1.1.2 The Investment Funds Practitioner – December 2011

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OSC
THE INVESTMENT FUNDS PRACTITIONER

What is the Investment Funds Practitioner?

The Practitioner is an overview of recent issues arising from applications for exemptive 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 sixth edition of the Practitioner. Previous editions of the Practitioner are available on the OSC website www.osc.gov.on.ca under Investment Funds – Related Information. 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.

Applications for Relief

Managed Accounts

We continue to see applications from portfolio managers seeking exemptive relief from the prospectus requirement in the Act to permit the distribution of pooled fund securities to fully managed accounts held by clients who do not qualify as accredited investors.

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 the account either personally qualifies as an "accredited investor" as defined in NI 45-106 or invests $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 the past, the Commission has granted exemptive relief from these requirements to accommodate exempt distributions in connection with the provision of portfolio management services to "secondary clients". These "secondary clients" are not accredited investors but 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 the exemptions primarily on the basis that the "secondary clients" are an incidental part of the applicant's asset management business, which is primarily focused on accredited investor clients.

Increasingly, we have received applications for exemptive relief to permit the distribution of pooled fund securities to fully managed accounts which are not required to have significant asset levels. More recently, the Commission has narrowed the relief to accommodate "secondary clients" only in situations where the vast majority of the portfolio manager's clients are accredited investors and where the portfolio manager has established a significant asset threshold for its managed accounts.[1]

In our analysis of these applications, staff continue to focus on (i) whether the principal business activity of the portfolio manager is to provide asset management services to its clients, (ii) the minimum account thresholds established by the portfolio manager, (iii) whether there is a bona fide portfolio management services relationship between the portfolio manager and each client, (iv) whether there is a close relationship between the "primary" managed account holders and the "secondary" account holders

[1] Refer to *In the Matter of K.J. Harrison & Partners Inc.* dated August 25, 2011, *In the Matter of Rae & Lipskie Investment Counsel Inc. et al.* dated August 24, 2011, and to the November 30, 2007 issue of The Practitioner for prior discussion of this issue.

regarding which the portfolio manager is seeking exemptive relief, and (v) the past experience and expertise of the portfolio manager in overseeing and managing managed accounts.

We have been hesitant to recommend exemptive relief when it appears that pooled funds may be distributed primarily to investors that would not otherwise have access to pooled fund securities under NI 45-106. Absent amendments to NI 45-106 to allow fully managed accounts in Ontario to qualify as "accredited investors" for purchases of pooled fund securities, we will generally only recommend exemptive relief in situations where there is a close relationship (e.g. close familial relationship) between "primary" managed account clients and "secondary" account clients and where the portfolio manager has established a significant minimum account level (typically $500,000 or more) for its managed account clients.

Requests for Confidentiality

Section 5.2(1)(a)(vi) of National Policy 11-203 *Process for Exemptive Relief Applications in Multiple Jurisdictions* specifies that exemptive relief applications should set out any requests for confidentiality. Section 5.4 of the Policy specifies that the application should also provide substantive reasons for the confidentiality request. We have seen a few applications initially marked as 'confidential' where substantive reasons for the confidentiality request have not been provided.

We remind filers to include confidentiality requests in their initial application along with submissions in support of the request. Staff will consider these requests on a case-by-case basis. Absent submissions in the initial application, the application will be made public.

Subadviser Conflicts of Interest

Recently, we have received a few novel applications in which filers have requested interfund trading or principal trading relief on behalf of both the filer, as portfolio manager, and on behalf of third party subadvisers to the filer's funds. Prior to NI 31-103, we did not receive applications for similar relief specifically from subadvisers.

Where the filer for exemptive relief is the manager and portfolio manager, our view is that separate relief is not needed on behalf of the subadviser as long as the subadviser operates on the same conditions applicable to the lead portfolio manager pursuant to any conflict relief granted specifically to the lead portfolio manager.

NI 81-107 imposes the obligation on a fund manager to identify conflict of interest matters and to refer them to the Independent Review Committee (IRC) of the manager's funds. Since the implementation of NI 81-107, staff's view has been that a fund manager should have in place policies and procedures to identify, monitor, and to address conflicts at the subadviser level. To the extent such matters raise a conflict of interest under section 1.2 of NI 81-107, the manager is responsible for referring such conflicts to the IRC of the funds.

Pooled Fund on Fund Relief

Recently, two filers were granted relief from certain conflict prohibitions in securities legislation to permit pooled funds to invest in underlying pooled funds, NI 81-102 funds and commodity pools managed by a common manager.[2] The conditions in these decisions are similar to those set out in section 2.5 of NI 81-102.

In recognition of the investment parameters on which the fund-on-fund exemption in NI 81-102 is premised, staff asked for additional conditions and representations that state: (i) the securities of the top and underlying pooled funds are valued and redeemable on a regular basis, either weekly or monthly, (ii) each top fund and underlying fund have matching or similar valuation and redemption dates, (iii) an underlying pooled fund will be managed to provide sufficient liquidity to fund redemptions in the ordinary course, (iv) top fund investors will receive the disclosure in some form prescribed by Form 81-101F1, Part B, Item 7(1)(c), and, (v) if applicable, top fund investors will be provided with disclosure that certain officers or directors of the manager or associates may have a significant interest in the underlying fund(s) and disclosure of potential conflicts of interest that may arise from such relationships.

Prospectuses

Prepaid Forwards

Staff are currently considering the use of forward purchase agreements (prepaid forwards) by both mutual funds and non-redeemable investment funds (closed-end funds). In the prepaid forward structure, the fund proposes to pay an amount at the outset of the agreement, that could be substantially all of the fund's assets, to a counterparty. The counterparty is obligated to deliver the performance of a reference fund to the fund at a later date.

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2 *In the Matter of RBC Global Asset Management Inc.* dated October 20, 2011 and *In the Matter of Fiera Sceptre Inc.* dated October 17, 2011.

Among the issues staff are examining are (i) the fund's exposure to the counterparty and the credit risk of the counterparty, and (ii) how the transfer of substantially all of the fund's assets to a counterparty changes the nature of the fund from a portfolio of diversified holdings to a concentrated investment in one asset that is essentially an unsecured obligation of the counterparty. We are concerned that these risks are inconsistent with the expectations of investors in an investment fund.

Generally, we are of the view that it is not appropriate for mutual funds to use prepaid forwards and more recently, staff have not recommended this exemptive relief for mutual funds.

For closed-end funds, which do not require exemptive relief to use prepaid forwards, staff remain concerned with the use of prepaid forwards and we are continuing to consider whether it is appropriate from a public policy perspective for closed-end funds to enter into this type of agreement.

As a result, staff have been prepared to recommend a prospectus receipt for closed-end funds only if the risks identified above are mitigated. One way filers have addressed counterparty exposure and credit risk has been by requiring the counterparty to post collateral for the benefit of the fund.[3] In such instances, staff will generally expect, at a minimum, that: (i) the amount of collateral be equal to 100% of the mark to market value of the underlying exposure, (ii) the amount of collateral be reset on a weekly basis back to 100%, (iii) the collateral consist of liquid securities with no more than 10% being securities of one issuer (both at the outset of the agreement and upon each reset), (iv) the fund have a perfected first priority security interest in the collateral, and (v) the collateral be free and clear of all claims, other than those in favour of the fund.

As an alternative, closed-end funds may wish to consider using a "conventional" forward structure with an appropriate settlement mechanism to ensure that the fund's exposure to the counterparty is not excessive. We recommend filers look to the settlement mechanism in section 2.7(4) of NI 81-102 as a starting point.

In all instances, staff expect the prospectus for a closed-end fund that proposes to use a prepaid forward to include a description of the terms of the prepaid forward under the heading "Overview of the Investment Structure" and a textbox on the cover page to inform investors of the fund's counterparty exposure and related risks. We also expect that the use of a prepaid forward structure and related risks will be given prominence in green sheets and marketing materials.

Staff will continue to consider other investment structures that rely on over the counter derivatives which raise concerns similar to the prepaid forward structure, including forwards where the fund deposits substantially all of its assets into an interest bearing account at the outset of the agreement.

Multiple Lapse Dates

Some filers have recently sought to consolidate several long form investment fund prospectuses with different lapse dates into a single multi-fund prospectus. We remind filers that the lapse date for a consolidated prospectus will be the earliest lapse date among the prospectuses being consolidated. Filers who would like to preserve the original lapse date for an investment fund should keep the prospectus of that fund as a stand-alone prospectus.

Multiple ETF Prospectuses

We remind filers of staff's expectation that investment funds offered in a long form prospectus should have substantially similar investment objectives.

The issue arose in the context of a long form prospectus which contained multiple exchange-traded funds (ETFs). We advised the filer that (i) a long form prospectus should contain only groupings of exchange-traded funds which have *similar* investment objectives and strategies, and (ii) it would not be appropriate for a prospectus to contain large numbers of different types of exchange-traded funds (e.g. index ETFs, commodity ETFs, actively managed ETFs, etc.) in one long form prospectus.

As set out in OSC Staff Notice 81-714 *Compliance with Form 41-101F2 – Information Required In An Investment Fund Prospectus*, staff's view is that when the number of investment funds incorporated in a prospectus interferes with full, true and plain disclosure, staff will request that the fund manager file separate prospectuses for its investment funds.

Disclosure of Management Fees

Some mutual funds have management fees that are payable directly by securityholders and may vary from securityholder to securityholder. This makes it difficult for amounts to be disclosed in the fund's prospectus. To address this issue, we've been asking filers to provide, in the simplified prospectus and Fund Facts (as noted further below), as much disclosure as possible about these management fees to be paid by securityholders, including (i) the highest possible rate or range of those management fees, as contemplated by Instruction 5, Part A, Item 8.1 of Form 81–101F1, or (ii) how fees applicable to that

[3] Refer to recent prospectuses for *Moneda LatAm Corporate Bond Fund* dated October 26, 2011 and *Symphony Floating Rate Senior Loan Fund* dated October 19, 2011.

series compare to those applicable to other series offered by the same fund. These requests have typically been made with reference to series I or O securities of a mutual fund offered to institutional investors.

Disclosure of Trailing Commission Payments

Staff have begun to consider how trailing commissions are described in disclosure documents. We understand that some investors who purchase mutual funds through a discount brokerage may not expect or understand that their discount broker receives trailing commissions. As a starting point, we are considering whether the current disclosure sufficiently highlights the fact that discount brokers receive trailing commissions. In our prospectus reviews, we are asking fund managers whether they pay the same trailing commissions to discount brokers and full service dealers. If they do, we are requesting that the "Dealer Compensation" section of the simplified prospectus clarify that trailing commissions are also paid to discount brokers, by including disclosure stating that the manager also pays trailing commissions to the discount broker for securities purchased through a discount brokerage account.

Publication of Staff Notice

We issued OSC Staff Notice 81-715 *Cross Listings by Foreign Exchange-Traded Funds* on August 26, 2011. The Notice sets out the views of staff regarding the application of prospectus requirements and investment fund product regulation in connection with cross-listings on an exchange in Ontario by foreign exchange-traded mutual funds. The Notice has been posted to the OSC website at www.osc.gov.on.ca.

Continuous Disclosure

Financial Statements Filed Before Filing Deadline

We remind filers that if financial statements are filed earlier than the required filing deadline, the accompanying management reports of fund performance (MRFPs) for those investment funds must also be filed at the same time. Since the MRFP may be obtained separately from the financial statements as a stand-alone document, the financial highlights in the MRFP should include additional information that may assist investors in understanding the information provided in the financial statements. A key element of the MRFPs is the Management Discussion of Fund Performance which provides an analysis and explanation that is designed to supplement an investment fund's financial statements.

Exemptive Relief and Inquiries Related to Fund Facts

Since July 8, 2011, securities legislation has required any mutual fund that files a preliminary or pro forma simplified prospectus to also file Fund Facts for every class or series of the fund. We discuss below some of the recent issues we've encountered concerning Fund Facts.

Fund Codes

We have received several applications for relief to permit the use of fund codes in the Fund Facts. Filers have requested this exemption from the form requirements of 81-101F3 under Part 6 of NI 81-101 by application letter filed with the applicable prospectus. While relief for this purpose is typically evidenced by receipt, the application process must still be observed. This involves 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.

Relief to Permit Early Delivery of Fund Facts

Exemptive relief was recently granted to a group of fund managers and a representative dealer to permit dealers to satisfy the delivery requirement under section 71(1) of the Act (the Delivery Requirement) by sending or delivering the most recently filed Fund Facts instead of the simplified prospectus.[4]

The relief includes the following key conditions:

- investor rights of withdrawal and rescission currently provided under section 71(2) and section 133 of the Act are preserved;
- a separate notice setting out these investor rights must be sent or delivered to investors along with the Fund Facts;

[4] *In the Matter of National Bank Securities Inc.* dated October 26, 2011*; In the Matter of BMO Nesbitt Burns Inc*. dated October 11, 2011; *In the Matter of I.G. Investment Management* dated September 16, 2011; *In the Matter of Value Partners Investments Inc.* dated September 16, 2011; and *In the Matter of Representative Dealers* dated August 26, 2011.

- all Fund Facts delivered in reliance on the relief must comply with Form 81-101F3 *Contents of Fund Facts Document*;

- prior to dealer reliance on the relief, dealers must be provided with, and return their written acknowledgement of, the conditions of the relief;

- fund managers must keep records of all dealers which intend to rely on the relief and must provide quarterly updates on the list of relying dealers to the fund manager's principal regulator; and

- the relief terminates on the earlier of (a) 6 months from any CSA notice stating that the relief granted may no longer be relied upon, and (b) the coming into force of any legislation or rule relating to the sending or delivery of the Fund Facts to satisfy the Delivery Requirement.

Disclosure of Expected Mergers in the Fund Facts

Form 81-101F3 contemplates prescribed headings in the Fund Facts. We recently granted relief from the prescribed requirements of the Fund Facts form to permit disclosure about an upcoming merger of a fund.[5] We remind filers to consider whether *material* changes to a mutual fund require additional disclosure or changes to the Fund Facts.

Fund Facts and Converting Funds

We remind filers that applications to use past performance in the simplified prospectus should also contemplate the use of past performance of the fund in the Fund Facts as appropriate. [6]

Risk Methodology

We remind filers that the risk methodology used to identify the investment risk level of a fund must be disclosed in the Fund Facts and the simplified prospectus. It must also be made available to investors upon request.

Staff's view is that in describing the fund manager's risk methodology under Item 9.1(1) of Part B to Form 81-101F1, the fund manager must provide a brief description or summary of the investment risk classification methodology used, and not simply identify what particular methodology is used. We have been asking filers, in the context of our prospectus reviews, to confirm that the disclosure in the simplified prospectus complies with this requirement. Consistent with Item 9.1(3) of Part B to Form 81-101F1, we note staff's expectation is that if an investor requests a copy of the methodology, it will be provided.

Disclosure of Separately Negotiated Fees

Staff have been raising comments on the need for appropriate disclosure in the Fund Facts on fees that are negotiated separately between the investor and the dealer or fund manager. Filers should note that this information must be included in the Fund Facts under the appropriate heading.

- *Advisory fees payable to the dealer (Series F)*

  If an investor is required to participate in a fee-based arrangement with their dealer in order to be eligible to purchase a particular class or series of the mutual fund, staff expect that the applicable Fund Facts will disclose this requirement. We have been asking filers to revise the "Other Fees" section of the applicable Fund Facts to include this disclosure.

- *Management/administration fees payable to the manager directly by investors (Series I, Series O)*

  For management fees, administration fees and/or other fees that are payable directly by investors, staff expect that the Fund Facts for such class or series disclose the existence of such fees and the maximum fees (as a percentage) that may be charged to an investor. We have been asking filers to add such disclosure in the "Other Fees" section of the applicable Fund Facts.

[5] *In the Matter of Manulife Mutual Funds* dated August 18, 2011
[6] For an example, refer to *In the Matter of AGF Investments Inc. et al*. dated June 28, 2011.