

## 1.1.2 The Investment Funds Practitioner

November, 2007

### THE INVESTMENT FUNDS PRACTITIONER

From the Investment Funds Branch, Ontario Securities Commission

#### What is the Investment Funds Practitioner

The Practitioner is an overview of recent issues that have arisen in connection with applications for discretionary relief, prospectuses, and continuous disclosure documents filed by investment funds with the OSC. We, the staff of the Investment Funds Branch, have written the Practitioner primarily for investment fund managers and their staff or advisors who regularly prepare public disclosure documents and applications for exemptive relief on behalf of investment funds.

The purpose of the Practitioner is to make you more broadly aware of some of the issues we have raised in connection with our reviews of documents filed with us and how we have resolved them. We hope that fund managers and their advisors will find this information useful and that the Practitioner can serve as a useful resource when preparing applications and disclosure documents.

Please note, however, that the information contained in the Practitioner is based upon particular factual circumstances and that outcomes may change as facts change or as regulatory approaches evolve. We will continue to assess each particular case on its own merits. Please also note that the Practitioner was prepared by staff of the Investment Funds Branch and the views it expresses do not necessarily reflect those of the Commission or the Canadian Securities Administrators.

#### Request for Feedback

This is the second edition of the Practitioner. We thank everyone for the feedback provided on the first edition published in April of this year on a trial basis. Your comments indicated that you find the Practitioner useful and that you are interested in seeing more editions of the Practitioner. We welcome your feedback and any suggestions for topics that you would like us to cover in future editions. Please forward your comments by email to [investmentfunds@osc.gov.on.ca](mailto:investmentfunds@osc.gov.on.ca), or feel free to contact us.

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#### Who we are

Since the OSC created the Investment Funds Branch in March, 2003, the Branch has added a number of people who you may not have met. Many of the people in the Branch have been with the Commission in the investment funds area for a number of years, while others are relatively new to the Branch. Currently, our group is:

Stacey Barker	Senior Accountant
Shaill Bahuguna	Administrative Support Clerk
Eric Buenaflor	Financial Examiner
Oriole Burton	Review Officer & Administrative Assistant
Leslie Byberg	Acting Director
Raymond Chan	Senior Accountant
Joan DeLeon	Review Officer
Daniela Follegot	Legal Counsel
Patricia Fuller	Administrative Assistant
Robert Gates	Legal Counsel
Rhonda Goldberg	Manager
Pei-Ching Huang	Legal Counsel
Irene Lee	Legal Counsel
Tracey Leonardo	Administrative Assistant
Chantal Mainville	Senior Legal Counsel
Darren McKall	Senior Legal Counsel
Merzana Martinakis	Accountant
Parbatee Nandacumar	Administrative Assistant
Viraf Nania	Senior Accountant

Vera Nunes	Assistant Manager
Sarah Oseni	Senior Legal Counsel
Stephen Paglia	Legal Counsel
Violet Persaud	Review Officer
Susan Thomas	Legal Counsel
Doug Welsh	Senior Legal Counsel
Sovener Yu	Accountant

We hope to welcome additional staff to the Branch over the next year.

### **Applications for Relief**

#### **NI 81-107 – Sunsetting or Terminated Relief Orders**

We have received several applications seeking the reissue of discretionary exemptions previously granted from the conflicts provisions in NI 81-102 – *Mutual Funds* and Part XXI of the Act. The sunset provisions under section 7.2 of NI 81-107 – *Independent Review Committee for Investment Funds* terminated these exemptions as of November 1, 2007.

NI 81-107 and consequential amendments to NI 81-102 codified the most frequently occurring exemptions. Several applicants, however, required the reissue of discretionary exemptions that we did not codify. The applications have included:

- The reissue of an exemption from s.4.1 of NI 81-102 to continue to permit funds to invest in private placements of reporting issuers underwritten by a related party underwriter.<sup>1</sup>
- The reissue of exemptions from s. 4.2 of NI 81-102 and s. 118(2)(b) of the Act to permit mortgage funds to continue to purchase and sell mortgages with a related party.<sup>2</sup>
- The reissue of an exemption from s. 4.2 of NI 81-102 and s. 118(2)(b) of the Act to permit certain mutual funds to continue to purchase and sell debt securities with a related party.<sup>3</sup>

In each case, the Director granted the exemptions subject to several conditions including, most notably, that the funds' Independent Review Committee approve the transactions.

#### **Relief to Permit Purchases of Asset Backed Commercial Paper(ABCP)**

Beginning in the summer, we received several applications for exemptions from s. 4.2 of NI 81-102 and s. 118(2)(b) of the Act in connection with related party purchases of ABCP<sup>4</sup>. The transactions were designed to address liquidity issues in the ABCP market. A key condition or representation in the exemptions was the involvement of the funds' IRC in the transaction. You will note varying degrees of IRC involvement in each case. This reflects that the IRC may not have been fully operational as of the date of the application given that NI 81-107 did not require an IRC to be reviewing conflicts of interest until November 1, 2007. We anticipate that applications for similar relief after November 1, 2007 will generally include a condition that the IRC has approved the transaction.

#### **Approval to Act as Trustee under the LTCA**

The Commission has the authority to approve a body corporate that manages a mutual fund trust to act as trustee under section 213(3)(b) of the *Loan and Trust Corporations Act*. The Commission often approves applicants to act as trustee of pooled funds under section 213(3)(b). These applicants are generally unable to rely on the terms of Approval 81-901 *Approval of Trustees Under Clause 213(3)(b) of the Loan and Trust Corporations Act*. These approvals have been based on a number of grounds including that the funds have a custodian that meets the custodian requirements of NI 81-102.

We've recently received some LTCA applications where the applicant seeking approval to act as trustee of a fund is unable to represent that the fund has a custodian that meets the requirements of NI 81-102. In each instance we've raised comments

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<sup>1</sup> See *In the Matter of Goodman & Company, Investment Counsel Ltd.* (August 24, 2007).

<sup>2</sup> See *In the Matter of Scotia Cassels Investment Counsel Limited* (October 31, 2007 under NI 81-102 and November 1, 2007 under Securities Act.) and *In the Matter of TD Asset Management Inc.* (October 31, 2007 under NI 81-102 and November 1, 2007 under Securities Act).

<sup>3</sup> See *In the Matter of Altamira Investment Services Inc. et al.* (October 31, 2007 under NI 81-102 and November 1, 2007 under Securities Act).

<sup>4</sup> See *In the Matter of Northwest Money Market Fund and Northwest Canadian Bond Fund* (September 25, 2007), *In the Matter of Mawer Investment Management Ltd. et al.* (September 20, 2007), *In the Matter of the Federation des Caisses Desjardins du Quebec* (September 18, 2007), and *In the Matter of IA Clarington Investment Inc. et al.* (September 4, 2007).

concerning the absence of a such a custodian. Applicants have generally responded by having the fund retain a qualified custodian.

### **Trades in Pooled Fund Units to Managed Accounts**

The Commission has granted a series of discretionary exemptions from the registration and prospectus requirements of the Act over the past couple of years to permit the distribution of pooled fund units to certain fully managed accounts held by “secondary clients” who do not qualify as accredited investors.<sup>5</sup>

A portfolio manager acting on behalf of a fully managed account in Ontario is not an accredited investor when purchasing securities of an investment fund. As such, a managed account in Ontario may only invest in an investment fund on an exempt basis where the holder of that account either personally qualifies as an “accredited investor” under the tests set out in the term’s definition in NI 45-106 or is able to invest \$150,000 in the investment fund in accordance with the \$150,000 minimum investment amount exemption in section 2.10 of NI 45-106.

In certain instances, portfolio managers of managed accounts may agree from time to time to provide services to clients who are not accredited investors. These “secondary clients” are typically accepted because of a relationship between the “secondary client” and the “primary client” who qualifies as an accredited investor.

The Commission has granted exemptions from the registration and prospectus requirements to accommodate “secondary client” managed accounts. The Commission has granted the exemptions primarily on the basis that the “secondary clients” are an incidental part of the applicants’ asset management business which is primarily focused on the accredited investor clients. Conditions to these exemptions include that the “secondary clients” must fit within a specific class of relationship to the “primary client”. The classes are generally limited to a spouse, parent, grandparent, child or sibling of a primary client, or individuals who have another relationship with a primary client where there are exceptional factors that have persuaded the portfolio manager to accept such persons as clients for business reasons. The exemptions also typically include representations regarding the applicants’ minimum account thresholds.

### **Prospectuses**

We have identified several prospectus disclosure issues over the past several months.

### **Closed End Funds – Annual Redemption at NAV**

A common feature of many closed end funds that trade on the TSX is that the securities are redeemable once a year for net asset value. The general purpose of this feature is to limit the market discount to NAV these securities often trade at. We have noted several instances where closed end trusts terminated prematurely as a result of a substantial number of redemption requests on the annual redemption date. We understand that one of the risks associated with the annual redemption feature at net asset value is it may create an opportunity for arbitrage leading up to the annual redemption date.

Several industry responses to this risk have included: the automatic conversion of a closed end fund to a mutual fund upon the occurrence of certain events; early redemption fees; and the removal of the annual redemption feature at net asset value. Recently, we have been raising comments on prospectuses filed by closed end funds that include an annual redemption feature at net asset value when it is unclear from the prospectus disclosure if the funds have adopted any measures to address the risks associated with the annual redemption feature. We have also been raising comments aimed at improving the risk factor disclosure typically provided regarding the annual redemption feature<sup>6</sup>.

### **Flow Through LPs and Closed End Funds - Performance Data of Related Funds**

Flow Through LPs and Closed End Funds often include disclosure in their prospectuses regarding the past performance of other funds managed by the same manager (Related Funds) or the past performance of a proposed portfolio of securities. Flow Through LPs also often include disclosure regarding the past performance of a Related Fund that the Flow Through LP will roll its assets into after 2 years.

We have raised comments over the years regarding the disclosure of past performance with a view to making it more balanced and full, true, and plain. Industry responses that we believe have improved disclosure include:

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<sup>5</sup> See, for example, *In the Matter of Gluskin Sheff and Associates Inc. et al.* (August 5, 2005); *In the Matter of Nexus North American Balanced Fund et al.* (August 28, 2007); *In the Matter of Cumberland Private Wealth Management Inc. et al.* (May 18, 2007); *In the Matter of Northwood Stephens Private Counsel Inc. et al.* (May 4, 2007); *In the Matter of Manitou Investments Management Ltd. et al.* (February 23, 2007); and *In the Matter of Newport Investment Counsel Inc. et al.* (October 2, 2007).

<sup>6</sup> See, for instance, the risk factor disclosure in the final prospectus filed by Faircourt Gold Corporation (October 30, 2007).

- Disclosing the performance data in the body of the prospectus, but not on the cover page.
- Including annual compound returns rather than cumulative returns.
- Including performance data for all Related Funds with similar investment objectives rather than just the Related Funds that have performed well.
- Including performance data for Related Funds or portfolio companies that have at least a 12 month reporting history.
- Including performance data for standard performance periods of 1, 3, 5, and 10 years when available or since inception if not.
- Including performance data net of fees.
- Including performance data for a Related Fund that is actually the fund that the Flow-Through LP will roll its assets into rather than a fund that is similar to the fund that the Flow-Through LP will roll its assets into.
- Removing hypothetical back tested performance data for a new formula or index.

### **Advertising During the Waiting Period**

We have received several inquiries from closed end trusts in the past few months regarding what content may be included in advertisements during the waiting period between the filing of a preliminary prospectus and the final prospectus. We suggest that issuers and their advisers review s. 65(2) of the Act and remind the industry that this provision applies to investment funds. Issuers and their advisers may also wish to review the guidance provided in OSC Policy 47-601 – *Advertising During Waiting Period Between Preliminary and Final Prospectuses*, OSC Policy 47-701 – *Advertising and Use of Marketing Material During the Waiting Period*, and OSC Policy 47-703 – *Media Articles Appearing During the Waiting Period*. In addition to the guidance provided in those policies, we suggest that issuers not disclose material during the waiting period that is unduly promotional and carefully consider whether the disclosure of performance data in advertising material is appropriate. We sometimes request a copy of the greensheet and other marketing materials under our prospectus reviews.

### **Continuous Disclosure**

#### **CICA Handbook Section 3855**

The Director granted an exemption under NI 81-106 from section 14.2 dated September 28, 2006<sup>7</sup> and recently renewed this exemption in a decision dated September 28, 2007.<sup>8</sup> Section 14.2 of NI 81-106 requires investment funds to calculate NAV in accordance with GAAP. The Director's 2006 decision effectively exempted investment funds from section 3855 in connection with calculating NAV for purposes other than their financial statements. The Director's decision included a condition that the investment fund's financial statements must include a reconciliation of NAV in the financial statements to NAV for other purposes. The decision also contained a sunset clause so that it expired on the earlier of September 30, 2007 or the date on which changes to Part 14 of NI 81-106 come into effect. The exemption will now expire on the earlier of September 30, 2008 and the date on which changes to Part 14 of NI 81-106 come into effect.

See, for instance, the risk factor disclosure in the final prospectus filed by Faircourt Gold Corporation (October 30, 2007).

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<sup>7</sup> *In the Matter of AGF Funds Inc. et al.* dated September 28, 2006.

<sup>8</sup> *In the Matter of AGF Funds Inc. et al.* dated September 28, 2007.