

### 1.1.2 OSC Staff Notice 81-708 Model Portfolios of Mutual Funds

#### OSC STAFF NOTICE 81-708 MODEL PORTFOLIOS OF MUTUAL FUNDS

Please refer to MRRS Decision Documents *In the Matter of Royal Mutual Funds Inc.*, *In the Matter of RBC Asset Management Inc.*, and *In the Matter of Royal Mutual Funds Inc.* (the **Decision Documents**), which are published in today's bulletin.

#### Overview

This notice addresses the issues raised in the Decision Documents for certain mutual fund dealers, investment counsels and portfolio managers (**IC/PMs**), and mutual fund managers conducting registerable activity in Ontario.

The intention of this notice is to provide guidance about exemptions required by market participants planning to introduce products and services in situations similar to those described in the Decision Documents.

#### The relevant fact situations

The Decision Documents provide exemptive relief for two firms: one firm is both an IC/PM and a fund manager (**IC/PM-Fund Manager**). The IC/PM Fund Manager makes decisions about rebalancing changes in model portfolios of mutual funds, including changes within pre-determined parameters as well as replacing existing funds with new funds. It also trades to carry out these rebalancing decisions made in its discretion. The other firm is an affiliated mutual fund dealer that sells these model portfolio products. A mutual fund dealer selling a model portfolio product that involves a separate IC/PM and fund manager would be in a similar situation.

Staff consider that the rebalancing activity undertaken by the IC/PM is discretionary management that affects the client's holdings directly. It is as though the IC/PM is advising the client directly, through its own actions as passed on through the mutual fund dealer. This situation differs from a fund of funds, where discretionary activity carried out in the top fund affects only that fund, and not the actual holdings in a client's account.

The mutual fund dealer through which the model portfolio product is sold to clients is therefore considered to be providing discretionary management to the client. This activity is not permitted for a mutual fund dealer without an exemption from the adviser registration requirement.

The IC/PM-Fund Manager in the Decision Documents carries out trades in units of the funds in each model portfolio that it decides in its discretion are appropriate, as authorised by the account opening agreement between the client and the mutual fund dealer. An IC/PM-Fund Manager in this situation usually holds no mutual fund dealer registration, to comply with MFDA rules.

Similar to the fact situation in the Decision Documents, if an IC/PM-Fund Manager trades to implement decisions made in its discretionary authority, it is required to be registered as a dealer in an appropriate category or obtain exemptive relief from the dealer registration requirements. This particular trading activity is not considered incidental to the IC/PM-Fund Manager's adviser registration.

### Disclosure about model portfolio products

#### *Existing disclosure*

Model portfolio products are not offered as separately qualified funds under a prospectus, like a fund of funds. Model portfolio products are generally described in a prospectus as a service. More specific details about the model portfolio product are usually found in the account opening documentation.

It is clear that disclosure is an important element in selling model portfolio products. While considering the applications for exemptive relief that resulted in the Decision Documents, staff consulted with members of the mutual fund industry and reviewed the prospectus and account opening documentation for numerous model portfolio products to learn more about products already in the marketplace.

Staff found that direct discretionary management of the client's investment is often involved in these model portfolio products, to varying degrees. The requirement to describe the model portfolio products is not particularly specific, and the result is that descriptions in both prospectuses and account opening documentation vary significantly, from very good to very unclear. Staff also found that some descriptions were quite detailed, while others were not; these differences made it impossible to compare the model portfolio products.

#### *Disclosure expectations*

Prospectuses that describe model portfolio products like those in the Decision Documents are expected at a minimum to include the following:

- clear description of the model portfolio product
- clear description of the number of model portfolios, including how many portfolios are offered, the types of portfolios offered (such as growth, income, or balanced), and the fact that the portfolios consist of funds of the fund manager
- clear explanation of how the model portfolios are designed and who is involved in designing them
- clear explanation of the how investment ranges are established, how re-balancing occurs, and whether new funds may be substituted in the model portfolios

- the minimum amount required to invest in the model portfolio product
- the fees associated with the model portfolio product, including the basis on which they are charged and how they are paid
- clear description of reinvestments of distributions
- where to get more information and how to sign up for the model portfolio product

The account opening documentation is typically generated by the fund manager, and it contains details about the model portfolio products such as fees as well as information specific to the client. To help investors better understand model portfolio products, staff expect that fund managers will ensure their account opening documentation fully describes their model portfolio products. In addition to the information included in the prospectus, the account opening documentation should include at a minimum:

- clear description of all fees payable, including the services for which the fees are to be paid, and the compensation received by each of the entities that are involved
- clear description of what discretionary authority is exercised, how it is exercised, and by which entity
- clear description of when client consent is required for an action
- clear description of the entity or entities legally responsible to the investor for any liabilities concerning the model portfolio product

Please refer your questions to:

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