

OSC

# 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 arising from applications for discretionary relief, prospectuses, and continuous disclosure documents that investment funds file with the OSC. It is intended to assist 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 Practitioner is also intended 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.

The information contained in the Practitioner is based on particular factual circumstances. Outcomes may differ as facts change or as regulatory approaches evolve. We will continue to assess each case on its own merits.

The Practitioner has been prepared by staff of the Investment Funds Branch and the views it expresses do not necessarily reflect the views of the Commission or the Canadian Securities Administrators.

## Request for Feedback

This is the fifth edition of the Practitioner. Previous editions of the Practitioner are available on the OSC website [www.osc.gov.on.ca](http://www.osc.gov.on.ca) under Investment Funds – Related Information.<sup>1</sup> 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).

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<sup>1</sup> At [http://www.osc.gov.on.ca/en/About\\_if\\_index.htm](http://www.osc.gov.on.ca/en/About_if_index.htm) or [http://www.osc.gov.on.ca/en/InvestmentFunds\\_index.htm](http://www.osc.gov.on.ca/en/InvestmentFunds_index.htm)

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## Applications for Relief

### Requirement to Calculate Daily NAV

We have seen a number of applications for exemptive relief from the requirement to calculate daily the net asset value (NAV) of an investment fund that uses specified derivatives. Subsection 14.2(3) of NI 81-106 requires that the NAV of an investment fund using specified derivatives be calculated at least once every business day (referred to as the NAV calculation requirement). Some investment funds that use specified derivatives wish to calculate NAV weekly or bi-weekly on the basis that the costs of calculating NAV daily outweigh the benefits to securityholders, given that such investment funds are not in continuous distribution and are listed on an exchange.

Generally, we are of the view that the typical cost of calculating NAV on a daily basis does not create a significant burden. Our view is that, for investment funds listed on an exchange, the NAV calculation requirement promotes effective portfolio management practices and enables market price discovery. Furthermore, it ensures market transparency and provides a fair representation of the investment fund's value which can be used if an investment fund's own securities trade infrequently, or in the event that trading in those securities is halted.

In reviewing these applications, we may ask how the investment fund will manage its portfolio on an ongoing basis without the benefit of a daily NAV, whether the nature of the portfolio assets affects the investment fund's ability to calculate NAV daily, and for submissions on the additional cost to the investment fund of calculating a daily NAV.

## **Split Shares – Relief from s. 119**

Historically, we have granted relief to split share companies from section 119 of the *Securities Act* (Ontario), a front-running prohibition which prevents someone with knowledge of the investment program of a mutual fund from trading ahead. Filers believed that sales and purchases of portfolio securities between the split share company and its related dealers (referred to as principal sales and purchases) were caught under s. 119.

Staff have reconsidered the applicability of s. 119 and determined that it may be more appropriate for applications relating to principal sales and purchases to be made under section 13.5(2) of National Instrument 31-103 *Registration Requirements and Exemptions* (formerly section 118 of the Act), which prohibits self-dealing.

While relief from s. 119 was given to split share companies in the past, these types of issuers should consider whether they are instead caught under s. 13.5(2) of NI 31-103.

## **Split Shares – Secondary Offerings**

Generally, split share companies offer monthly retractions at a price computed by reference to the value of a proportionate share of the net assets of the fund. Accordingly, they qualify as mutual funds under applicable securities legislation and are subject to the provisions of NI 81-102. However, a split share company differs from a conventional mutual fund as: (i) it will not be in continuous distribution; and (ii) its capital and preferred shares are listed on an exchange. Routinely, split share companies receive relief from mutual fund requirements and restrictions on investments, calculation and payment of redemptions, preparation of compliance reports, and setting the record date for payment of distributions.

When split share companies engage in a secondary offering of shares, they often request relief from the same provisions in NI 81-102 again. Filers should consider whether this is necessary, as the relief was granted to the issuer itself, not to a particular class of shares. For most aspects of the relief, the original representations should still be valid. New relief may be needed for the calculation and payment of the redemption price of shares (sections 10.3 and 10.4(1) of NI 81-102), if the split share company is offering a new class of shares not contemplated in the original exemption.

## **Prospectuses**

### **Publication of Staff Notice**

The OSC issued OSC Staff Notice 81-714 *Compliance with Form 41-101F2 - Information Required in an Investment Fund Prospectus* on March 4, 2011. The Notice sets out the views of staff on certain disclosure required by Form 41-101F2 and the types of comments staff will generally raise in the course of a review of an investment fund long form prospectus.

## Forward Fees

When the use of forward agreements is a material feature of a fund, we have been raising comments to request the disclosure of fees and any other costs associated with the forward agreements. One filer submitted that full, true and plain disclosure would be provided without the disclosure of such fees, and that this information was proprietary; however, the forward agreement fees, generally, have been material enough to persuade staff that this information is key to investors. Filers have shown the fees as a percentage of the forward agreement and have disclosed either the maximum percentage or a range.

## PIFs for CCO

The prospectus rules require that a personal information form (PIF) be provided for every director or executive officer of the manager (and issuer, if applicable). In our view, the chief compliance officer of the manager is an individual who falls within the definition of "executive officer" as defined in the prospectus rules and a PIF must be provided for this individual.

## Use of Short Form Prospectus

We have noted a number of issuers who make one or more subsequent offerings within a year of filing a long form prospectus in connection with their initial public offering. We remind filers that a new reporting issuer is not qualified to use a short form prospectus unless it can rely on the exemption in section 2.7 of NI 44-101 *Short Form Prospectus Distributions*. One criterion of using the short form is that a new reporting issuer must have a final prospectus that includes "comparative annual financial statements for its most recently completed financial year" (section 2.7(1)(b)).

We remind filers that the short form prospectus regime incorporates by reference a reporting issuer's continuous disclosure record; accordingly, a fund must have an established continuous disclosure record before it can file a short form prospectus. If a new fund has not yet completed a financial year, staff's view is that the fund's continuous disclosure record is not comprehensive enough because it does not have comparative annual financial statements<sup>2</sup> and, therefore, it cannot rely on the new reporting issuer exemption to use the short form prospectus.

One filer thought that it could rely on the new reporting issuer exemption because its final prospectus included an audited opening balance sheet and it intended to include unaudited interim financial statements in its short form prospectus. Staff were of the view that the combination of these documents could not replace audited "annual financial statements" because: (i) an opening balance sheet, although audited, does not reflect the results of a completed financial year since there have not yet been any operations of the fund; and (ii) while interim financial statements capture the recent operations of the fund, they are not accompanied by an auditor's report. In this case, staff asked the filer to use the long form prospectus.

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<sup>2</sup> In the case of a fund with a final prospectus that incorporates audited annual financial statements for the first completed financial year, staff have not taken issue when that fund relies on the new reporting issuer exemption, even though the financial statements are not comparative. While the inclusion of comparative figures in the financial statements is a requirement, they cannot be provided if the fund has only been in operation for one year.

## Relief from 90-Day Filing Requirement

The simplified prospectus and long form prospectus rules both require a final prospectus to be filed no more than 90 days after the preliminary prospectus.<sup>3</sup> If an exemption from this requirement is granted, the prospectus rules state that the exemption may be evidenced by the issuance of a receipt for the final prospectus.<sup>4</sup>

Recently, one family of funds submitted an application for this relief and then immediately filed the final prospectus before receiving confirmation from staff that the application had been processed and approved. The Filer thought that the submission of the application, filing of final materials, and the issuance of a receipt would take place in quick succession.

While relief from the 90-day filing requirement may be evidenced by receipt, the application process must still be observed. This involves the review and consideration of the application by staff; a recommendation being made to the decision maker; and the signing of an approval letter if the decision maker agrees to the relief. Once these steps have been completed, final materials can be filed for staff's review.

## Continuous Disclosure

### Review of NI 81-107 Related Disclosure

As noted in the fourth edition of the Practitioner, Investment Funds staff reviewed, on an issue-oriented basis, a sample of investment funds to evaluate compliance with the disclosure obligations introduced in NI 81-107. Our review concluded in 2010 and resulted in the publication of OSC Staff Notice 81-713 *Focused Disclosure Review of National Instrument 81-107 Independent Review Committee for Investment Funds*. The Notice summarizes the findings from our review and was published on March 25, 2011.

## Public Inquiries and FAQs

### Definition of Index Participation Unit

We have received a number of inquiries seeking staff's views on what constitutes a "widely quoted market index" for the purposes of the definition of "index participation unit" in NI 81-102. In particular, we have been asked whether an index that tracks the price of a commodity or the price of options on a commodity could be considered a "market index".

Staff are generally of the view that the term "market index" should be interpreted in a manner that is consistent with the investment restrictions set out in NI 81-102. As a result, an index, which provides exposure to asset classes or strategies that a mutual fund would not be able to engage in directly, would not generally qualify as a "market index".

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<sup>3</sup> The 90-day filing requirement is found in section 2.1(2) of NI 81-101 for a simplified prospectus and 2.3(1) of NI 41-101 for a long form prospectus.

<sup>4</sup> Evidence of exemption can be found in section 6.2 of NI 81-101 or 19.3 of NI 41-101.

On this basis, staff would not generally consider an index that tracks the price of a commodity to be a “market index”. The same conclusion would apply to an index that purports to track the performance of hedge funds, real property, or that incorporates leverage or shorting strategies.

We note that over the past few years there has been a proliferation in the number of product offerings from index providers. We also recognize that there is an interest on the part of exchange traded fund providers to differentiate themselves in the market by branching out beyond the traditional indices. Staff caution filers and their advisors that, while an index provider may label something as an “index” and that index may appear to be widely quoted, it still may not qualify as a “market index” under NI 81-102.

Additionally, we note that the prospectus for certain exchange traded funds includes disclosure stating that the fund qualifies as an IPU for the purposes of NI 81-102. Mutual fund managers and portfolio managers, however, should conduct their own analysis of whether that fund is an IPU and should not rely solely on the disclosure provided by the exchange traded fund.

### **Point of Sale FAQs**

Stage 1 of the Point of Sale (POS) project was completed on January 1, 2011 when amendments to NI 81-101 came into force. NI 81-101 contains the requirements to produce and file the Fund Facts document and for it to be made available on the mutual fund’s or mutual fund manager’s website. Since the amendments to NI 81-101 came into force, we have received inquiries about the content of and filing deadlines for the Fund Facts document. Below is a brief summary of these inquiries and our responses.

#### *1. Transition period*

- Q.** *When must a mutual fund file a Fund Facts document and post it to the mutual fund’s or mutual fund manager’s website?*
- A.** No later than July 8, 2011, every class or series of mutual fund must file and post the Fund Facts to the mutual fund’s or mutual fund manager’s website.

#### *2. Filing fees*

- Q.** *Please confirm whether there are additional filing or regulatory fees for the Fund Facts document.*
- A.** We can confirm that CDS will not apply any fees to file the Fund Facts on SEDAR. We can also confirm that there are no regulatory fees to file the Fund Facts in Ontario.

#### *3. Frequency of filing*

- Q.** *How frequently does the Fund Facts document need to be filed?*
- A.** After the initial filing of a Fund Facts, the document must be re-filed along with the renewal simplified prospectus (SP). It must also be filed upon the occurrence of a material change that relates to the information contained in

the Fund Facts. A change to the investment mix of the fund is not likely to be considered a material change so there will generally not be any requirement to file an amendment simply to update the Top 10 investments list or the portfolio breakdown chart. A change to the fund's investment objectives, however, would generally result in such a requirement.

#### *4. Fund Facts format*

- Q.** *Please confirm whether the Fund Facts document filed by a mutual fund must follow the template in Appendix A to Companion Policy 81-101CP.*
- A.** Form 81-101F3 *Contents of Fund Facts Document* sets out requirements for content, order and headings but it does not specify or mandate a specific format other than a requirement to use tables in certain areas. The sample Fund Facts that was published as Appendix A to Companion Policy 81-101CP was intended to be an illustration of what a Fund Facts document might look like, but there is no requirement for mutual funds to use that exact layout. Provided that the document follows the mandated order for content, is written in plain language and uses a font that is legible, mutual funds will have flexibility in terms of the format of the Fund Facts. Given that the Fund Facts may be disseminated in an electronic format, the information must be presented in a way that enables it to be printed in a readable format.

#### *5. Disclosure of past performance*

- Q.** *Please confirm whether past performance information for mutual funds not in distribution for a full calendar year may be disclosed in the "Year-by-year returns" chart of the Fund Facts document.*
- A.** The Year-by-year return chart requires a mutual fund to have completed a calendar year (January 1 to December 31) before including performance in the Fund Facts. A mutual fund that completes a calendar year following the filing of a Fund Facts, but before renewal, may amend the Fund Facts to include the relevant past performance information.