

Dialogue with the OSC Speaking Notes November 17, 2005

Introduction

In this part of our presentation, I will be talking about some of the operational and file issues that we face in Investment Funds on a daily basis. In addition to our substantial policy agenda, which Darren has just highlighted for you, we allocate a significant amount of resources to reviewing investment fund prospectuses and applications for exemptions from various investment fund requirements. These filings often raise important policy issues because the products or structures are novel or because we have not previously considered an issue in the context of a product or structure that we've seen before.

Unfortunately, because of the manner that the filing process functions, the identification of these issues and their resolution may not always be as transparent as funds and their advisors would like. This sometimes leads to frustration on the part of a fund or its advisors who feel they are being treated unfairly relative to other funds that have been reviewed before them.

My hope today in making these comments is to better inform you regarding the issues that have arisen in filings recently. We also hope to keep you better informed on an on-going basis regarding file issues through some form of newsletter or other publication on the Investment Funds page of the OSC website. As a first step, I will post my comments today under the Investment Funds icon on our website at www.osc.gov.on.ca. We'd also be interested in your views regarding how you think we can keep you better informed regarding file issues on a timely basis.

Before I begin though, I'd like to briefly comment on the use of precedents. I believe the most popular recurring submission that we receive when we raise an issue in the context of a product or fund that is not novel is that we did not raise the issue in the context of similar previous filings, therefore it is unfair for us to raise it now.

This ignores our on-going obligations under the Act in connection with each particular filing and the public interest generally. It further ignores the practical reality that as we analyse products further new issues may come to light or that the regulatory landscape may change creating issues that did not previously exist. All that to say, precedents remain valuable sources of information, but please rely upon them with caution.

Foreign Content Restrictions

One of the most significant developments in the regulatory landscape facing investment funds in recent years was the Federal government's decision to repeal the foreign content restrictions. These restrictions previously limited a fund's ability to invest in foreign securities to roughly 30% of its assets. The removal of this restriction resulted in significant activity on both the applications and the prospectus side.

Applications

The first significant issue the industry faced was in connection with clone funds. These funds were designed to mimic the returns generated by funds that were not RRSP eligible. The clone funds accomplished this through the use of derivatives that also made them more expensive to run. As this expensive structure was no longer necessary to achieve RRSP eligibility, it was likely inconsistent with a manager's fiduciary duty to continue to operate them.

Our initial response was CSA Staff Notice 81-314 – Removal of Foreign Content Restrictions for Registered Plans – Eliminating Indirect Foreign Content Exposure in Certain RSP Funds. That notice set out CSA staff's view that for standard clone fund structures, we agreed that managers should be able to close out the fund's indirect foreign exposure without having to hold a unitholder meeting. We accepted that it made sense for managers to be able to quickly remove the costly derivative structure in the clone funds and simply gain direct exposure to the underlying fund.

This notice was followed by issuing two different MRRS decisions in connection with Mackenzie Financial's termination of its clone funds and C.I. Mutual Funds merger of its clone funds. We issued each decision on a representative basis so that other industry participants that were similarly affected by the change to the foreign content restrictions could rely upon them.

The Mackenzie decision exempted the clone funds from the requirement in NI 81-102 to provide securityholders 60 days notice before terminating the funds. The CI decision exempted the clone funds from the requirement to have a securityholder meeting in connection with their merger into the funds they were designed to clone. In some cases, it was more efficient for clone funds that were "fund of funds" to proceed by way of merger rather than termination.

In both cases, the managers were required to issue press releases about the terminations or mergers, and to follow-up with a notice to unitholders in due course. The relief was granted on this basis for a period of three months, after which it could not be relied upon. The reason for putting the time limit on the relief was to acknowledge that fund managers told us they would need to respond quickly to close-out their clone fund structures once the budget change was approved. Any managers who were not able to rely on the representative relief or who did not rely on it within that time needed to come to us separately for relief.

Prospectus Disclosure

After focusing our initial attention on the clone funds, beginning in late July of this year, we began raising comments on prospectus reviews in connection with funds that had previously disclosed that they may invest in securities up to the foreign content limit as part of their investment strategy. We focused, in particular, on funds whose investment objective was to invest primarily in Canadian securities. Our goal in raising these comments has not been to prescribe appropriate foreign content limits, but rather to obtain disclosure that explains to investors what impact, if any, the repeal of the foreign content restrictions has on a fund's investment strategy. Funds have responded by disclosing in their investment strategies that they may invest in foreign securities up to a certain maximum percentage. We suggest that issuers that are currently in the process of preparing their renewals give some thought to these issues.

We are also going to closely monitor the standard fund categories created and maintained by the Investment Funds Standards Committee. We know that discussions are occurring about how the categories might need to change in light of the removal of the foreign content restrictions.

Some Frequently Occurring Applications that have Disappeared

We witnessed the disappearance of two of our most frequently occurring applications earlier this year: (1) section 74(1) applications for prospectus exemptions in connection with the distribution of covered call and cash covered put options to financial institutions; and (2) section 74(1) applications for prospectus exemptions in connection with the distribution and resale of units received under a distribution reinvestment plan.

Covered call and cash covered put options

We have historically recommended s. 74(1) prospectus exemptions to exchange traded funds that distribute over the counter cash covered put options and covered call options as part of their overall investment strategy. Filers have generally submitted that the protections afforded by the prospectus requirement are unnecessary for these distributions as the buyers are sophisticated financial institutions. This rationale is now encoded in the accredited investor exemption provided in National Instrument 45-106. Consequently, the applications are generally unnecessary and we have been asking any applicants to look to the accredited investor exemption.

Distribution Reinvestment Plans (Drips)

Historically, we have also received many s. 74(1) applications from exchange traded funds in connection with the distribution of units under their distribution reinvestment plans (DRIP). Applicants generally filed these applications for technical reasons. The exemptions were generally granted on the basis that there was no policy rationale upon which to distinguish the distributions of units by a trust that are financed by an investor's reinvestment of cash distributions from other similar distributions that were already exempt under the Act. This technical incongruence was recently fixed in NI 45-106 which now codifies an exemption for the distribution of units under a distribution reinvestment plan.

Historically, filers also applied for resale relief in connection with these s. 74(1) applications. Generally, filers applied for an exemption on the basis that they may wish to make their initial distribution under the Drip prior to the filer being a reporting issuer for 4 months. This could result in recipients of Drip units having to hold these units for a period of approximately a month and a half as the initial distributions normally occur after the filer has been a reporting issuer for two and a half months. Filers generally analogized to the exemption provided in OSC Rule 81-501 – Mutual Fund Reinvestment Plan and noted that we did not impose a seasoning period on units issued under a mutual fund reinvestment plan.

We believe, however, that this analogy overlooked that the exemption provided in Rule 81-501 was practical in nature. It recognized that conventional mutual funds are in continuous

distribution and able to provide distribution reinvestment investors with a prospectus, but that practically it did not make sense for those funds to have to provide those investors with the fund's prospectus for each Drip distribution. In addition, Rule 81-501 did not contemplate resale restrictions as conventional mutual fund units do not trade in a manner similar to units of exchange traded funds.

Consequently, NI 45-106 maintains the 4 month seasoning period for units of exchange traded funds distributed under a Drip and we will generally not recommend an exemption from this seasoning period.

Other Prospectus Disclosure Issues

Two of the most frequently occurring issues we raised on prospectus reviews during the year were in connection with the disclosure of historical performance data and leverage based upon debt to equity ratios or debt to net asset ratios.

Historical Performance Data

While not limited to this context, we became concerned about the disclosure of historical performance data in connection with flow-through limited partnerships in particular. Generally these partnerships disclose the cumulative returns of other similar partnerships organized by the same manager. During the year we began asking these issuers to also include the annualized

returns of these other partnerships that have been in existence for more than one year in order to provide investors with more balanced disclosure. We've also requested that these issuers disclose the historical performance data for all of the other similar partnerships run by the same manager, not just the ones that have performed well.

Also, there is an issue regarding whether we think that it's appropriate to disclose historical returns that include periods after the limited partnership was dissolved and its assets rolled into a mutual fund.

For many kinds of investment funds, we continue to see a variety of performance data presentations in long form prospectuses and we continue to review and comment on them. Overall, we are looking to make sure that the presentations are relevant, fair and not misleading. We do encourage issuers that would like to use performance data in unique or novel ways to consider contacting us to discuss what they would like to disclose in the prospectus before they file. We have done this in the past and it has made the review process smoother and more effective.

Leverage Disclosure

We've also been asking exchange traded funds to supplement their leverage disclosure when they disclose leverage using debt to equity ratios. We understand that the use of debt to equity ratios is generally the industry and analyst accepted ratio for expressing leverage. We're concerned, however, that the average investor may not fully appreciate the amount of leverage being used particularly in cases where the debt to equity ratio is 1:1. The average investor may not fully appreciate that means that up to half of the fund's assets may be financed with debt. Consequently, we've been requesting issuers to include total asset to equity ratios along with the debt to equity ratios.

NI 81-105 issues

I want to take this opportunity to address some sales practices issues that have to our attention in the last year. I would like to reinforce a couple of points:

1. ***Practice Management***

We understand that there may still be some confusion about whether co-operative support can be given to educational conferences and seminars for representatives which cover topics largely related to practice management, for instance, topics that include coaching representatives on how to sell products to investors, how to establish relationships with clients targeted by the representatives and how to integrate the sale of financial products other than mutual funds into the representatives' business.

Our concern continues to be that the scope of these sessions is beyond that permitted by Part 5 of NI 81-105 and accordingly they do not comply with section 5.2 of NI 81-105.

We recommend that fund managers and distributors closely review the content of any conferences and seminars to ensure that the program they are offering or participating in complies with Part 5 of NI 81-105. In particular, we want to remind sponsoring organizations that the primary purpose of the conference or seminar must be the provision of educational information about financial planning, investing in securities, mutual fund industry matters, the mutual fund, the mutual fund family of which the mutual fund is a member or mutual funds generally.

Trailing Commissions Paid from Performance Fees

Over the last year, in reviewing prospectuses, we have seen that some managers propose to pay a portion of performance fees earned by them to dealers as an additional trailing commission. We have raised and are continuing to raise this comment on prospectus filings where we see these trailing commission structures. We are concerned that an additional trailing commission paid out of performance fees is beyond those commissions permitted to be paid under Part 3 of NI 81-105.

In our view, the proposed payment of these trailing commissions from performance fees is contrary to NI 81-105, on the basis that these fees do not meet the intent of paragraph 3.2(d)(ii) of NI 81-105, which prohibits trailing commissions to be tied to increases in the amount or value of securities of the mutual fund. We also consider these fees to be non-compliant with the

general purpose of NI 81-105, which is designed to minimize the conflicts between the legitimate commercial goals of industry participants and their obligations towards investors.

CD Reviews

National Instrument, 81-106 became effective on June 1 this year. The first filings under this new investment funds continuous disclosure rule were made at the end of October, including the first new Management Reports of Fund Performance. The Investment Funds Branch is starting its CD review program. We plan to look at CD filings made under 81-106 for overall compliance with the 81-106 requirements and to see what quality of disclosure is being provided in the MRFPs, among other things. We are considering looking at other types of disclosure on a sample basis including, for example, sales communications.

We are close to finalizing and publishing a series of frequently asked questions on NI 81-106. A webcast was produced a few months ago to give an overview of key parts of the rule and explain new provisions introduced in the rule.