

1.1.2 The Investment Funds Practitioner – July 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 15th 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* on the *Industry* tab. 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

Prospectus Review Priorities

Staff continue to see investment funds offering an increasing number of classes or series of securities, each with slightly different attributes or features. For full reviews of prospectus filings, staff will now focus on disclosure relating to the different classes or series offered by investment funds. As set out in the November 2013 edition of the *Investment Funds Practitioner*, staff will also continue to focus on fees and expenses disclosure and on the clear articulation of investment objectives and strategies.

Staff's current prospectus review priorities are intended to achieve the following objectives:

- encourage more consistent disclosure by investment funds to enhance comparability of the three noted themes;
- promote the disclosure of all relevant information to investors in a clear, understandable and accurate manner and challenge "boiler plate disclosure"; and
- provide more focused comments to filers on issues of particular importance to investors to assist them in making more informed investment decisions.

Staff will consider, among other things, the scope of the following disclosure in the prospectus:

Classes or Series Offered by an Investment Fund:

- sufficient clarity to assist investors in distinguishing the differences between and purpose of each class or series, including the type of investor and fee model each class or series is intended for, if applicable;
- disclosure of the differences in dealer compensation for each class or series;

- explanations of the differences in fees, in addition to dealer compensation, that are in plain language and clear for each class or series; and
- sufficient disclosure regarding switches between classes or series, including automatic and default switches.

Fees and Expenses:

- a summary of all applicable fees and expenses;
- explanations of fees and expenses that are in plain language and clear so that investors can understand what each fee is for and what services or activities the fee covers; and
- sufficient clarity to allow staff to determine that there is no duplication of fees and expenses and whether the overall cost of the fund is comparable to similar investment funds and not contrary to the public interest.

Investment Objectives and Strategies:

- investment objectives and strategies of the fund that provide meaningful information to investors, namely, a clear and accurate picture of the fund and the asset classes the fund will invest in;
- identification of all material risks associated with the fund's objectives and strategies; and
- sufficient differentiation in the disclosure to assist investors in distinguishing between multiple funds within a prospectus or fund family and understanding the difference between funds that appear similar in name and/or investment strategies.

Staff remind investment fund issuers and their counsel that staff's increased focus on these areas in our prospectus reviews does not take away from the issuer's responsibility to comply with all applicable securities legislation, policies and practices. Staff will continue to raise general comments in the course of a prospectus review as appropriate.

Default Mutual Fund Distributions – Fixed Rate Distribution Series

As noted in the April 2015 edition of the *Investment Funds Practitioner*, staff continue to review and examine distribution policies generally, with a particular emphasis on funds or series that seek to make regular distributions.

In the course of our prospectus reviews, staff have been raising comments on the distribution policies of funds offering fixed rate distribution securities (FRDS), often referred to as "T-series". Generally, FRDS are marketed to investors seeking consistent monthly cashflow. Annual distribution rates are often set above the level of income expected to be generated by the fund, resulting in distributions comprised of return of capital, potentially providing investors with more tax efficient distributions. For many FRDS, distributions are reinvested rather than paid in cash, unless the investor specifically requests cash distributions.

Generally, staff's view is that when investors have the option to receive distributions in the form of reinvested securities or cash, having a "default" feature of reinvestment of FRDS distributions can cause investor confusion because such reinvestment appears to be inconsistent with the purpose of these securities, which is to provide monthly cashflow. As a result, staff have been asking fund managers to explain why a default feature of reinvestment of distributions is appropriate given the purpose of these securities and to consider changing the distribution policy so that FRDS distributions default to cash, rather than reinvestment.

To date, a number of fund managers have either changed their distribution policies for FRDS to default to cash distributions or have committed to doing so within a reasonable time period. We generally expect that this change will be made on a going forward basis to new purchases, with the exception of purchases made pursuant to an existing pre-authorized plan.

Going forward, staff will be contacting fund managers with FRDS to bring this issue to their attention and to communicate staff's concerns and expectations. We will continue to work with issuers and their counsel for a consistent approach to the implementation of distribution policies for FRDS.

Mutual Funds Currently Investing in Closed-End Funds

Recent amendments to National Instrument 81-102 *Investment Funds* (NI 81-102), which became effective on September 22, 2014 (the Modernization Amendments) prohibit a mutual fund from investing in, or holding, securities of a non-redeemable

investment fund (NRIF).¹ Mutual funds that filed a prospectus on or before September 22, 2014 have until March 21, 2016 (the Transition Date) to comply with this requirement.

As staff continue to review pro forma renewal prospectuses for these mutual funds, we are reminding such issuers and their counsel that the mutual funds' investments in NRIFs, often referred to as 'closed-end funds', will need to cease by the Transition Date, unless the mutual fund has obtained exemptive relief to continue with these investments. Mutual funds invested in NRIFs with renewal prospectuses receipted between March 2015 and March 2016 will be eligible to distribute their securities beyond the Transition Date but cannot be invested in NRIFs beyond the Transition Date. We remind fund managers that obtaining a prospectus receipt during this period should not be considered as an indication of staff's willingness to allow these mutual funds to continue to invest in an NRIF beyond the Transition Date or to recommend exemptive relief to permit these investments beyond the Transition Date. Any applications for exemptive relief to permit such investments beyond the Transition Date will be considered on a case-by-case basis.

Staff encourage issuers and their counsel to contact staff as early as possible to discuss any plans to seek exemptive relief.

Disclosure of IRC Compensation

We have recently seen variations in the prospectus disclosure of annual compensation paid to members of a fund's Independent Review Committee (IRC) established pursuant to National Instrument 81-107 *Independent Review Committee for Investment Funds* (NI 81-107). Disclosure of the compensation paid by a fund to each member of a fund's IRC is required in the fund's most recently completed financial year.² In certain cases, we have seen only the aggregate compensation paid to all IRC members be disclosed, and in other cases, only the retainer payable to IRC members in the normal course is disclosed.

Staff remind issuers that these sections require disclosure of the name of the individual IRC member and the specific amount of compensation, including any expenses reimbursed by the fund, actually paid to the individual IRC member during the fund's most recently completed financial year.

Use of "Index" in Investment Fund Names and Objectives

On July 9, 2015, staff published OSC Staff Notice 81-728 *Use of "Index" in Investment Fund Names and Objectives* (Staff Notice 81-728)³ which provides guidance on the issues that staff will consider in reviewing the prospectuses of investment funds that describe themselves, in their names and investment objectives, as tracking an index. Staff Notice 81-728 was drafted in response to an increasing trend in investment funds that track indices.

APPLICATIONS

IRC Notification Requirements – Inter-Fund Trades Involving Pooled Funds

Relief to permit inter-fund trades between investment funds that are reporting issuers and pooled funds has been routinely granted on conditions similar to those set out in section 6.1 of NI 81-107. Among other items, the conditions have included the requirement for each pooled fund to establish an Independent Review Committee (IRC) to oversee such trades on behalf of the pooled funds.

Section 4.5 of NI 81-107 requires the IRC of an investment fund that is a reporting issuer to notify the fund's principal regulator when the IRC becomes aware of an instance where the manager acted in a conflict of interest matter under subsection 5.2(1)⁴ of NI 81-107 but did not comply with a condition or conditions imposed by securities legislation or the IRC in its approval. This reporting requirement has also been included in exemptive relief decisions to permit inter-fund trades involving investment funds not covered by NI 81-107, for example, pooled funds.⁵

Staff wish to remind filers that we will continue to require the inclusion of this notification requirement as a representation in decisions granting relief to permit inter-fund trades between pooled funds or between pooled funds and other investment funds that are reporting issuers.

¹ Subsection 2.5(2) of NI 81-102.

² Item 15(2) of Form 81-101F2 *Annual Information Form*, Item 19.1(12) of Form 41-101F2 *Information Required in an Investment Fund Prospectus*, and Part D, Item 2.7(2) of Form 41-101F3 *Information Required in a Scholarship Plan Prospectus*.

³ Staff Notice 81-728 can be found on the OSC website at http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20150709_81-728_use-of-index.htm.

⁴ Section 5.2(1) of NI 81-107 refers to three types of conflict of interest matters i.e. inter-fund trading, related party underwriting and purchases of securities of a related issuer over an exchange.

⁵ See *In the Matter of PIMCO Canada Corp.* dated October 7, 2014, *In the Matter of Manulife Asset Management* dated July 5, 2013, and *In the Matter of Deans Knight Capital Management Ltd.* dated January 25, 2012.

Scope of Future-Oriented Relief for Pooled Funds Investing in Related Pooled Funds

Staff have recently reviewed a number of applications for relief from the conflict of interest investment restrictions in securities legislation to permit pooled funds to invest in related pooled funds. These applications have often included requests for relief for future fund-on-fund structures (future-oriented relief) that are not yet actually planned and that may not be substantially similar in features and purposes, to those structures described in the application. In these applications, the scope of future-oriented relief requested has often been much broader than the scope needed for the fund-on-fund structures described in the application.

Staff are prepared to consider recommending future-oriented relief for future fund-on-fund structures that are substantially similar in features and purposes, to fund structures that a Filer expects to implement in the near future. While we appreciate that prior decisions may have been framed more broadly, staff are increasingly taking the view that future-oriented relief should generally be limited to the specific facts (i.e. structures) that trigger the need for the relief. Accordingly, in recent decisions, staff have only recommended future-oriented relief limited to structures substantially similar to the planned structures described in the application⁶

Staff also note that the terms and conditions of a decision are contemplated to address the conflicts in the particular planned fund-on-fund structures described in an application but may not address the conflicts in a different structure. Consequently, staff also require that each planned structure be described in sufficient detail, as to its features and purpose, to permit staff to consider any potential conflicts of interest, so as to propose conditions appropriate, in staff's view, for the specific structure.

CONTINUOUS DISCLOSURE

Awards in Sales Communications

As part of staff's ongoing continuous disclosure review of sales communications, we have reviewed selected investment fund managers (IFMs) with advertising and marketing materials that reference various industry awards. It is staff's view that awards are, in substance, performance based ratings, and that sales communications that contain references to such ratings or rankings should comply with the requirements set out in National Instrument 81-102 *Investment Funds* (NI 81-102).⁷ Based on staff's review of the criteria and methodology applied to the selection of award winners, while the quantitative considerations are performance based, criteria generally also includes a subjective component.

The sales communication requirements for mutual funds in Part 15 of NI 81-102 do not permit the use of a performance rating or ranking of a mutual fund that is based partially on a subjective component. NI 81-102 permits the use of a performance rating or ranking in a sales communication where it meets certain requirements, including the requirement that the performance rating or ranking be prepared by a mutual fund rating entity. While other methodologies employed may fall within the definition of "mutual fund rating entity", in staff's view, given the subjective component of industry awards generally, these awards are typically not a rating or ranking permitted to be used in a sales communication for a mutual fund.

While staff note that the references to industry awards in sales communications appear to be a wide-spread practice among mutual funds and exchange-traded funds in the marketplace, staff's view is that this practice should be discontinued. Staff recognize the importance of sales communications and strongly encourage IFMs and their counsel to contact staff regarding sales communications that may give rise to questions concerning this issue.

⁶ Recent decisions reflecting more limited future-oriented relief for pooled funds investing in related pooled funds include: *In the Matter of East West Investment Management Corporation* dated May 19, 2015, *In the Matter of BloombergSen Inc.* dated April 17, 2015 and *In the Matter of MacDougall Investment Counsel Inc.* dated January 29, 2015.

⁷ Subsection 15.3(4) of NI 81-102.