

### 1.1.3 The Investment Funds Practitioner – April 2012

April 2012

## 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 seventh 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

##### Incorrect Fee Disclosure

We've recently received inquiries on how to correct fee disclosure errors in a prospectus. In these instances, staff are notified subsequent to the receipt of the final prospectus that the fees cited in the prospectus contain an error. Filers have requested staff's permission to simply re-file the prospectus.

We remind filers of their responsibility to ensure that all disclosure, including fees stated in a prospectus, is complete and accurate before filing their final prospectus with the Commission. Should incorrect fees be disclosed in the prospectus, staff generally take the view that an amendment must be filed to correct the error. Staff will typically ask questions about the fees that have been charged, and a securityholder vote or reimbursement to the fund or its securityholders may be requested as possible ways to address issues arising around the fee correction. Staff generally will also request that securityholders who purchased securities under the prospectus with the incorrect fee disclosure be notified of the error and the expected fees going forward.

##### Fund Names

We've seen a few funds in recent preliminary prospectus filings with names that are not consistent with the fund's investment objectives or investment strategies. In these cases, the fund's investment objectives suggest that the fund will focus on a specific asset class or set of classes, but this focus is not readily apparent from the fund's name. In some instances, terminology generally included in marketing materials has been included in the fund name.

In naming new funds, fund managers should consider the requirement in Item 6(1) of Part B to Form 81-101F1 or Item 5.1(1) of Form 41-101F2. These provisions generally require that the fund's investment objectives describe the fundamental features of

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<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).

the mutual fund that distinguish it from other funds. Similarly, in naming new funds, we encourage fund managers to select names which closely reflect the fund's investment objectives and which distinguish the fund from other funds.

Staff will continue to examine fund names and consider whether additional guidance or rule-making is needed in this area.

### **ETFs that Track an Index**

A wide range of exchange-traded funds (ETFs) propose to track specified indices. In some cases, the index has been created specifically for the fund and is, therefore, not widely used or recognized.

In a recent filing for new ETFs, staff advised the fund manager that it was not sufficient for the investment objectives to merely state that the fund aimed to replicate the performance of the specified index, without stating the primary asset composition and key features of the fund under normal market conditions. We also confirmed our view that the investment strategies section of the fund's prospectus had to sufficiently describe each index, to state the key factors in determining which securities form part of each index and where the public can access the composition of each index at any given point in time.

### **ETF Portfolio Transparency**

Staff have begun a review of portfolio transparency of actively-managed ETFs in continuous distribution. As part of our prospectus reviews, we are requesting information on how often the ETF portfolio holdings are publicly disclosed on the website of the fund manager. We are also asking fund managers whether ETF portfolio holdings are disclosed to their designated brokers or market makers, how often this disclosure is made, if there is a contractual obligation to do so, and whether the frequency of this disclosure differs from the frequency of disclosure of the portfolio holdings to the public.

Upon completion of the review, we will consider whether additional guidance or rule-making is needed in this area.

### **Counterparty Hedging Fees**

We have recently seen prospectus disclosure which states that a fund pays a separate fee to the counterparty under a forward agreement, which is intended to compensate the counterparty for the costs of hedging its exposure under the forward agreement. In these instances, staff expect the prospectus to disclose the amount of this fee, the range or the maximum expected counterparty hedging fees to be paid by the fund annually. For long form prospectuses, the counterparty hedging fees should be disclosed under the sub-heading "Summary of Fees and Expenses." For simplified prospectuses, the counterparty hedging fees should be disclosed in the fee table required by Item 8 of Part A, Form 81-101F1 for each fund that uses forward agreements.

### **Closed-end Fund Exposure To Foreign Non-Reporting Issuer Investment Funds**

Recently, staff have seen a number of closed-end funds that propose to invest a significant portion of their assets, either directly or indirectly through a derivative such as a forward agreement,<sup>2</sup> in one or more foreign-based investment funds or portfolios that are not reporting issuers in Canada (underlying funds). This effectively results in the investors in the closed-end fund investing, albeit indirectly, in the underlying funds.

In the course of our prospectus review, we generally ask for the following disclosure concerning each underlying fund:

- **Prospectus Disclosure**

The prospectus of the closed-end fund should include sufficient disclosure about each underlying fund and its operations, including disclosure about its manager and portfolio manager, conflicts management system and custodianship of portfolio assets, akin to the disclosure required of the closed-end fund under NI 41-101, and complete financial reporting disclosure. The prospectus disclosure should explain where the continuous disclosure of each underlying fund can be found.

The risks disclosed in the closed-end fund prospectus should similarly include the risks inherent in the investment strategies of the underlying fund. Also, as the underlying fund and its manager are foreign-based, the risk relating to the difficulty of enforcing legal rights against non-residents of Canada should be identified. Often, we will ask for this risk to be highlighted and put in a textbox on the prospectus cover page.

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<sup>2</sup> Refer to the December 2011 OSC *Investment Funds Practitioner* for a discussion of staff's views of the use of forward agreements, particularly the use of prepaid forward agreements by closed-end funds.

- **Continuous Disclosure**

As the performance of the closed-end fund depends primarily on the performance and operations of the underlying fund, staff expect investors of the closed-end fund to have timely access to the continuous disclosure of the underlying fund, consistent with the disclosure and level of detail in NI 81-106. In our view, this would include the following:

- **Financial Statements**

The most recently audited financial statements and any other financial reporting of the underlying fund should be made available to investors of the closed-end fund. Typically, we will ask that the financial statements and other continuous disclosure of the underlying fund be filed on the SEDAR profile of the closed-end fund.

- **Management Reports of Fund Performance (MRFPs)**

The MRFPs of the closed-end fund should provide a detailed look-through discussion of the underlying fund including information about any related party transactions, a summary of its investment portfolio, results of operations, recent developments and past performance.

- **Material Changes**

The closed-end fund manager should ensure that investors of the closed-end fund are made aware of all material changes (as defined in NI 81-106) to the underlying fund and should consider whether any such change would be a material change to the closed-end fund.

- **Submission to Jurisdiction and Appointment of Agent for Service of Process**

Typically, we will request that each underlying fund manager file a submission of jurisdiction and appointment for agent for service of process in substantially the same form as Appendix C to NI 41-101.

Generally, the issues identified above are best addressed by the underlying fund filing a prospectus, which would make it a reporting issuer. Staff strongly encourage issuers to consider this approach. We may have additional comments on any proposed structure. Issuers and their counsel are encouraged to contact staff at an early stage in the planning of any offering that may give rise to any questions concerning the issues discussed above.

## Warrant Offerings

We continue to note the increased use of standalone warrant offerings by closed-end funds. Staff discussed these offerings in OSC Staff Notices 81-712<sup>3</sup> and 81-716<sup>4</sup> and in the September 2008 edition of the OSC *Investment Funds Practitioner*. Staff have the following concerns surrounding the use of this type of offering:

- warrants may have dilutive effects on the value of units if not exercised by the unitholder. Steps to mitigate dilution, such as selling the warrants on secondary markets, may be ineffective or not sufficient to compensate the unitholder for any loss of value to their units;
- as warrants are automatically issued to unitholders, warrants may be viewed as coercive, with unitholders obligated to make an additional investment or face the risk of dilution;
- unitholders may not have expected the future issuance of warrants as part of their initial investment bargain. This is problematic given the dilutive and coercive effects of warrants; and
- as warrants increase assets under management (AUM) when they are exercised, a possible conflict of interest may exist when the manager is making decisions on capital raising options, as the issuance of warrants is generally determined by the manager, whose interests are related directly to the AUM.

Staff will continue to raise comments on warrant offerings with a view to better understanding how each of the concerns noted above have been adequately addressed and why the warrant offering is in the best interests of the fund.

We will continue to consider whether additional guidance or rule-making is needed in this area.

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<sup>3</sup> 2010 *Investment Funds Branch Annual Report*.

<sup>4</sup> 2011 *Summary Report for Investment Fund Issuers*.

## Continuous Disclosure

### Portfolio Disclosure Review

Investment Funds staff recently completed an issue-oriented 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, where applicable. The contents of these disclosure documents were assessed for their consistency with the fund's stated investment objectives and investment strategies as set out in the fund's prospectus. The sample included a range of fund types, i.e., exchange-traded funds, conventional mutual funds, labour-sponsored funds, flow-through limited partnerships and closed-end funds. Staff expect to publish observations and guidance arising out of this review by Summer 2012.

### Yield / Income Funds Review

Staff recently conducted a review of select investment funds which make regular distributions to investors. The scope of this review included the distribution policies and related disclosures as well as the investment fund manager's decision making process on the amount and the form of the distributions.

Our review identified a few key issues. We note that several funds pay distributions which are regularly and significantly in excess of the fund's increase in NAV from operations, both on an annual basis as well as on a cumulative basis since inception. In these cases, the distributions, in substance, are a return to the investor of their own capital, whereas the use of the terminology 'yield' or 'income' in the Fund's name or elsewhere implies underlying performance or earnings to investors. Additionally, cash distributions in excess of earnings deplete the asset base of the fund and can hinder the fund's ability to meet its other investment objectives.

We further note that some funds typically pay distributions in the form of reinvested units unless, for funds held in non-registered plans, the investor expressly chooses to receive cash distributions. In our view, this default form of distributions (i.e., reinvested units) tends to conflict with the funds' stated focus of providing investors with a regular income stream. The onus is on investors to expressly advise the fund manager and/or dealer if they want distributions in the form of cash.

Finally, to the extent that investors may be assessing a fund's performance based on its distribution rates or yield, they may reach incorrect conclusions about their returns on these funds. The fund's distribution rate or yield is based on its distributions, rather than its earnings or performance.

For these types of funds, staff will ask for the following:

#### Prospectus Disclosure

- Include prominent disclosure that investor action is needed if distributions in the form of cash are desired. Disclosure should also highlight that if an investor subsequently desires to convert a distribution that has been made in the form of reinvested units into cash, the order of redemption (as specified in the prospectus) would generally result in reinvested units being redeemed last, triggering payment of redemption fees.
- In bold typeface and in plain language, that any distributions made in excess of the fund's cumulative income generated since the fund's inception represent a return of the investor's capital back to the investor.
- Where a distribution or yield is quantified in the prospectus, sales communication or elsewhere (such as a website), the disclosure should specify all of the following: a) the basis of the calculation, b) the percentage of total distributions comprising reinvested units, c) whether the yield is calculated based on the NAV or market price of the fund's securities, d) the time period covered by the distributions and the NAV (or market price, as applicable), e) the key assumptions, and f) the impact of changes in key assumptions on the target distribution or yield.
- The form of the distribution (i.e., cash or reinvested units) should be specified whenever a reference to distributions is made (e.g., in the investment objective or elsewhere).

#### Continuous Disclosure

- When distributions during a period exceed the fund's earnings from operations during that period, staff expect the fund's MRFP to discuss why the distribution was made despite insufficient earnings. Further, in case of a shortfall between total distributions and the fund's earnings since inception to-date, the MRFP should discuss the rationale for continuing to make distributions, the impact of the distributions made by the fund on the fund's ability fulfill its investment objectives, and how the shortfall will be made up going forward in the future.

Staff will continue to consider whether additional guidance or rule-making is needed in this area.

## **Fund Facts Risk Review**

In January 2011, as part of Stage 1 of the Point of Sale initiative, the CSA implemented the requirement to prepare, file and post to a mutual fund or mutual fund manager's website a Fund Facts for every class or series of a mutual fund. Stage 1 also requires a fund manager to assign and disclose a risk rating for each mutual fund in the Fund Facts and to disclose its risk classification methodology in the simplified prospectus.

As part of our review of Stage 1 implementation, staff have begun targeted continuous disclosure reviews of risk classification methodologies and risk ratings in the Fund Facts. To date, staff have focused on mutual funds that have a "low to medium" or "medium" risk level rating when similar funds managed by peers were rated "medium to high" or "high". We have also relied on objective data and benchmarks to support our analysis.

To date, six mutual funds with total assets under management exceeding \$1.3 billion have increased their risk ratings to "medium to high" as a result of our continuous disclosure reviews. In these instances, filers were asked to file an amended and restated Fund Facts and simplified prospectus, and to consider how best to publicly notify unitholders of the change in risk rating.

We remind filers that we would generally consider changes to a mutual fund's risk level to be a material change under securities legislation. We are also of the view that where historical information is not available for a new mutual fund, it is appropriate for a fund manager to use a benchmark in assessing the fund's risk classification rating.

## **Process Matters**

### **Closure of Outstanding Files**

In some instances where exemptive relief applications and prospectuses have been filed, we do not receive responses to our comment letters for long periods of time. While staff recognize that novel filings may take longer than the standard timelines, such cases should be the exception.

We will continue to follow up with filers for exemptive relief applications and prospectuses that are outstanding for three months or more. Absent a response or substantive reasons for files to be kept open, staff practice is to notify filing counsel that we will close the file without notice within two weeks of our most recent correspondence. After such notification, the file will be closed. This approach is consistent with Item 5.8(2) of NP 11-203.

## **Marketing Practices**

### **NI 81-105 – Cooperative Marketing Practices**

We remind fund managers that generally, staff consider the posting of mutual fund sales communications on participating dealers' intranet websites to be a cooperative marketing practice governed by NI 81-105. Mutual fund companies are expected to fully document their use of this marketing practice to evidence compliance with NI 81-105.

Mutual fund companies should document whether or not they were solicited by a participating dealer to engage in this cooperative marketing. In these cases, we would also expect mutual fund companies to pre-approve the participating dealer's costs for this marketing to ensure that the costs will, in fact, be consistent with the requirements of NI 81-105, and that the costs are reasonable for the actual work to be done. We remind mutual fund companies that the sales communications will also need to clearly disclose that the mutual company has paid a portion of the costs of presenting the sales communication on the participating dealer's intranet.