1.1.3 OSC Staff Notice 81-711 – Closed-End Investment Fund Conversions to Open-End Mutual Funds

OSC STAFF NOTICE 81-711

CLOSED-END INVESTMENT FUND CONVERSIONS
TO OPEN-END MUTUAL FUNDS

Purpose

This notice sets out the views of staff of the Ontario Securities Commission (OSC staff) on the regulatory issues related to the conversion of closed-end funds into mutual funds, and the types of comments OSC staff will generally raise in the course of a review of a built-in conversion feature or a conversion.

Background

Closed-end funds differ from mutual funds in several key ways.

Mutual funds are typically in continuous distribution, which means that they issue an unlimited number of units or shares from treasury. These funds provide a regular redemption feature, typically daily, at the fund's net asset value (NAV). Mutual funds are regulated by National Instrument 81-102 *Mutual Funds* (NI 81-102), which prescribes product requirements including rules related to investment restrictions, borrowing, organizational costs, incentive fees, conflicts of interest, purchases and redemptions and sales communications.

By contrast, closed-end funds are not in continuous distribution. Rather, they issue a finite number of units or shares from treasury on an initial public offering (or IPO) which may be followed by subsequent offerings. Following issuance, these units or shares are typically traded on a stock exchange, often at a discount to NAV. Closed-end funds may offer an annual redemption at NAV. These funds are not subject to NI 81-102 and often engage in investment strategies, such as borrowing, beyond the limits prescribed for mutual funds.

The differences in structure and features of closed-end funds and mutual funds and in the regulatory regimes that govern them give rise to a number of regulatory issues when a conversion of a closed-end fund into a mutual fund is contemplated or occurs.

Types of closed-end fund conversions

Recently, OSC staff have seen a number of closed-end funds that intend to convert to a mutual fund, often within less than two years of their initial offering. A key objective of conversion is to provide investors in the closed-end fund with enhanced liquidity through a more frequent redemption feature at NAV.

To date, OSC staff have seen a variety of ways a closed-end fund may convert to a mutual fund. The following are among the more common approaches to conversion:

- *Built-in conversion features* – The closed-end fund is structured with an automatic conversion feature that typically will be triggered in one of two ways: (1) as at or before a specified date, usually within two years of the fund's initial offering; or (2) after a specified date, if the fund trades at a certain discount (often 2%) to NAV for more than a set period of time (often 10 days);

- *Securityholder approvals* – At some point after the initial distribution, the fund manager seeks securityholder approval to convert or merge the closed-end fund into a mutual fund; or

- *Mergers* – The closed-end fund is merged with a mutual fund at some point after the initial distribution of the closed-end fund. These mergers are often in accordance with 'permitted merger' provisions of the closed-end fund's declaration of trust. Under these provisions, the requirement for securityholder approval is typically not triggered provided certain conditions are met, such as the merging funds having consistent investment objectives and strategies.

Regulatory issues

To date, OSC staff have reviewed built-in conversion features and conversions as part of our prospectus reviews and in the context of applications for exemptive relief, pre-filings and inquiries. OSC staff have identified a number of key regulatory issues for consideration in the context of a conversion-related review. In the course of such review, the issuer may be asked for submissions to assist staff in determining whether these regulatory issues have been appropriately addressed.

1. The conversion process

Transparency

OSC staff expect that the key aspects of the conversion process will be clearly disclosed to investors. Disclosure should include a description of the event or events that will trigger the conversion, the expected timing and steps of the conversion, what approvals, if any, will be required to effect the conversion, any expected periods of illiquidity, who will bear the cost of the conversion, what class or series of units or shares investors will hold after the conversion and the investor's ability to redeem after the conversion.

For closed-end funds with a built-in conversion feature, disclosure regarding the conversion should be made prominently in the fund's initial prospectus.

Where closed-end funds do not contain a built-in feature, but it is contemplated that the closed-end fund may convert to a mutual fund within a foreseeable period of time following initial distribution, OSC staff will generally expect disclosure regarding the possible conversion, as well as key aspects of the contemplated conversion process, to be provided in the initial prospectus.

Where closed-end funds do not contain a built-in feature and the decision to convert is made only after the initial distribution of the closed-end fund, OSC staff expect that this decision will trigger the material change reporting requirements. If the fund manager is seeking securityholder approval for the conversion, OSC staff expect appropriate disclosure regarding the conversion to be in the circular sent to investors in connection with the approval.

Notice to investors

OSC staff expect that investors will be provided with sufficient written notice prior to the conversion of the closed-end fund. For closed-end funds with a built-in conversion feature, our view is that the fund's initial prospectus should disclose that prior written notice of the conversion will be provided to investors and the length of the notice period. In instances where securityholder approval is not being sought, OSC staff would generally consider at least 60 days prior written notice to be appropriate. Where securityholder approval is being sought for the conversion, securities legislation sets out the notice requirements for a meeting of securityholders.

Redemption right and periods of no liquidity

Typically, a closed-end fund will cease trading on the exchange and may temporarily suspend redemptions prior to and immediately following conversion to a mutual fund. OSC staff expect that investors will be provided with a redemption right prior to such suspension and conversion. We further expect that the conversion will be structured so that any period of no liquidity (both before and after the conversion), is as short as possible.

2. Post-conversion compliance with NI 81-102

Compliance with NI 81-102

OSC staff generally expect that a closed-end fund with a built-in conversion feature will comply with NI 81-102 from its inception, particularly if the conversion may, or will, happen within a foreseeable period of time from the initial distribution of the closed-end fund.

If the closed-end fund intends to operate in a manner not permitted by NI 81-102, it may need exemptive relief to continue certain investment strategies or features at the time that it converts to a mutual fund. In these instances, OSC staff recommend that the application for the exemptive relief be filed concurrently with the initial prospectus filing of the closed-end fund. These applications will be evaluated in the context of the regulatory regime and policy concerns currently applicable to conventional mutual funds. If the decision to convert is made only after the initial distribution of the closed-end fund, OSC staff expect the issuer to have considered what modifications, if any, to the features or investment strategies of the fund are necessary to be in compliance with NI 81-102 upon conversion to a mutual fund.

Consistent investment objectives and strategies

For a closed-end fund without a built-in conversion feature that converts after the initial distribution, OSC staff expect the issuer to consider if there will be a fundamental change to the investment objectives, strategies, fees, management and operations of the closed-end fund following its conversion to a mutual fund. If so, OSC staff would generally expect securityholders of the fund to be given the opportunity to vote on these fundamental changes.

Illustration of past performance

OSC staff have observed that, following conversion to a mutual fund, some funds wish to show the past performance of the closed-end fund in sales communications. Section 15.6 of NI 81-102 prohibits a mutual fund from showing in sales communications past performance from a period that is before the time when the mutual fund offered its securities under a simplified prospectus. This would prohibit the display of the past performance of the closed-end fund. However, the form requirements applicable to management reports of fund performance under Form 81-106F1 require that reporting issuers show past performance from inception, including pre-conversion past performance.

When contemplating a built-in conversion feature or conversion, OSC staff expect issuers to consider how they intend to illustrate past performance. If the issuer requests exemptive relief to permit the mutual fund to show the past performance of the closed-end fund in sales communications, OSC staff will consider whether the past performance is relevant and useful for investors and will be appropriately presented and qualified, as necessary.

3. Costs associated with the conversion

Merger costs

When conversions are structured as a merger between the closed-end fund and a mutual fund, OSC staff expect that the fund manager will absorb the costs of the merger. Costs of the merger are more appropriately borne by the fund manager as opposed to securityholders where it is the fund manager’s decision to merge the funds and the manager benefits from the merger. In such instances, OSC staff generally take the view that it is inappropriate for any merger costs to be charged either to the terminating closed-end fund or to the continuing mutual fund.

For Further Information

Issuers and their counsel are encouraged to contact OSC staff at an early stage in the planning of a conversion feature or conversion that may give rise to any questions concerning the issues discussed in this Notice.

Questions

If you have any questions, please refer them to:

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