

Chapter 1

Notices / News Releases

1.1.1 The Investment Funds Practitioner – March 2014

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 eleventh 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.

Reports

Summary Report for Investment Fund Issuers

We recently issued OSC Staff Notice 81-723 – *Summary Report for Investment Fund Issuers* (2013) which provides an overview of the activities and initiatives of the Ontario Securities Commission that relate to investment fund issuers. The report was published in the OSC Bulletin on February 13, 2014 and can be found on the OSC website.¹

Applications

Performance Fees and Mutual Fund Reorganizations

In a recent application for merger approval of certain public investment funds, staff raised questions about changes in the method of calculating performance fees for some of the funds that were made pursuant to a merger. We also raised questions about how the changes in the method of calculating performance fees for the affected funds were made.

We remind filers to consider whether changes in the method of calculating performance fees, that occur pursuant to a merger transaction, require a separate vote of securityholders under Part 5 of NI 81-102.

Filers and their counsel are encouraged to contact staff at an early stage in the planning of any transaction that may give rise to any questions regarding performance fees in the context of a merger.

¹ At http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20140213_81-723_summary-rpt-if-issuers-2013.htm.

Pre-Authorized Purchase Plans and Prospectus Delivery Relief

Some filers have been previously granted exemptive relief from the prospectus delivery requirement for pre-authorized purchase plans. Under such pre-authorized purchase plans, an investor purchases a specified amount of mutual fund securities on a regularly scheduled basis.

Filers are reminded that the final amendments implementing Stage 2 of the Point of Sale disclosure initiative, published on June 13, 2013, will cause these exemptive relief orders to terminate no later than June 13, 2014, which is the effective date of the requirement to deliver Fund Facts instead of the prospectus. Filers who intend to seek exemptive relief from the requirement to deliver the Fund Facts for pre-authorized purchase plans after June 13, 2014 are encouraged to submit an application for exemptive relief well in advance of June 13, 2014.

In the CSA Notice and Request for Comment *Implementation of Stage 3 of Point of Sale Disclosure for Mutual Funds – Point of Sale Delivery of Fund Facts* published on March 26, 2014, the CSA contemplates an exception from the proposed pre-sale delivery requirements for pre-authorized purchase plans. Depending on stakeholder feedback, the CSA may codify the relief from the delivery requirement for subsequent purchases under pre-authorized purchase plans. The comment period ends on May 26, 2014.

Prospectuses

Exchange Options

Staff recently reviewed a prospectus for an investment fund which proposed to accept some securities (Exchange Eligible Issuers or EEIs) under an exchange option that were not consistent with the fund's investment objectives.

The list of EEIs in the prospectus included issuers that were not consistent with the investment objectives of the fund and no cap was placed on the amount of non-core EEIs the fund would accept under the exchange option. The fund's investment restrictions, however, capped the value of securities of EEIs that do not operate in the fund's core sectors to 25% of the portfolio (Non-Core Sector EEIs). By not capping the maximum value of securities of the Non-Core Sector EEIs acceptable to the fund, the fund could potentially be offside its investment restrictions on day one. The absence of a cap could also force the fund to bear the cost of disposing Non-Core Sector EEI securities to comply with its investment restrictions.

This issue was resolved by imposing a limit on the total value of the securities of EEIs not operating in the core sectors. The limit would allow the issuer to accept approximately 25% of Non-Core Sector EEIs permitted by the investment restrictions of the fund, and enable the fund to be in compliance with its investment restrictions when it began operating.

Issuers are encouraged to closely review the list of exchange eligible issuers considered acceptable to a fund pursuant to an exchange option, to ensure consistency with the fund's investment restrictions and investment objectives at the outset of the fund's operation.

Bulleted Placeholders in Prospectuses

In the November 2012 edition of the Practitioner, we advised of staff's view that certain material information should be disclosed in preliminary prospectuses filed using Form 41-101F2 for long form prospectuses and Forms 81-101F1 and 81-101F2 for simplified prospectuses. This information, for example, would include the auditor's name in an audit report, the minimum offering amount on the cover page of a long form prospectus, expenses and fees, and the name of the custodian. Implicit in this list is the management fee payable by the investment fund. In recent filings of preliminary prospectuses, staff requested that the management fee be included in the preliminary prospectuses before issuing a preliminary receipt. Staff's view is that a preliminary prospectus should contain all material information before it is received at the preliminary stage.

The November 2012 edition of the Practitioner noted that the absence of certain information in the preliminary prospectus may result in staff raising comments at the time of the filing of the final prospectus which may result in a delay in the issuance of the final receipt. Further to this view, we note that the absence of material information in the preliminary prospectus may also result in a preliminary receipt not being issued for the preliminary prospectus until such information is otherwise included.

Flow-Through Limited Partnerships – Past Performance Disclosure

We have observed that recent flow-through limited partnership prospectuses have included annualized after-tax returns but not annualized before-tax returns. We remind filers that, as discussed in the May 2013 edition of the Practitioner, where a flow-through limited partnership prospectus includes annualized after-tax returns of prior flow-through limited partnerships managed by the manager, staff are generally prepared to accept such disclosure provided annualized before-tax returns are also disclosed in the prospectus.

In more recent discussions, filers have indicated that presenting annualized before-tax and after-tax returns for standard performance periods of 1, 3, 5 and 10 year periods is not appropriate since most flow-through limited partnerships exist for less than 3 years before they rollover into mutual funds. Filers also pointed out that 1 year returns may not be relevant or useful to investors given that securities of flow-through limited partnerships cannot generally be redeemed prior to the rollover date.

Upon further consideration of this feedback, staff are now generally prepared to accept annualized before-tax and after-tax returns for the period from the date of inception of the flow-through limited partnership to the date of the rollover of the flow-through limited partnership into a mutual fund. All relevant assumptions should also be clearly disclosed.

Flow-Through Limited Partnerships – Finder's Fees

Staff have reviewed prospectuses for certain flow-through limited partnerships which permit compensation arrangements involving entities related to the fund's manager. These entities are typically paid a fee for sourcing investment opportunities in the securities of resource issuers for the flow-through limited partnership. The fees payable to such related entities are often referred to as 'finder's fees'.

Staff's view is that finder's fee arrangements represent a conflict of interest matter under National Instrument 81-107 *Independent Review Committee for Investment Funds* and should be referred to the fund's Independent Review Committee (IRC) for its recommendation. Staff also expect that appropriate disclosure of these arrangements will be made in the prospectus.² Such disclosure should (a) identify the arrangement as a conflict of interest under NI 81-107; (b) indicate that the arrangement has been referred to the fund's IRC for its recommendation; (c) state the fees associated with the arrangement and payable to the related entity; (d) identify who pays the finder's fee and the basis for payment; (e) explain the details of the services provided by the related entity in exchange for the fee; and (f) state any limits on the arrangements, for example, on the amount of fees payable to the related entity or on the percentage of the fund's portfolio investments that may be sourced by the related entity.

Continuous Disclosure

Review of Exchange-Traded Funds (ETFs)

Staff recently undertook a review of ETFs, focusing on the liquidity of underlying assets and the effectiveness of the market making function by designated brokers. For more information, please refer to OSC Staff Notice 81-723 – *Summary Report for Investment Fund Issuers* (2013).

Portfolio Disclosure of Cash

We received an inquiry as to the appropriate disclosure of cash and money market funds in the management report of fund performance (MRFP), Fund Facts, and quarterly portfolio disclosure. In staff's view, cash is a portfolio holding and must be included in a summary of investment portfolio in order to provide the reader with a complete understanding of the portfolio, especially if the level of cash held is significant.

The summary of investment portfolio in the MRFP is comprised of a listing of the top 25 positions and a portfolio breakdown into subgroups. In the top 25, staff expect cash and cash equivalents to be disclosed on a line separate from an investment in a money market fund. Cash, cash equivalents and money market funds cannot be treated interchangeably because money market funds, as defined in securities legislation,³ have the ability to invest in short-term debt in addition to cash and cash equivalents. Additionally, presenting a money market fund as a separate holding is consistent with how we expect any investment in another mutual fund to appear in the top 25. In the portfolio breakdown, however, holdings in money market funds can be grouped with cash and cash equivalents into one category. Staff hold this view because the summary nature of the portfolio breakdown allows for flexibility to group money market funds, cash and cash equivalents together.

In the Fund Facts, the same treatment should be applied in the top 10 investments, separating cash and cash equivalents from money market funds. We remind investment funds of the instruction in the Fund Facts form to use subgroups in the investment mix that are consistent with the fund's MRFP disclosure.

The top 25 holdings in the quarterly portfolio disclosure should be exactly the same as the fund's MRFP disclosure because of the requirement to prepare the quarterly portfolio disclosure in accordance with MRFP requirements.

² For an example of this disclosure, refer to the prospectus for *Pathway Mining 2011 Flow-Through Limited Partnership* dated January 27, 2011 at page 72.

³ Item 1.1 of National Instrument 81-102 *Mutual Funds*.

Continuous Disclosure Review – Fixed Income Volatility

Staff have undertaken a review of fixed income funds to assess their processes around portfolio risk management, ability to pursue their investment objectives while meeting redemptions, and disclosure of current risks and market developments. From a portfolio risk management perspective, we note that portfolio managers have taken steps such as shortening fixed income portfolio durations and investing in floating rate instruments while still staying within their investment objectives. We encourage portfolio managers to conduct scenario analysis for conditions such as spiking interest rates, widening spreads and elongated periods of higher volatility in the fixed income markets to assess the impact such conditions may have on their fixed income portfolios.

We note that fund managers generally monitor the liquidity of their portfolios to ensure that they can continue to meet redemption demands. Portfolio liquidity is generally managed through limiting exposure to illiquid securities to certain pre-determined limits. We encourage fund managers and portfolio managers to stress test and assess the sources of liquidity of the funds during normal, as well as times of high redemption demand and/or reduced liquidity over longer periods of time. From a disclosure perspective, our review found that investment funds are generally providing a detailed discussion of market events under the management discussion section of the Management Report of Fund Performance (MRFP) document. This disclosure generally explains fixed income market performance over the recent past, the general market outlook for the future and the strategies undertaken by the portfolio manager to manage the risks that have arisen in the markets. We encourage investment funds to continue providing robust disclosure to investors in the MRFP and other reporting documents around risks that have arisen due to recent events and the potential impacts of steps taken by central governments around the world on fixed income portfolios. Investment funds should also consider increasing the frequency of monitoring their risk ratings given the elevated volatility in fixed income markets.

Fund Facts

Stage 2 of the Point of Sale Disclosure Initiative

Stage 2 of the Point of Sale disclosure initiative was completed with the publication of final amendments (Amendments) on June 13, 2013. The Amendments, which are phased-in, will require delivery of the Fund Facts instead of the simplified prospectus to satisfy the prospectus delivery requirements under securities legislation to deliver a prospectus within two days of buying a mutual fund. The Amendments also include changes to the presentation of risk and performance in the Fund Facts.

Filers are reminded that the amendments to Form 81-101F3 *Contents of Fund Facts Document* are now in effect. As of January 13, 2014, a mutual fund that files a preliminary or pro forma simplified prospectus and annual information form must concurrently file a Fund Facts in the amended form for each class or series of the mutual fund offered under the simplified prospectus on SEDAR under the applicable filing category, i.e. "Preliminary fund facts" or "Pro forma fund facts". A mutual fund that files an amended Fund Facts must also file the Fund Facts in the amended form.

If a mutual fund has not already done so, the Amendments also require the mutual fund to file a Fund Facts in the amended form for each class or series of the mutual fund by May 13, 2014. In the latter case, the Fund Facts in the amended form should be filed under the SEDAR filing category "Stage 2 Fund Facts". Fund Facts filed under "Stage 2 Fund Facts" will be made public automatically and do not require a certificate page or a blackline showing changes from the latest Fund Facts previously filed.

For implementation questions related to the Stage 2 final amendments, filers may refer to OSC Staff Notice 81-721 – *Frequently Asked Questions on the Implementation of Stage 2 of Point of Sale Disclosure for Mutual Funds – Delivery of Fund Facts*.

CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts

On December 12, 2013, the CSA published *CSA Notice 81-324 and Request for Comments Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts* (the Proposed Methodology), which sets out a proposed risk classification methodology for use by mutual fund managers in the Fund Facts. The CSA developed the Proposed Methodology in response to stakeholder feedback that the CSA has received throughout the CSA Point of Sale disclosure initiative, notably that a standardized risk classification methodology proposed by the CSA would be more useful to investors as it would provide a consistent and comparable basis for measuring the risk of different mutual funds.

Prior to the publication of the Proposed Methodology, the CSA held consultations with industry representatives, academics and investor advocates to seek feedback on the CSA's proposed risk classification methodology. The comment period for the Proposed Methodology was open until March 12, 2014. We are also seeking feedback on whether the CSA should mandate the Proposed Methodology or, alternatively, adopt it as guidance for investment fund managers.

Process Matters

Mandatory Electronic Delivery of Documents

OSC Rule 11-501 – *Electronic Delivery of Documents to the Ontario Securities Commission* (Rule 11-501) became effective on February 19, 2014. Rule 11-501 requires all market participants, effective February 19, 2014, to electronically file a number of documents that are currently filed in paper format with the OSC. Electronic filing will facilitate the efficient collection and use of information and streamline the submission process for market participants in Ontario.

Rule 11-501 requires a number of documents to be electronically delivered to the OSC including:

- Form 45-106F1 and Form 45-501F1 – *Reports of Exempt Distribution*
- Applications for exemptive relief and notice filings
- Pre-files or waiver applications (for prospectuses or applications)
- Forms, notices and other materials required under Ontario's securities rules that are not filed through SEDAR, SEDI and NRD, the CSA national electronic filing systems.

Filers must electronically transmit required documents through the electronic filing portal located on the OSC's website (documents that are required to be filed through SEDAR, SEDI and NRD must continue to be filed through these systems). In addition, applicable fees payable in connection with the filing of documents to the OSC can now be paid electronically using credit or debit card.

For more information, please refer to Rule 11-501 and the OSC's electronic filing portal page.⁴

⁴ At http://www.osc.gov.on.ca/en/SecuritiesLaw_forms_index.htm.