

1.1.3 OSC Staff Notice 81-705 Implementation of a Continuous Disclosure Review Program for Investment Funds - Investment Funds Branch

**ONTARIO SECURITIES COMMISSION
STAFF NOTICE 81-705**

**IMPLEMENTATION OF A CONTINUOUS DISCLOSURE
REVIEW PROGRAM FOR INVESTMENT FUNDS**

INVESTMENT FUNDS BRANCH

The Investment Funds Branch (the "Branch") at the Ontario Securities Commission ("OSC") is responsible for administering regulation of all investment funds. Investment funds include mutual funds, non-redeemable investment funds (defined in OSC Rule 14-501), exchange-traded funds, split share corporations, labour sponsored funds, commodity pools and scholarship plans.

The Branch currently has 14 members including lawyers, accountants, review officers and support staff.

One of the goals of the Branch is to improve continuous disclosure documents for the benefit of investment fund investors. To this end, the Branch published proposed National Instrument 81-106 – Investment Fund Continuous Disclosure on September 20, 2002. As a next step, the Branch will introduce a continuous disclosure review program for all investment funds ("CD Review Program") in March 2003. The purpose of this Notice is to communicate the general features of the CD Review Program.

In addition to monitoring investment funds for timely and complete disclosure of information, the CD Review Program will be used to monitor how investment funds are being managed. This will include checking for compliance with Ontario securities law and how an investment fund is being managed compared to the investment objective and strategies disclosed in the fund's prospectus.

Types of Review

Investment funds will be subject to either a full, issue-oriented or basic review based on selective review criteria. Like the selective review approach to prospectus review, the responsibility for full compliance with applicable securities legislation, policies and practices remains with the investment funds and their managers. The fact that an investment fund has not been selected for review in a given year in no way detracts from such responsibility.

Full Review

A full review would typically include a comprehensive examination of the investment fund's entire disclosure record including financial statements for a minimum of the past two years. In addition to all the prescribed regulatory filings, staff may review other materials that are aimed at investors, such as the fund manager's website and newsletters.

Issue Oriented Review

An issue-oriented review focuses on particular issues. Some of these issues may include valuation, compliance with investment objectives, compliance with conditions of orders (e.g. conflict of interest orders) and incentive fee disclosure.

Basic Review

A basic review ensures all required continuous disclosure documents have been filed in accordance with the requirements of Ontario securities law.

How will investment funds be selected for review?

The CD Review Program will focus on those investment funds whose principal jurisdiction is Ontario.

Investment funds will be selected for review primarily through a risk-based approach. A random selection basis will also be used from time to time to supplement the risk-based selection. Since the selection process is primarily risk-based, some investment funds may be reviewed more frequently than others.

The continuous disclosure review criteria are likely to change frequently as certain disclosure related issues gain greater prominence or as questions are raised about particular accounting issues or disclosure practices.

We do not propose to review all the funds in a fund family unless there is reason to believe that the risks are more widespread. Rather, we intend to select a sample of funds from within a fund family based on our risk assessment.

The following is the current list of continuous disclosure review criteria:

1. Investment Fund's Financial Condition or Results
 - The investment fund is experiencing financial difficulty, as indicated by high net redemptions, few liquid assets, high concentration of assets and other financial indicators.
 - The investment fund has recently restated or corrected prior years' financial results (e.g., due to a NAV correction).
 - The investment fund is not complying with its stated investment objective.
 - The investment objective results in significant exposure to small issuers, high-yield (low-grade) bonds.
 - The investment fund has investment objectives and strategies akin to a hedge fund.

2. Accounting Methods and Practices
 - The investment fund has completed transactions where the accounting treatment is unclear or where staff is aware of divergent views as to accounting practice.
3. Auditor Related Issues
 - The auditors' report includes a qualified opinion, non-standard wording or missing information.
 - The auditor is terminated or resigns, and the investment fund has disclosed a disagreement, unresolved issue or consultation as described in National Policy Statement 31.
 - Previous experience or information available to staff indicates that the investment fund, its auditor or a particular director or officer of the investment fund or the fund manager warrants additional scrutiny.
4. Prior Regulatory Scrutiny
 - The investment fund or the fund complex has not recently been the subject of a CD Review by staff of the OSC or another provincial securities regulator.
 - The investment fund or fund complex has a history of prior defaults or prior non-compliance with securities requirements.
 - Another branch of the Commission, or another regulator, has referred a matter to the attention of the Investment Funds Branch.
 - Public complaints, media reports, staff observations or other credible sources indicate that disclosure issues may exist.

What is a Continuous Disclosure Review process?

The following outlines how a typical review would be performed:

- Each review begins with a "desk review". In a desk review, staff will review all relevant filings to identify potential issues that would require additional investigation. During a desk review, the fund will not usually be contacted. If no issue is identified, the review is completed. Essentially, the CD Review Program will not impose cost or resource demands on investment funds that meet all of their regulatory obligations and are managed according to their prospectus disclosure and other representations.
- If the desk review has identified certain issues, then additional information may be requested for further investigation. A letter would be sent to the investment fund advising that it had been selected

for a CD Review. The letter would also outline what information is being requested. We expect the investment funds to provide their response within a specified time frame. Please note that a comprehensive, complete response will allow the Investment Funds Branch to complete the CD review in an effective and timely manner and reduce the amount of follow up work. If necessary, additional comment letters would follow.

How will issues identified in a CD Review be resolved?

Staff will work with the investment fund to resolve issues in a timely manner. Staff will be aggressive in pursuing matters arising from continuous disclosure reviews and in enforcing the requirements of Ontario securities law through all available means. The Investment Funds Branch works closely with the Enforcement Branch when determining the type of regulatory action necessary if staff believes an investment fund has breached Ontario securities law.

What is the impact to the investment funds prospectus review criteria?

The Investment Funds Branch will continue its selective review of prospectus filings. When necessary and appropriate, staff will co-ordinate its work on the two review programs to improve effectiveness and efficiency.

Communication with the industry

At least annually, the Branch will publish the findings of its CD Review Program.

For further information, please contact:

Paul Dempsey
Manager, Investment Funds
416-593-8091
pdempsey@osc.gov.on.ca

Anne Ramsay
Senior Accountant, Investment Funds
416-593-8243
aramsay@ocs.gov.on.ca

Raymond Chan
Accountant, Investment Funds
416-593-8128
rchan@osc.gov.on.ca

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