

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 eighth 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).

**Prospectuses**

***Bulleted Placeholders in Prospectuses***

We remind filers that the disclosure requirements set out in Form 41-101F2 for long form prospectuses and Forms 81-101F1 and 81-101F2 for simplified prospectuses apply to both the preliminary prospectus and the final prospectus unless otherwise specifically stated. Recently, we have noticed preliminary prospectuses with bulleted placeholders for items that should be disclosed at the time of the preliminary filing, such as 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. Generally, staff take the view that this information should be disclosed in the preliminary prospectus rather than presented for the first time in the final prospectus. Otherwise, staff may raise comments at the time of the filing of the final prospectus which may result in a delay in the issuance of the final receipt.

***Investment Objectives for a Fund of Funds***

We have observed fund-of-fund structures involving conventional mutual funds under common management where only the name of the bottom fund is referenced in the investment objectives of the top fund, along with a statement that the top fund will invest in securities of the bottom fund. These structures have involved a one-to-one relationship between a top and bottom fund. Absent from the investment objectives of the top fund, however, has been disclosure about the specific investment objectives of the bottom fund.

Where there is a one-to-one relationship between conventional mutual funds under common management, staff do not consider it sufficient for the investment objectives of the top fund to only state that the top fund's investment objectives are to invest in a named bottom fund. Disclosure of the bottom fund's investment objectives in the top fund's investment objectives is appropriate in view of the fund-of-fund structure which provides direct exposure to the portfolio of securities held by the bottom fund and is

---

<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).

also consistent with disclosure rules.<sup>2</sup> Issuers are reminded to provide this disclosure for conventional funds where there is a one-to-one relationship between top and bottom funds.

### **Linked Note Pricing Supplements**

CSA Staff Notice 44-304 *Linked Notes Distributed Under Shelf Prospectus System* dated July 20, 2007 sets out the process for requesting pre-clearance of linked notes offered under the shelf prospectus system. Some filers have developed the practice of filing, in draft form, subsequent prospectus supplements with the Commission that are based on prospectus supplements that have been previously pre-cleared. Such filings are often marked as 'draft' or as 'preliminary pricing supplements' and are often made to ensure that the Commission has a copy of the supplement the issuer intends to use for marketing purposes.

Filers should be aware that if a cover letter requesting pre-clearance does not accompany the filed draft prospectus supplement, staff will presume that the supplement has not been filed for preclearance, but rather for marketing purposes only. We remind filers that all requests for pre-clearance of prospectus supplements involving linked notes should be accompanied by a cover letter requesting pre-clearance and the appropriate fee.

For draft prospectus supplements filed for marketing purposes only, it would be helpful to staff if the filing indicates that preclearance is not required, but that a final prospectus supplement will follow in due course.

### **Fixed Administration Fees with Adjustment Payments**

Some investment fund managers charge a fixed administration fee to each of their mutual funds. The fixed administration fee is paid by a mutual fund to the investment fund manager in exchange for the investment fund manager bearing most of the operating expenses of the mutual fund. The fee is calculated as a fixed percentage of the NAV of the mutual fund and replaces the cost allocation methodology for charging operating expenses.

In some instances where investment fund managers have introduced a fixed administration fee, they have made it subject to an adjustment payment, which may be payable by a mutual fund in addition to the fixed administration fee, where the assets of the mutual fund fall below a specified threshold.

The introduction of a fixed administration fee, with or without an adjustment payment, triggers the requirement for securityholder approval under Part 5 of NI 81-102. Staff is of the view that an adjustment payment is not consistent with investors' general expectation of the fixed rate administration fee structure. When the adjustment is triggered, the total administration fee that would be payable as a percentage of a fund's net asset value would not be fixed and could potentially increase to a significant amount depending on the magnitude of the decrease in the fund's net asset value.

Where an adjustment payment is part of the fixed administration fee, staff has requested disclosure of the maximum limit on the total adjustment fee payable as a percentage of a fund's NAV. In our view, this disclosure provides investors with greater predictability and clarity of what the administration fee will be under different market conditions, and gives investors better information to inform their decision to approve the fixed administration fee. The management information circular should also provide an illustration, in dollars, of the differences between the proposed fixed administration fee, including the adjustment payment, and the current fee model.

### **Cover Page Images on Prospectuses**

Some filers include graphics, photos, or artwork on the cover page of a fund's prospectus. Usually, this is done to highlight the features of the fund or to make the fund more appealing to the target investor. Recently, we have seen prospectuses where the cover pages included images that were not relevant to the content of the prospectus. In such cases, staff's view was that the images were not useful in conveying the features of the fund product nor how the product should appeal to any specific group of investors.

We remind issuers that any graphics, photos, or artwork included on the prospectus cover page must be relevant to the fund or the distribution of the fund's securities and cannot be misleading<sup>3</sup>. The cover page images should also not detract from the information disclosed in the prospectus. Any image should be provided to staff early on in their review to ensure that delays do not occur late in the filing process.

---

<sup>2</sup> Instruction 9 to Item 3 – *Investments of the Fund in Form 81-101F3 Contents of Fund Facts Document*.

<sup>3</sup> General Instruction (7) – *Form 81-101F1 – Contents of Simplified Prospectus*.

## Applications

### **Managed Accounts**

As discussed in the December 2011 edition of the Practitioner, the Commission has previously granted exemptive relief from the prospectus requirements in the Act to accommodate exempt distributions in connection with the provision of portfolio management services to “secondary clients”, who are not accredited investors but have a relationship to the “primary client” who qualifies as an accredited investor. Exemptive relief is granted primarily on the basis that the “secondary clients” are an incidental part of the portfolio manager’s asset management business, which is primarily focused on accredited investor clients.

Increasingly, we have received exemptive relief applications where secondary clients constitute more than just an incidental part of the portfolio manager’s asset management business. The Commission has raised questions about minimum account thresholds that are low, for example, below \$500,000. The Commission has also expressed concerns with business models that permit a portfolio manager to waive the minimum account threshold established for its managed accounts at its discretion in order to increase its client base with secondary clients. Such discretion to waive the minimum account threshold raises policy concerns that pooled funds could be distributed primarily to investors that would not otherwise have access to pooled fund securities under NI 45-106. To address the Commission’s concerns, a recent decision<sup>4</sup> included a representation from the portfolio manager that the minimum account threshold for its managed accounts will be waived only in rare or limited circumstances.

We have been hesitant to recommend exemptive relief when the portfolio manager is not able to represent that the minimum account threshold for its managed accounts will be waived in rare and limited circumstances.

### **Sub-Adviser Conflicts of Interest**

We recently received an application for relief from subsection 4.1(1) of NI 81-102 to allow mutual funds to invest in a private placement underwritten by an underwriter that is related to the funds’ portfolio sub-adviser. Both the sub-adviser and the underwriter are not related to the funds’ investment fund manager who also acts as the portfolio adviser. As subsection 4.1(1) of NI 81-102 applies only to dealer managers which are defined in NI 81-102 as portfolio advisers, staff’s position is that on a technical reading of subsection 4.1(1) of NI 81-102, the funds’ investments in securities underwritten by an underwriter related to a sub-adviser are not prohibited and exemptive relief is not required.

While staff are of the view that subsection 4.1(1) of NI 81-102 is not triggered, the fact that a sub-adviser and an underwriter are related does raise a conflict of interest pursuant to NI 81-107. Such a conflict of interest is contemplated in item 4 in the commentary to section 1.2 of NI 81-107 and in item 1 in the commentary to section 1.3 of NI 81-107. Staff expect the manager of the funds to refer this conflict of interest matter to the funds’ Independent Review Committee.

### **Use of Past Performance Data in the Prospectus**

As discussed in the December 2011 edition of the Practitioner, we remind filers that applications requesting to use a fund’s past performance data in the simplified prospectus should also contemplate the use of past performance data in the Fund Facts as appropriate. Requests for relief to use past performance data have generally been requested in the past in the context of fund mergers or the conversion of a closed-end fund to a newly established mutual fund.

We further remind filers that such applications should include all aspects of past performance data that will be referenced in the simplified prospectus and Fund Facts. Among other items for example, this may include disclosure of the management expense ratio (MER) in the Fund Facts.

### **Index Funds**

For conventional mutual funds and exchange-traded funds that propose to track specified indices (index funds), we remind fund managers to consider whether a change in a fund’s index is a change to the fundamental investment objectives of the fund. Generally, the fundamental investment objectives of a mutual fund are those attributes that define its fundamental nature. Section 2.5(c) of 81-102CP uses index funds as an example of mutual funds that pursue a highly specific investment approach which defines their fundamental nature. Consequently, a change by an index fund to the index it is tracking will likely be viewed as a change to the fund’s fundamental investment objective. While many factors may be relevant, the companion policy indicates that the manner in which a mutual fund is marketed may provide further evidence as to its fundamental nature. For example, if an index fund’s name or advertising suggests that it is an index fund or provides exposure to a specific index, that may suggest that a change by that fund to the index being tracked is a change to its fundamental investment objective. Such a change requires the prior approval of securityholders unless exemptive relief is obtained.

---

<sup>4</sup> *In the Matter of Rae & Lipskie Investment Counsel Inc. et al.* dated August 24, 2011.

## **Continuous Disclosure**

### ***Advertising Review***

Investment Funds staff recently commenced a review program for advertising and marketing materials of a sample of investment funds. In addition to the existing adhoc reviews of advertising materials, staff will select 4-6 investment fund managers for review on a quarterly basis. Investment fund managers selected for a review will be asked to provide all advertisements and marketing materials used during the previous quarter and to describe their policies and procedures relating to their marketing activities. The reviews will cover a wide spectrum of fund types including conventional mutual funds, closed-end funds, ETFs, commodity pools and LSIFs. Staff expect to publish observations and guidance arising out of this review by early next year.

### ***Portfolio Disclosure Review***

As noted in the April 2012 edition of the Practitioner, Investment Funds staff recently completed a targeted review of a sample of investment funds to evaluate compliance with the portfolio disclosure requirements relating to a fund's statement of investment portfolio, MRFPs and Fund Facts documents. OSC Staff Notice 81-717 *Report on Staff's Continuous Disclosure Review of Portfolio Holdings by Investment Funds* reports the findings from our review and was published in the OSC Bulletin on August 2, 2012.

## **Independent Review Committees (IRCs)**

### ***Changes to IRC Composition***

Section 3.3(4) of NI 81-107 specifies that an individual may not serve on an IRC for longer than six years unless the fund manager agrees to the reappointment of the member. In view of this requirement and given that the Rule has been in place for almost six years, we expect that the next year may yield changes to IRC composition.

Fund managers and IRCs are reminded of the requirement in section 3.10(4) of NI 81-107 to provide notification of any changes to IRC composition to the fund's principal regulator and to disclose any changes to IRC composition or membership in the report to securityholders in accordance with section 4.4(1)(d) of NI 81-107.

## **Process Matters**

### ***E-forms for Filing NI 45-106 Reports***

An electronic version (the E-form) of Form 45-106F1 *Report of Exempt Distribution* was made available on the OSC website on June 21, 2012. As noted in OSC Staff Notice 45-708 *Introduction of Electronic Report of Exempt Distribution on Form 45-106F1*, issuers and underwriters that are required to prepare and file a report of exempt distribution on Form 45-106F1 (the Report) may now choose to prepare and file the Report using the E-form, instead of in paper format. At this time, filing of the Report electronically is voluntary, although staff anticipate moving towards mandatory electronic filings in the future. While filers may continue to prepare and send in the paper version of the Report, they are encouraged to use the E-form whenever possible. Use of the E-form will provide filers with confirmation of receipt of the filing and should make future filings easier and quicker.

### ***Prospectus Amendments – Historical Information***

We have recently observed that the titles of certain amendments to simplified prospectuses, annual information forms, and long form prospectuses (the Amended Documents) do not contain the history of the Amended Documents. For example, instead of stating that the amendment is an amendment to the simplified prospectus and setting out the date of each prior version of the Amended Document, certain amendments have included only the amendment number in their titles, e.g. Amendment No. 2, with the date of the amendment.

Staff's position is that the title of an amendment to an Amended Document should provide the complete history, including all previous amendments made to the Amended Documents.

## **Public Inquiries**

### ***The Definition of an "Investment Fund"***

We have recently received inquiries concerning whether certain issuers meet the definition of investment fund set out in the *Securities Act* (Ontario) (the Act).

Consistent with the definition of “non-redeemable investment fund” in the Act and the CSA’s discussion in section 1.2 of Companion Policy 81-106CP, staff continue to regard an investment fund as an issuer that does not seek to exercise control over, or become involved in the management of, investee companies. Generally, staff expect the investment approach undertaken by an investment fund to be passive in nature. Our view is that any degree of control or active involvement in the management of investee companies by an issuer would mean that the issuer is not an investment fund.

In determining whether an issuer proposing to be an investment fund exercises control over, or is involved in the management of, an investee company, staff will generally consider indicators, including: (i) whether the issuer holds securities representing more than 10% of the outstanding equity or voting securities of the investee company; (ii) any right of the issuer to appoint board or board observer seats on the investee company; (iii) restrictions on the management, or approval or veto rights over decisions made by the management, of the investee company by the issuer; or (iv) any right of the issuer to restrict the transfer of securities by other securityholders of the investee company. The presence of one or more of these factors is generally indicative of control.

To the extent that questions arise, filers are encouraged to consult with staff for greater clarity as appropriate.