Chapter 1

Notices / News Releases

1.1 Notices

1.1.1 The Investment Funds Practitioner – April 2015

OSC

THE INVESTMENT FUNDS PRACTITIONER

From the Investment Funds and Structured Products 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 and Structured Products 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 14th edition of the Practitioner. Previous editions of the Practitioner are available on the OSC website www.osc.gov.on.ca under *Investment Funds & Structured Products*. 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.

Prospectuses

Dual Class Structures of Flow-Through Limited Partnerships

We have recently observed changes in the structures of flow-through limited partnerships in prospectus filings. Typically, we see flow-through limited partnerships file prospectuses to qualify one class of units that is referable to one portfolio of assets.

In recent prospectus filings for flow-through limited partnerships, we observed that some limited partnerships propose to issue two classes of units under one prospectus, with each class comprising a separate non-redeemable investment fund with its own separate portfolio of assets. However, the minimum offering amount that must be reached may consist of any combination of units of the two funds. Among other issues, staff questioned why two separate investment funds could rely on the other for reaching their minimum offering amount. In response to staff's concerns, the filers revised the offering to ensure that each fund qualified in the prospectus had to reach its own minimum offering amount. Staff also asked that each of the two investment funds qualified by the same prospectus provide disclosure in response to the items in Form 41-101F2 *Information Required in an Investment Fund Prospectus* unless the responses are identical for both classes. In response, the filers revised their prospectuses, for instance, by disclosing the maximum leverage ratio for each fund, rather than the maximum leverage ratio for the limited partnership as a whole, and by disclosing the estimated offering expenses for each fund, rather than offering expenses for the limited partnership as a whole.

We continue to review and monitor developments on dual class structures for flow-through limited partnerships and will provide further guidance as needed. Issuers and their counsel are encouraged to contact staff in the planning stage of any structure that may give rise to questions concerning this issue.

Redemption Price of Securities – Exchange-Traded Funds

As noted in the November 2014 edition of the *Investment Funds Practitioner*, subsection 10.3(4) of National Instrument 81-102 *Investment Funds* (NI 81-102) explicitly prohibits redemptions of securities of non-redeemable investment funds at a price higher than the net asset value (NAV) per security, to prevent dilution of the value of the fund's remaining securities. In staff's view, subsection 10.3(3) of NI 81-102 should be interpreted to impose the requirement that the redemption price not exceed NAV per security on exchange-traded mutual funds (ETFs). The same public policy concern regarding dilution exists for ETFs as for non-redeemable investment funds.

Staff have recently reviewed prospectuses of ETFs that offer periodic redemptions of their securities at a price determined with reference to the closing market price of those securities (Market Price Redemptions). However, where Market Price Redemptions are offered, if the securities of the ETF trade at a premium to the NAV per security, the redemption price may dilute the value of the remaining outstanding securities of the ETF. To prevent dilution, staff expect the redemption price for Market Price Redemptions to be capped at NAV.

To ensure that the concerns with respect to dilution are addressed, in recent prospectus reviews for ETFs with Market Price Redemptions, staff have asked that the disclosure regarding Market Price Redemptions include a statement that the amount payable per security redeemed will not exceed the NAV per security of the ETF.

Default Mutual Fund Distributions

In the course of our prospectus reviews, we are placing a greater emphasis on the various practices that currently exist for mutual funds regarding distributions paid in the form of reinvested units or shares instead of cash. More specifically, we are focused on funds that are designed to pay regular distributions. Of particular concern are those mutual funds that set the payment of distributions in the form of reinvested units or shares as the default option, if securityholders do not specifically request distributions in cash.

Staff's view is that where a choice to receive distributions in cash or in reinvested units or shares is available, a fund manager should ensure that a securityholder has, in fact, made that election, rather than proceeding with a default option in the absence of instructions. This is particularly so where that default option could result in additional fees being paid by a securityholder. For example, if a fund is purchased under a deferred sales charge (DSC), fees may be payable on redemption of those reinvested units, whereas no fees would apply to cash distributions.

Staff's emphasis is part of a larger focus on the use of default options, in the absence of receiving instructions from securityholders. We are concerned that these default options could interfere with the client/advisor relationship since they permit transactions to proceed whether or not a securityholder discusses and understands their options with their advisor.

We expect to continue to review distribution policies generally, with a particular emphasis on funds that seek to make regular distributions. We will continue to examine default options and the differing treatment of reinvested distributions versus cash with respect to redemption fees payable in a DSC series. Staff will provide further guidance as needed.

Issuers and their counsel are encouraged to contact staff in the planning stage of any structure that may give rise to questions concerning this issue.

Offering Expenses of Split Share Companies

Staff have begun to request additional prospectus disclosure of the offering expenses of split share companies. Typically, split share companies issue two classes of shares, namely, preferred shares and capital shares, with preferred shares ranking in priority to the capital shares with respect to repayment of capital. This structure results in offering expenses effectively being borne by the capital shareholders, with the capital class' net asset value reduced by the total offering expenses, as long as the net asset value per unit (comprised of both the capital share and the preferred share) is greater than the redemption amount of the preferred share.

Staff will continue to request enhanced disclosure on the cover page and in the *Fees and Expenses* tables within the prospectus summary and the body of the prospectus, specifying that the expenses of the offering, of both the preferred shares and capital shares, are effectively borne by the capital shareholders.[1]

[1] For an example of such disclosure, see *Brompton Oil Split Corp.* dated January 29, 2015.

Recent Amendments to NI 81-102 – Closed-End Funds

Since the coming into force of the recent amendments to NI 81-102 introducing core investment restrictions and fundamental operational requirements for non-redeemable investment funds, staff have noticed the continued inclusion of disclosure in closed-end fund prospectuses that suggest that the closed-end fund would be permitted to do certain activities that are now contrary to the amended NI 81-102.

The first type of disclosure relates to the suspension of redemptions. This disclosure generally states that the fund may suspend the redemption of securities for any period not exceeding a specified number of days during which the fund manager determines that conditions exist which render impractical the sale of the fund's assets or which impair the ability of the fund manager to determine the value of the fund's assets. However, section 10.6 of NI 81-102 now only provides for two situations during which a closed-end fund may suspend redemptions, neither of which represents the situation described in the prospectus. As such, this type of disclosure would contravene section 10.6 of NI 81-102.

Staff's view is that this disclosure should either be fully removed or be revised to only state that, aside from the situations described in section 10.6 of NI 81-102, the fund may suspend the redemption of securities only with regulatory approval.

The second and third types of disclosure that staff have seen both relate to the list of matters that can only be undertaken with securityholder approval. For example, that securityholder approval is required for issuances of additional securities at more than NAV, inferring that securityholder approval would not be required for issuances of additional securities at less than NAV. However, subsection 9.3(2) of NI 81-102 now prohibits dilutive offerings at less than NAV for closed-end funds. Similarly, we've seen disclosure that says that securityholder approval would be required for rights or warrants offerings. However, section 9.1.1 of NI 81-102 now prohibits warrants or rights offerings. Staff's view is that both of these types of disclosure should be removed from closed-end fund prospectuses.

Closed-end fund issuers and their counsel are reminded to consider the recent amendments to NI 81-102 before filing their prospectus to ensure the disclosure reflects regulatory changes.

Fund Facts

Past Performance Presentation in Fund Facts

Under the "How has this fund performed?" section of the Fund Facts, mutual funds are required to provide disclosure of past performance. The form requires inclusion of a year-by-year return chart, a best and worst 3-month return chart, and the average annual return for the mutual fund. In the course of our prospectus reviews, we have noticed that there are certain scenarios that are not contemplated by the form requirements, which could lead to inconsistent or unclear disclosure.

The Fund Facts is required to be prepared for each class or series of a mutual fund. Occasionally, we encounter situations where certain classes or series of a fund have had periods during which no shares or units were outstanding. In such circumstances, it may not be possible to show performance for a complete calendar year, or to calculate an average annual return since there will be gap periods during which the class or series would not have had any assets (asset gaps).

In order to maximize the utility of the Fund Facts for investors, staff have been asking fund managers to consider alternative approaches to the presentation of past performance. For example, in situations where a class or series of a mutual fund experiences periods where there are asset gaps, some fund managers have used the performance record of another class or series of the mutual fund as a "proxy" for the missing performance information. In selecting the proxy class or series, the fund manager should ensure that the fees are not lower than those of the class or series with the asset gap. In addition, the proxy class or series should not have any special features that would cause a material difference in performance (e.g., currency hedging).

Where a fund manager does adopt an alternative approach to deal with any asset gap issues, staff would expect the Fund Facts to include a notation indicating that the performance of a proxy class or series has been presented.

Public Inquiries

Rehypothecation of Collateral for OTC Derivatives

We recently received an inquiry concerning over-the-counter (OTC) derivatives. At issue was whether portfolio assets deposited by an investment fund with a counterparty as collateral in connection with a specified derivatives transaction pursuant to subsection 6.8(3) of NI 81-102, may be rehypothecated (i.e., pledged, sold or otherwise encumbered) by the counterparty.

Staff concluded that rehypothecation of collateral deposited by an investment fund with a counterparty is generally not permitted under NI 81-102.

Staff's view is that subsection 6.8(3) of NI 81-102, which permits an investment fund to deposit its portfolio assets as collateral with a counterparty in connection with a particular specified derivatives transaction, is a carve-out from the requirement in subsection 6.1(1) of NI 81-102 that all of a fund's portfolio assets be held by the custodian. This carve-out permits assets of the investment fund to be deposited with an entity other than the custodian (i.e., the counterparty) in limited circumstances, for the sole purpose of effecting a specified derivatives transaction. In this context, staff's view is that the counterparty stands in the place of the custodian to safeguard the portfolio assets deposited with it. Given that all or substantially all of a fund's assets may be deposited with a counterparty under subsection 6.8(3) of NI 81-102, if the counterparty were to rehypothecate the portfolio assets, the investment fund would be subject to risks inconsistent with the core restrictions in NI 81-102.

We also note that the reference in subsection 6.8(3) of NI 81-102 is to a *"…deposit in connection with a particular specified derivatives transaction"*. Our view is that this language limits the carve-out to the sole purpose of entering into the particular specified derivative contract. Staff are aware that permitting rehypothecation of collateral could reduce the cost of the derivative transaction to the fund, however, subsection 6.8(3) of NI 81-102 does not contemplate this purpose.

Given this interpretation, we remind fund managers of their responsibility to ensure that any agreement documenting the OTC derivatives transaction (such as the ISDA or other agreement) prohibits the counterparty from using the collateral for any purpose other than the purpose for which it was originally pledged to the counterparty, namely, the completion of the *"particular specified derivatives transaction"*. Further, our view is that a fund manager must ensure that any documentation evidencing the terms of a specified derivatives transaction: (i) adequately protects the investment fund's portfolio assets from counterparty credit risk, (ii) limits the purpose for which collateral has been deposited by the investment fund to that of the completion of the derivatives transaction consistent with NI 81-102, and (iii) limits the ability of the counterparty to deal with portfolio assets deposited by the investment fund as collateral, in a manner that is consistent with the ability of the fund's custodian to deal with the fund's assets under custody.

We encourage fund managers to be mindful of these considerations when establishing OTC derivative arrangements for the investment funds they manage.