**Growth Fund Series D Shares**) effective October 1, 2016 (the **Re-designation**). Growth Fund Series D Shares were to be identical to the Growth Fund Series A Shares in all respects, including the frequency of redemptions and the High-Water Mark set at \$10. This notice was not filed with the Commission or on SEDAR.
21. The Growth Fund Series D Shares were not offered for sale and were closed to additional investment following the Re-designation. The Growth Fund Series A Shareholders who acquired Growth Fund Series A Shares before June 1, 2016 maintained the same High-Water Mark of \$10 in respect of the performance fee payable by the Growth Fund Series D Shares. The Re-designation allowed AlphaNorth to collect performance fees on Growth Fund Series A Shares sold on or after June 1, 2016 due to the lower High-Water Mark.
22. AlphaNorth did not take the necessary regulatory steps during 2016 to properly effect the Re-designation.
23. In February 2017, the external auditor of the Growth Fund's financial statements asked for documentation supporting the creation of the Growth Fund Series D Shares and the Re-

designation, including articles of amendment and prospectus disclosure. AlphaNorth then engaged external legal counsel to develop a rectification plan, which it carried out as described below, after receiving a positive recommendation to proceed from the IRC and after notifying Staff of the Commission of the issues regarding the Growth Fund Series A Shares and Growth Fund Series D Shares.

24. On March 6, 2017, AlphaNorth filed articles of amendment to recognize the creation of the Growth Fund Series D Shares and the re-designation of the Growth Fund Series A Shares outstanding before June 1, 2016 to Growth Fund Series D Shares.

Incorrect Prospectus Disclosure

25. AlphaNorth failed to file an amendment to its prospectus for the Growth Fund Series A Shares to disclose the lower High-Water Mark in a timely manner, and therefore investors who acquired Growth Fund Series A Shares from June 1, 2016 to April 26, 2017 (the date of the prospectus amendment, described below), acquired their shares without disclosure of the lower High-Water Mark.
26. AlphaNorth filed a prospectus amendment dated April 26, 2017, which (i) disclosed the Re-designation and (ii) disclosed a second re-designation, effective May 31, 2017, of the Growth Fund Series A Shares outstanding as of May 31, 2017 to Growth Fund Series D Shares. The prospectus amendment also disclosed a lower High-Water Mark applicable to the Growth Fund Series A shares, which would affect investors acquiring Growth Fund Series A shares after April 26, 2017. Growth Fund Series D Shares maintained the High-Water Mark of \$10.
27. Investors in Growth Fund Series A Shares, purchasing from June 1, 2016 until April 26, 2017, did not receive accurate disclosure concerning the High-Water Mark applicable on their investment.

Failure to Obtain Securityholder Approval

28. Furthermore, the lowering of the High-Water Mark for Growth Fund Series A Shares as of June 1, 2016 was a fundamental change for which securityholder approval should have been sought by AlphaNorth, as required per paragraph 5.1(1)(a) of NI 81-102. Part 6 of Companion

Policy 81-102CP (the Companion Policy) notes that securityholder approval is required before the basis of the calculation of a fee or expense that is charged to an investment fund is changed in a way that could result in an increase in charges to the investment fund, and that the Canadian securities regulatory authorities note that the phrase “basis of the calculation” includes any increase in the rate at which a particular fee is charged to the investment fund.

Incorrect Continuous Disclosures

29. Form 81-106F1 – *Contents of Annual and Interim Management Report of Fund Performance (Form 81-106F1)* requires material information, which is likely to influence or change a reasonable investor’s decision to buy, sell or hold securities of an investment fund, to be disclosed in a fund’s continuous disclosure documents. The Growth Fund’s Management Reports of Fund Performance (**MRFP(s)**) for the six-month period ended June 30, 2016 and the year ended December 31, 2016 did not discuss the change in the High-Water Mark, nor the Re-designation. The Growth Fund’s annual audited financial statements for the year ended December 31, 2016 provided disclosure about the Re-designation, but none in respect of the lowered High-Water Mark for Growth Fund Series A Shares.

Failure to Refer to IRC

30. Section 5.1 of NI 81-107 requires conflict of interest matters, which include a situation where a reasonable person would consider a manager to have an interest that may conflict with the manager’s ability to act in good faith and in the best interests of the fund, to be referred to the fund’s IRC for its review, before the manager may take any action in the matter. AlphaNorth did not refer the Re-designation or the change in High-Water Mark to the IRC, even though the changes to the Growth Fund Series A Shares were a conflict of interest matter for AlphaNorth, and therefore should have been referred to the IRC for their review prior to carrying out the changes.
31. On February 21, 2017, AlphaNorth notified the IRC of the concerns raised by the external auditor with the Re-designation and the resetting of the High-Water Mark for the Growth Fund and explained its intention to develop a rectification plan with the assistance of external

counsel. In April 2017, AlphaNorth referred the rectification plan to the IRC and the IRC provided a positive recommendation to proceed with its implementation.

Failure to Identify Deficiencies regarding the Growth Fund

32. The Growth Fund's external auditors' concerns raised during the audit of the Growth Fund's 2016 annual financial statements led AlphaNorth to take steps to rectify the issues around the Re-designation and the lower High-Water Mark.
33. Before the concerns were raised by the external auditor, AlphaNorth and Palmer, in his capacity as CEO and UDP of AlphaNorth, failed to take the necessary steps to ensure compliance with applicable securities and corporate laws, including documenting the newly created Growth Fund Series D Shares, updating the prospectus documents for Growth Fund Series A Shares and Growth Fund Series D Shares, obtaining appropriate securityholder approval, providing adequate disclosures in the MRFPs, and referring the attendant conflicts of interest matters to the IRC.

IMPROPER RE-SETTING OF THE HIGH-WATER MARK FOR THE RESOURCE FUND

34. Between June 8, 2016 and March 31, 2017, AlphaNorth charged and collected a performance fee for Resource Fund Series B Shares by lowering the High-Water Mark in respect of the performance fee payable per share from \$10 to \$8.916, which was an average of the two different prices of the Resource Fund Series B Shares as acquired by the applicable shareholders in the two tranches referred to in paragraph 35.
35. AlphaNorth did not provide any notice to existing Resource Fund Series B Shareholders of this change. Resource Fund Series B Shares have not been offered to new investors since 2013, and were acquired by Resource Fund Series B Shareholders in two tranches at two different prices. Accordingly, no new shareholders acquired Resource Fund Series B Shares during the Material Time. During the Material Time, AlphaNorth collected \$42,839 (inclusive of HST) in performance fees from Resource Fund Series B Shares because of the lower High-Water Mark.

36. In February 2017, the external auditor of the Resource Fund’s financial statements inquired about the lowered High-Water Mark in connection with their audit of the Resource Fund’s financial statements for the year ended December 31, 2016. AlphaNorth then engaged external legal counsel to develop a rectification plan, which included reimbursing the Fund and affected Resource Fund Series B Shareholders for the over-payment, inclusive of a 5% per month payment to compensate the Fund and the affected shareholders for lost opportunity costs.

Failure to Obtain Securityholder Approval

37. Resource Fund Series B Shareholders who held Resource Fund Series B Shares as of June 8, 2016 were not provided the opportunity to vote on the lowering of the High-Water Mark by AlphaNorth. As described in paragraph 28 above, the lowering of the High-Water Mark is a fundamental change for which the Resource Fund Series B Shareholders’ prior approval should have been sought by AlphaNorth pursuant to paragraph 5.1(1)(a) of NI 81-102.

Incorrect Continuous Disclosures

38. The Resource Fund’s MRFPs for the period ended June 30, 2016 and the year ended December 31, 2016 did not reflect the change in the High-Water Mark. As described in paragraph 29 above, material information such as this should have been disclosed pursuant to the requirements of Form 81-106F1.

39. The Resource Fund’s MRFP for the interim period ended June 30, 2017 disclosed the following: “We discovered an error in calculation of the performance fee during the first quarter of 2017. This was corrected ...” AlphaNorth’s disclosure in this regard fails to fully reflect AlphaNorth’s role in the lowering of the High-Water Mark.

40. The rectification of the performance fee payments was disclosed in the MRFPs for the year ended December 31, 2017.

Failure to Refer to IRC

41. As described in paragraph 30 above, section 5.1 of NI 81-107 requires conflict of interest matters to be referred by the manager to the fund’s IRC for its review, before the manager

may take any action in the matter. AlphaNorth did not refer its proposal to lower the High-Water Mark for the Resource Fund Series B Shares, even though the proposal was a conflict of interest matter for AlphaNorth, which necessitated a referral to the IRC and a positive recommendation to proceed by the IRC.

42. AlphaNorth and Palmer, as CEO and UDP, failed to identify, assess or address the securities law implications associated with lowering the High-Water Mark for the Resource Fund, including obtaining appropriate securityholder approval, providing adequate disclosures in the MRFPs, and referring the matter to the IRC.

DEFICIENCIES IN ALPHANORTH'S INTERNAL CONTROLS AND COMPLIANCE SYSTEMS

43. AlphaNorth has an obligation as a registrant to establish, maintain and apply policies and procedures that establish a system of controls and supervision to (i) provide reasonable assurance that AlphaNorth and each individual acting on its behalf complies with securities legislation, and (ii) manage the risks associated with its business in accordance with prudent business practices.
44. During a compliance review conducted by Staff of the Commission covering the period of June 1, 2016 to May 31, 2017 (the **Compliance Review**), Staff identified significant deficiencies in AlphaNorth's compliance with Ontario securities law, including:
 - a. inadequate oversight of AlphaNorth's dealing activities for third-party exempt products and its dealing representative, who was an agent of AlphaNorth (and not a principal of the partners of AlphaNorth) for the period contrary to subsection 32(2) of the Act and section 11.1 of NI 31-103;
 - b. failure to identify and appropriately address conflict of interest matters, and refer them to the Funds' IRC, in relation to finder's fees received from issuers when causing the Funds to invest in certain securities, contrary to subsection 5.1(1) of NI 81-107; and

- c. failure to disclose the conflict of interest in the prospectus documents of the Funds, in relation to finder's fees received by AlphaNorth and/or its affiliates when causing the Funds to invest in certain securities, contrary to section 116 of the Act.
45. As the UDP, Palmer failed to discharge the responsibilities required by section 5.1 of NI 31-103, in supervising the activities of AlphaNorth and those acting on its behalf, towards ensuring and promoting compliance with applicable securities legislation.

C. BREACHES OF ONTARIO SECURITIES LAW AND CONDUCT CONTRARY TO THE PUBLIC INTEREST

46. Enforcement Staff allege the following breaches of Ontario securities law and/or conduct contrary to the public interest:

(a) The Funds

- a. AlphaNorth's activities described above regarding the lack of accurate and timely prospectus disclosures for Growth Fund Series A Shares were contrary to sections 56 and 57 of the Act;
- b. AlphaNorth's failure to obtain prior securityholder approval in lowering the High-Water Mark for the Growth Fund Series A Shareholders and the Resource Fund Series B Shareholders as described above was contrary to paragraph 5.1(1)(a) of NI 81-102;
- c. AlphaNorth's conduct resulted in the Growth Fund's MRFPs and the Resource Fund's MRFPs during the Material Time not being prepared in accordance with Form 81-106F1 and was contrary to the requirements of paragraph 4.4(a) of NI 81-106;
- d. AlphaNorth's failure to refer the Growth Fund's Re-designation and the lowering of the Funds' High-Water Mark to the Funds' IRC prior to taking any action in the matter was contrary to section 5.1 of NI 81-107;
- e. In implementing the changes to lower the High-Water Marks of the Growth Fund Series A Shares and the Resource Fund Series B Shares described above,

AlphaNorth did not satisfy the standard of care prescribed for an investment fund manager under paragraph 116(b) of the Act;

- f. Palmer, as the CEO and UDP of AlphaNorth, authorized and permitted the breaches of Ontario securities law engaged in by AlphaNorth, contrary to section 129.2 of the Act;

(b) AlphaNorth's Internal Controls and Compliance Systems

- g. As described above, AlphaNorth's compliance system was not adequate to allow it to discharge its responsibilities under Ontario securities law, as required per subsection 32(2) of the Act and section 11.1 of NI 31-103. Palmer, as the UDP of AlphaNorth, did not adequately discharge his responsibilities as required by section 5.1 of NI 31-103; and
- h. Collectively, in respect of the Funds and AlphaNorth's internal controls and compliance systems, the above described conduct and non-compliance with Ontario securities law constitute conduct contrary to the public interest.

47. Enforcement Staff reserve the right to amend these allegations and to make such further and other allegations as Enforcement Staff may advise and the Commission may permit.

DATED this 14th day of February, 2019.

Christina Galbraith
Litigation Counsel
Enforcement Branch
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, ON M5H 3S8
Tel: (416) 596-4298
Email: cgalbraith@osc.gov.on.ca

Lawyer for Staff of the Ontario Securities Commission