1.1.3 The Investment Funds Practitioner

April, 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, 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.

Request for Feedback

We are publishing this first edition of the Practitioner on a trial basis. Please let us know if you find it useful and if you would be interested in seeing further editions of the Practitioner. We welcome any feedback. Please forward your comments by email to 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	Accountant
Shaill Bahuguna	Administrative Support Clerk
Eric Buenaflor	Financial Examiner
Oriole Burton	Review Officer & Administrative Assistant
Leslie Byberg	Manager
Raymond Chan	Senior Accountant
Robert Day	Senior Analyst
Joan DeLeon	Review Officer
Daniela Follegot	Legal Counsel
Patricia Fuller	Administrative Assistant
Rhonda Goldberg	Assistant Manager

Pei-Ching Huang	Legal Counsel
Irene Lee	Legal Counsel
Tracey Leonardo	Administrative Assistant
Chantal Mainville	Senior Legal Counsel
Darren McKall	Senior Legal Counsel
Mark Mulima	Senior Legal Counsel
Parbatee Nandacumar	Administrative Assistant
Vera Nunes	Senior Legal Counsel
Sarah Oseni	Senior Legal Counsel
Stephen Paglia	Legal Counsel
Violet Persaud	Review Officer
Susan Silma	Director
Fern Stark	Legal Counsel
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

Merger Costs

We've seen a couple of applications in the past year that raised issues regarding the payment of merger costs by investment funds.

In the first case, the Commission affirmed the Director's decision to not approve a merger that proposed to charge the costs of the merger to the funds.[1] Several labour sponsored investment funds sought the Director's approval under subsection 5.5(1)(b) of NI 81-102 in connection with the amalgamation of the funds. The funds were unable to rely upon the pre-approval provisions in section 5.6 of NI 81-102 for several reasons including that the managers proposed that the funds would bear the costs of the merger. The Director declined to approve the merger so long as the managers proposed that the funds bear the costs. The applicants sought a hearing and review of the Director's decision before the Commission. The Commission upheld the Director's decision. The Director subsequently approved the merger provided that the funds did not bear the costs of the merger.[2]

The Commission also questioned the payment of merger costs by a fund in the context of an inter-fund trading application[3] filed to facilitate a merger of exchange traded closed end trusts. The applicant applied for an exemption from the prohibition contained in paragraph 118(2)(b) of the Act against a portfolio manager purchasing or selling the securities of any issuer from or to the account of a responsible person. The Commission granted the exemption and noted in the headnote that it was "extremely reluctant to approve requested relief since costs of the merger were to be borne by the unitholders and this was not disclosed in any materials. Order was approved based on fact that in the past, there was no requirement that managers bear the cost of mergers in the context of entities not subject to NI 81-102 and no notice that staff would generally insist on this as a pre-condition to recommending in favour of discretionary relief in connection with such mergers."

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1 See the Commission's order and reasons for decision *In the Matter of Triax Growth Fund Inc. et al* dated November 23, 2005 and December 13, 2005.

2 See the Director's decision *In the Matter of Covington Group of Funds Inc. and Triax Growth Fund Inc. et al* dated December 15, 2005.

3 See *In the Matter of Lawrence Payout Ratio Trust et al.* dated December 30, 2005.

Commingling Relief

The Director recently granted relief from the commingling prohibition in section 11.1(1)(b) and section 11.2(1)(b) of National Instrument 81-102 *Mutual Funds* ("NI 81-102") in four decisions[4]. The relief permits dealers to commingle, in a single trust account, monies associated with the purchase and redemption of mutual fund securities with monies associated with the purchase and sale of other types of securities a dealer is permitted to sell. The relief is subject to inclusion of certain representations on behalf of dealer applicants (participating dealers or principal distributors). Most of the representations considered intrinsic to the relief rely on the applicant's membership in the MFDA and the applicant's anticipated compliance with MFDA Rules.

The relief granted to date is subject to the condition that it terminate on the reduction of coverage provided by the MFDA Investor Protection Corporation of mutual fund related cash, and 'other' cash (i.e. cash for the purchase or sale of products other than mutual funds, which the dealer is permitted to sell).

Dealers that want relief to permit them to commingle mutual fund related cash and 'other cash' should approach the CSA and the MFDA. We note that applicants who apply to the CSA for this relief should be named in Schedule A to the MFDA Decision Document dated June 23, 2006 granting similar relief from the commingling prohibition found in section 3.3.2(e) of MFDA Rules.

Prospectuses

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

IFIC Risk Classification Guidelines:

We have seen some fund groups use the IFIC Risk Classification Guidelines to assign and disclose risk categories to their mutual funds. The Guidelines set out six defined risk categories and a process for determining the appropriate risk category for each type of fund. Standard deviation is the stated basis for determining the risk volatility of the fund.

The use of the Guidelines by managers is not mandatory. We have raised some comments, however, in connection with prospectuses filed by some funds that have adopted the Guidelines. We've generally raised the comments with a view to resolving apparent discrepancies between a fund's adoption of a particular risk classification based upon the Guidelines and the disclosure contained in its prospectus regarding its investment objective and investment strategy.

Flow Through Limited Partnerships

We have been raising comments regarding the exit strategies for investors of flow through limited partnerships. Typically these vehicles disclose that they will roll their assets into a mutual fund upon the termination of the partnership and provide investors with mutual fund units in exchange for their partnership units. We have been raising comments in instances where the partnership discloses that it will roll its assets into a mutual fund that is not a reporting issuer. The comments address potential concerns with non-reporting issuers distributing securities to retail investors that may not be accredited investors under National Instrument 45-106 and concerns regarding the liquidity of a mutual fund that is not a reporting issuer.

DSC Switches

We've recently been requesting additional information concerning DSC Switches as part of our prospectus reviews. DSC Switches generally involve either the practice of automatically switching investors' 10% deferred sales charge (DSC) units each year into units of the same fund carrying a front-end sales charge or other series of units, or the switch of the investor into front-end sales charge units at the end of the investor's DSC redemption schedule. The result of these switches to front-end sales charge units is often a higher trailing commission payable to the dealer. We have raised comments on these arrangements as part of our prospectus reviews with a view to encouraging full, true, and plain disclosure in the simplified prospectus that these switches will or may occur, that the dealer is or may be paid a higher trailing commission, and what that higher trailing commission is if the DSC units are switched.

Shelf Prospectuses for Linked Notes

We've recently been looking at base shelf prospectuses that propose to qualify different types of note programs. We've generally been raising the comments in connection with distributions by financial institutions of structured note products for which the value or payment obligation is linked to certain underlying interests that are unrelated to the operations or securities of the issuer. It is generally the case that the substantive details of these types of offerings are not typically available in the base

[4] See *In the Matter of Desjardins Financial Security Investments Inc.* (February 8, 2007), *In the Matter of Scotia Securities Inc.* (November 7, 2006), *In the Matter of Fidelity Retirement Services Company of Canada Limited* (August 11, 2006) and *In the Matter of Manulife Securities International Ltd.* (July 25, 2006).

shelf prospectus which is subject to regulatory review. Instead, those details are set out in the shelf prospectus supplements or pricing supplements which are filed after the distribution has taken place. To ensure that we have adequate opportunity to review the disclosure pertaining to these types of offerings, we have been asking issuers to provide an undertaking that they will pre-clear the shelf prospectus supplements with us prior to completing the distributions. In particular, we have been requesting such an undertaking in connection with notes that may be linked to actively managed baskets of commodities or securities or notes that may be linked to investment funds.

Continuous Disclosure

As discussed previously in OSC Staff Notice 81-705 *Implementation of a Continuous Disclosure Review Program for Investment Funds*, one of the goals of our continuous disclosure review program (the CD Review Program) is to improve the quality of investment fund continuous disclosure. We have developed our CD Review Program through a pilot review of initial filings under NI 81-106 *Investment Fund Continuous Disclosure* followed by a review of a larger sample of investment funds. We anticipate disclosing the results of these initial reviews, likely in the form of a staff notice. We will also discuss issues encountered under the CD Review Program in future newsletters as they arise.

CICA Handbook Section 3855

One issue that we've encountered under the CD Review Program is the implementation of new CICA Handbook section 3855, *Financial Instruments – Recognition and Measurement*. The Director granted an exemption under NI 81-106 from section 14.2 dated September 28, 2006.[5] Section 14.2 of NI 81-106 requires investment funds to calculate NAV in accordance with GAAP. The Director's decision effectively exempts investment funds from section 3855 in connection with calculating NAV for purposes other than their financial statements. The exemption contains a sunset clause so that it will expire the earlier of September 30, 2007 or the date on which changes to Part 14 of NI 81-106 come into effect. This will provide time for us and industry to further consider the impact of section 3855. Otherwise, investment funds must continue to calculate NAV in accordance with GAAP. The Director's decision also includes a condition that the investment fund's financial statements must include a reconciliation of NAV in the financial statements to NAV for other purposes.

[5] *In the Matter of AGF Funds Inc. et al* (September 28, 2006).