Chapter 1

Notices / News Releases

1.1 Notices

1.1.1 OSC Staff Notice 81-724 – Report on Staff's Continuous Disclosure Review of the Fees and Expenses Disclosure by Investment Funds

OSC STAFF NOTICE 81-724 – REPORT ON STAFF'S CONTINUOUS DISCLOSURE REVIEW OF THE FEES AND EXPENSES DISCLOSURE BY INVESTMENT FUNDS

May 8, 2014

PURPOSE

This notice sets out recommendations from staff of the Investment Funds Branch of the Ontario Securities Commission (**Staff** or **we**) based on our observations from a targeted continuous disclosure (**CD**) review of the fees and expenses disclosure practices of investment funds.

OBJECTIVE AND SCOPE OF OUR REVIEW

As part of our broader review of fee disclosure, starting August 2013, Staff conducted targeted CD reviews of the fees and expenses disclosure practices of a sample of fund managers.

Included in our review were 18 fund managers offering various types of investment funds, including conventional mutual funds, exchange-traded funds and closed-end funds. These fund groups have assets under management of approximately $210 billion.

We reviewed their funds' current prospectus and continuous disclosure records, including financial statements, management reports of fund performance (**MRFPs**) and independent review committee reports to examine whether the current disclosure of fees and expenses:

i. provides sufficient information to investors on how the fees and expenses are being charged; and

ii. accurately and fully describes fund managers' allocation of expenses to the funds they manage.

We coordinated our review closely with, and followed similar approaches of, staff in the Compliance and Registrant Regulation Branch (the **CRR Branch**) who regularly conduct reviews of fund expenses as part of their oversight of registrants. Further guidance on expense allocation will be issued by staff in the CRR Branch in their upcoming publication in OSC Staff Notice 33-743 *Guidance on Sales Practices, Expense Allocation and Other Relevant Areas Developed from the Results of the Targeted Review of Large Investment Fund Managers* (**Staff Notice 33-743**).

BACKGROUND

Funds generally pay management fees and operating expenses to cover the various costs of their operation. These typically include costs for various services such as fund administration, portfolio advisory services, fund distribution, security services, safekeeping and custodial services, fund accounting and valuation, and audit and legal services.

Management fees are generally calculated as a percentage of the net assets of a fund and are paid to the fund manager. Operating expenses are either charged directly to the funds as they are incurred or may be covered by a fixed administration fee charged to the fund. The fixed administration fee is calculated as a percentage of the net assets of a fund and is paid to the fund manager in exchange for the fund manager bearing the operating expenses of the fund.

The management agreement or trust agreement between the fund and the fund manager generally sets out which services are covered by the management fees and which services are covered by the operating expenses.

In practice, fund managers have to arrange for their funds' operations to be performed either in-house or by third party service providers. Where a fund manager provides operating services in-house to its funds, and the management agreement does not explicitly stipulate that those services are covered by the management fee, the fund manager may expect to recover the costs of such services, including a portion of its general overhead and administrative expenses, from its funds as operating expenses.

SUMMARY OF OBSERVATIONS

Overall, we noted good general compliance with disclosure requirements related to fees and expenses. In some instances, we noted opportunities for fund managers to enhance the disclosure. Our targeted CD review yielded the following observations regarding fees and expenses disclosure practices and expense allocation practices in the fund industry:

1. Fees and Expenses Disclosure

- We noted varying fee and expense models within the fund industry. While certain fund managers paid for the costs of certain operating services out of their management fees, others charged those costs to their funds as operating expenses. For example, the costs associated with custodians were included in the management fees for some funds, or charged separately as operating expenses for other funds;

- The prospectuses we reviewed generally did not include the detail necessary for investors to know the specific costs and services paid for out of management fees relative to those charged to funds as operating expenses. General "catch-all" wording, such as "general administrative services" or "costs to administer the fund", were often used to describe the costs and services covered by the management fees. Similarly, wording such as "other general operating expenses", "other day-to-day operating expenses", or "general administrative costs" were used to describe operating expenses. Staff frequently needed to refer to the trust agreement or management agreement for greater detail on the services paid for out of management fees; and

- Staff also noted the use of "catch-all" wording in the MRFPs which did not provide sufficient specificity of the services received by the fund in consideration of the management fees paid to the fund manager.[1] Similarly, some funds did not disclose their expenses in the financial statements as separate line items[2] but rather used one catch-all line item, such as "operating costs" or "general operating expenses" to include a variety of fund expenses.

2. Expense Allocation

- About half of the fund managers in our sample allocated part of their expenses to the funds they manage. While allocation practices varied among them, the expenses they generally allocated included such items as salaries, office rent, utilities, printing and copying, postage, and office supplies. The remaining fund managers either did not allocate their expenses to their funds or charged fixed administration fees;

- Fund managers used different allocation models to allocate expenses. Generally, fund managers charged to their funds the proportionate share of their costs based on the time or resources they dedicated to the funds' day-to-day operations. Those costs were further allocated across the family of funds and among various series of each fund using varying metrics such as number of investors in the funds/series or the assets under management of the funds/series;

- The majority of those fund managers who allocated expenses to their funds relied on general disclosure in the prospectus that the funds pay their own operating expenses as a basis to recover expenses from their funds. Only a few of those reviewed briefly mentioned in the prospectus that the fund manager recovers certain costs from their funds; and

- In our review of the financial statements and MRFPs, we observed that the majority of fund managers who allocated expenses to their funds did not provide related party disclosure.[3] Only a few provided note disclosure with respect to the allocation, but failed to provide details such as the amount or measurement basis of the transactions.

Based on these observations from our CD review, Staff make the following recommendations for fees and expenses disclosure and expenses allocation going forward.

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1 As required under part B, item 3.3 of Form 81-106F1 *Contents of Annual and Interim Management Report of Fund Performance* (**Form 81-106F1**).

2 As required by section 3.2 of National Instrument 81-106 – *Investment Fund Continuous Disclosure* (**NI 81-106**).

3 As required by International Accounting Standard 24 *Related Party Disclosures*, and by part B, item 2.5 of Form 81-106F1.

RECOMMENDATIONS

1. Fees and Expenses Disclosure

a. Transparency in Disclosure of Management Fees and Expenses

In Staff's view, the prospectus and continuous disclosure documents should disclose the specific services that the fund manager provides to the fund in consideration of the management fees and the types of expenses charged to the fund as operating expenses. The use of general "catch all" terminology should be avoided.

To meet the standard of full, true and plain disclosure[4], the prospectus should provide details sufficient for investors to clearly distinguish the types of expenses, in particular the types of administrative and operating expenses, that are covered by management fees from those that are covered by operating expenses. Investors should not have to refer to the management or trust agreement to determine whether a particular cost is covered by management fees or charged as a separate operating expense to the funds. Having all the relevant fees and expenses information disclosed in the prospectus will enable investors to compare the different fee models and structures, and make an informed investment decision.

We also remind fund managers to clearly describe the major services paid for out of the management fees in their funds' MRFPs, as well as to provide the required line items in the funds' financial statements, in accordance with existing requirements.[5] We encourage fund managers to disclose as much information as possible regarding the types of operating expenses that are charged to the funds in the financial statements by using relevant and descriptive line items, in addition to the mandated line items.

b. Transparency in Disclosure of Expense Allocation

In Staff's view, fund managers should consider enhancing the transparency of their expense allocation as a way to mitigate the actual and perceived conflicts of interest inherent in such practices (as further discussed below). For example, a fund manager should, to the extent possible, ensure that its funds' prospectus specifies the types of costs the fund manager may recover from its funds. We also remind fund managers to disclose the particulars of the material conflicts of interest in the prospectus.[6]

On the continuous disclosure side, we remind fund managers to comply with related party disclosure requirements and provide the relevant details of the transactions in the funds' financial statements and MRFPs.[7] Disclosure should also explain how the conflicts are mitigated by including, for example, information concerning the policies, practices or guidelines of the funds or the manager relating to the allocation practice in the annual information form. [8]

2. Expense Allocation

a. Conflict of Interest

Fund managers have an inherent conflict of interest when allocating expenses between themselves and the funds they manage. We remind fund managers of their duty to act honestly, in good faith and in the best interests of the fund[9] when allocating expenses. Managers should be able to demonstrate that the allocation of an expense is not inconsistent with their duty of care and that they are not putting their own interests ahead of those of the fund and its securityholders.

Staff expect the general expenses allocated to the funds to have a direct relationship to the daily operation of the funds and to be fair and reasonable to the funds, as if the result of arm's length bargaining. Fund managers should avoid recovering expenses using opaque or complex methodologies that are not intuitive and not directly linked to the services being performed for the funds.

b. Compliance with NI 81-107

Given that the allocation of expenses is generally viewed as a conflict of interest matter, it should be referred to the independent review committee.[10] Fund managers should have policies and procedures in place dealing with the allocation of expenses

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4 As required by section 56(1) of the *Securities Act* (Ontario).

5 See notes 1 and 2.

6 As required by Item 19.3 of Form 41-101F2 *Information Required in an Investment Fund Prospectus.*

7 See note 3.

8 As required by Item 12(1)(b) of Form 81-101F2 *Contents of Annual Information Form.*

9 As required by section 116 of the *Securities Act* (Ontario).

10 As required by section 5.1 of National Instrument 81-107 *Independent Review Committee for Investment Funds* (**NI 81-107**).

between the fund manager and its funds.[11] We found that the fund managers selected in our review generally complied with these requirements, and reviewed their policies and procedures at least annually.

c. Appropriate Expense Allocation

Because of the inherent conflict of interest, Staff expect the expenses allocated to the funds to generally be limited to:

- costs and expenses that were necessarily incurred in the daily operation of the funds;
- reasonable costs and expenses that are reasonably incurred in the operation of the funds;
- expenses that are closely linked to the specific operation of the funds; and
- the proportionate share of the allocated expenses can be accurately and readily determined.

Certain costs must be incurred by fund managers to carry out their business as fund managers. Staff are generally of the view that it is not appropriate for funds to pay for the:

- costs and expenses that the fund manager would normally incur in the ordinary course of their operations as fund manager, such as, the compensation paid to their executive officers and directors; or
- costs that are driven by the fund manager's business and organizational initiatives, such as, restructuring and rationalizing funds line-up.[12]

We encourage fund managers to exercise sound judgement in their expense allocation. In situations where it is uncertain whether certain expenses may be appropriately allocated to the funds, fund managers should make their decision having regard to the best interests of securityholders, and avoid any allocation that gives rise to a material conflict of interest for the fund managers.

Please refer to Staff Notice 33-743 for further examples and guidance on this topic to be issued by staff in the CRR Branch.

CONCLUSION

The fees and expenses of a fund are an important consideration for investors. We encourage fund managers to clearly disclose fees and expenses to provide more transparency and clarity, where possible, on what services are paid for out of the management fees, which services are charged as operating expenses and how all the fees and expenses are being allocated. Staff remind fund managers of their duty of care when allocating expenses.

We encourage fund managers to consider the recommendations in the notice when preparing disclosure so as to promote investors' understanding of fees and expenses.

Questions may be referred to:

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[11] As required by section 2.2 of NI 81-107.

[12] See OSC Staff Notice *Issues Arising Out Of Mutual Fund Mergers and Similar Reorganizations* dated September 15, 1995.