

1.1.2 The Investment Funds Practitioner – December 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 16th 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

New Scholarship Plans – Up-Front Commission Structure

Staff have previously raised comments in respect of group scholarship plans that require subscribers to pay up-front commissions to sales representatives. We have recently observed that some plan providers appear to be shifting their focus towards the development of new individual plans with similar features.

Group scholarship plans (**GSPs**) have historically required the up-front payment of sales commissions to sales representatives who sell them. Currently, most plan providers require 100% of a subscriber's initial contributions to a GSP to be directed to the payment of the sales commission until half of the commission is paid. Subsequently, 50% of the subscriber's contributions are directed to the payment of the sales commission until it is paid in full. This practice only allows for a small portion of a subscriber's initial contributions, if any, to be invested in the plan's actual portfolio investments. Depending on the circumstances, it can take two years or longer before the sales commission is fully paid. Staff have determined to no longer recommend prospectus receipts for new scholarship plans with similar up-front commission structures that lack the ability of a subscriber to receive a refund, in whole or in part, for paid sales commissions in appropriate circumstances.

We recently received a prospectus which proposed to establish a new individual scholarship plan. The plan, however, required subscribers to pay an up-front sales commission without the possibility of any refund should the subscriber withdraw from the plan. Staff indicated that we would not be willing to recommend a prospectus receipt for this plan on the basis that receipting it, without a mechanism to provide for a refund, in whole or in part, of any sales charges to subscribers, would not, in our view, be in the public interest. The prospectus was subsequently withdrawn.

We encourage any scholarship plan providers that are contemplating the creation of new scholarship plans to consult with staff prior to developing new compensation models for their sales representatives.

APPLICATIONS

Relief from Fund Facts Delivery Requirement for Automatic Switching Programs that Facilitate Fee Reductions Based on Client Asset Thresholds

Staff have recently recommended exemptive relief from the Fund Facts delivery requirement in order to facilitate a new automatic switching program. The automatic switching program involves the fund manager, on behalf of investors, initiating automatic switches between a new set of series of funds, with each series offering a different tier of management and administration fees based on the size of an investor's investment, in order to enable investors to immediately benefit from fee discounts for which they become eligible. Each automatic switch involves the redemption of units of one series, immediately followed by the purchase of units of a different series. Each such purchase would be considered a "distribution" as defined in the *Securities Act* (Ontario), which would trigger the fund facts delivery requirement.

The conditions of the decision include (a) prospectus and Fund Facts disclosure of, among other things, (i) the eligibility requirements for the various series and (ii) the rates of the fees applicable, or the fee discounts applicable, to the various series and (b) notification provided to existing and new investors in the relevant series of funds¹.

Issuers and their counsel contemplating the launch of similar automatic switching programs are encouraged to contact staff if there are any questions about the conditions of such relief.

Relief from Financial Statement Filing and Delivery Requirements of NI 81-106 for Pooled Fund on Funds

We continue to receive some applications on behalf of pooled funds (i.e. mutual funds that are not reporting issuers) that act as top funds in fund on fund structures, for exemptive relief from the financial statement filing and delivery deadlines under National Instrument 81-106 *Investment Fund Continuous Disclosure (NI 81-106)*. Although there are some past decisions granting this relief, no recent decisions granting similar relief have been issued.

In the past decisions, filers requested relief to accommodate fund on fund arrangements where the bottom fund was established in a foreign jurisdiction and had a different financial statement reporting deadline than the top fund. While there is an exemption in section 2.11 of NI 81-106 available to pooled funds from the requirement to file financial statements, the filers generally submitted that the top funds were unable to comply with the financial statement delivery deadlines in NI 81-106 because the top funds' auditors could not complete their audit until they received audited financial statements of the bottom funds. The decisions granted an extension of the annual financial statement due date to align the top funds' reporting deadlines with those of the bottom funds.

Staff have further considered the issue and hold the view that top fund pooled funds should structure their affairs and set their financial year ends so that they can comply with their obligations under NI 81-106. As a result, going forward, staff are not generally prepared to recommend this type of relief.

CONTINUOUS DISCLOSURE

IFRS for Investment Funds

Last year, staff commenced an issue-oriented continuous disclosure review focusing on the transition to International Financial Reporting Standards (**IFRS**). We reviewed the first IFRS financial statements required to be filed under NI 81-106, which consisted of the interim financial reports of investment funds with calendar year-end reporting periods. In Fall 2014, we issued a number of IFRS Releases, outlining the most common issues identified during the review. IFRS Release No. 4 – *First IFRS Annual Financial Statements – Tips for Year End* published on January 23, 2015 was a tip sheet listing key elements that are required in the first IFRS annual financial statements.

In 2015, we expanded our review by examining a sample of the IFRS audited annual financial statements for investment funds with the financial year ended March 31, 2015. As part of our review, we checked for compliance with the IFRS transition requirements found in NI 81-106. We identified one issue relating to the presentation of financial highlights in the annual management report of fund performance (**MRFP**).

For the first annual MRFP after the transition to IFRS, both the current and immediately preceding financial years in the financial highlights table must present information derived from IFRS because these periods are derived from audited financial statements prepared in accordance with IFRS (see Part B, Item 3.1(7.1)(c) of Form 81-106F1 *Contents of Annual and Interim Management Report of Fund Performance* (the **Form**)). In our review, we noted that one fund manager presented information for the current financial year in IFRS, but used Part V of the CPA Canada Handbook (pre-changeover Canadian GAAP) to

¹ See *In the Matter of Fidelity Investments Canada ULC* dated October 28, 2015.

prepare information for the immediately preceding financial year. In addition, the same manager did not include a footnote to the financial highlights table disclosing the accounting principles applicable to each period (see Part B, Item 3.1(7.1)(d) of the Form).

MRFPs for the next few years will contain financial highlights tables that present information derived from both financial statements prepared in accordance with IFRS and pre-changeover Canadian GAAP. As an example, for investment funds with calendar year-end reporting periods, information in the financial highlights table will be derived from financial statements prepared in accordance with IFRS for 2013, 2014 and all subsequent financial years. For as long as the 2012 financial year is included in the table, both IFRS and pre-changeover Canadian GAAP information will be presented in the table. Accordingly, an explanation of the accounting principles applicable to each period must appear as a footnote to the table until 2017, at which point all financial highlights in the table will be based on the same accounting principle.

For the vast majority of investment funds selected during our review, we did not identify any issues in the IFRS audited annual financial statements and related MRFPs. Given the level of compliance that we have observed in respect of the transition requirements in NI 81-106, staff's view is that the review of the IFRS annual financial statements does not need to be extended.

PROCESS MATTERS

Transition of Investment Funds to Corporate Issuer Status

We have recently seen closed-end investment funds seeking to transition to corporate issuers for various reasons, one of which is to change the investment strategy of the fund to focus on obtaining control of, or becoming involved in, the management of underlying investee companies.

Staff generally take the view that a fund manager's decision to change a fund's operation from investment fund to corporate issuer constitutes a "restructuring" that triggers the requirement for a securityholder vote as contemplated by subparagraph 5.1(1)(h)(iii) of NI 81-102.

Staff's view is that the following disclosure should be provided in the management information circular² for the securityholder meeting:

- financial statements and management's discussion & analysis for the issuer's two most recently completed financial years and most recent interim period prepared in accordance with applicable Canadian securities legislation as if the issuer were a corporate issuer instead of an investment fund;
- a discussion of the key differences between the requirements in securities legislation that apply to an investment fund versus a corporate issuer, for example, the differences in the disclosure requirements; and
- a statement of executive compensation prepared in compliance with Form 51-102F6 *Statement of Executive Compensation*.

Fund managers considering the transition of investment funds they manage to corporate issuers should be mindful of the above requirements and are encouraged to engage staff in the Corporate Finance Branch of the Commission prior to transitioning if their framework for transition raises novel issues outside of the above-noted parameters.

² Refer to section 5.4 of NI 81-102 and Part 12 of NI 81-106 for requirements relevant to the management information circular required for securityholder meetings pursuant to section 5.1 of NI 81-102.