

1.1.3 The Investment Funds Practitioner

January, 2010

THE INVESTMENT FUNDS PRACTITIONER

From the Investment Funds Branch, Ontario Securities Commission

What is the Investment Funds Practitioner?

The Practitioner is an overview of recent issues arising from applications for discretionary relief, prospectuses, and continuous disclosure documents that investment funds file with the OSC. It is intended to assist investment fund managers and their staff or advisors who regularly prepare public disclosure documents and applications for exemptive relief on behalf of investment funds.

The Practitioner is also intended to make you more broadly aware of some of the issues we have raised in connection with our reviews of documents filed with us and how we have resolved them. We hope that fund managers and their advisors will find this information useful and that the Practitioner can serve as a useful resource when preparing applications and disclosure documents.

The information contained in the Practitioner is based on particular factual circumstances. Outcomes may differ as facts change or as regulatory approaches evolve. We will continue to assess each case on its own merits.

The Practitioner has been prepared by staff of the Investment Funds Branch and the views it expresses do not necessarily reflect the views of the Commission or the Canadian Securities Administrators.

Request for Feedback

This is the fourth edition of the Practitioner. Previous editions of the Practitioner are available on the OSC website www.osc.gov.on.ca under Investment Funds – Related Information. We welcome your feedback and any suggestions for topics that you would like us to cover in future editions. Please forward your comments by email to investmentfunds@osc.gov.on.ca.

Applications for Relief

NI 81-107 and the Conflicts Provisions

As noted in the third edition of the Practitioner, we continue to see a number of novel applications for relief from the various conflicts provisions under the Act and NI 81-102 based on IRC approval. We remind filers that the CSA deliberately chose to maintain the various conflicts provisions in the legislation and codify only limited exemptions from them in NI 81-107, rather than replace them wholesale with a fund governance agency.

We intend to complete a series of reviews with a view to assessing how the IRC approval system is working with the existing codified exemptions. In the interim, we encourage filers to carefully consider the basis for any novel relief from the conflicts provisions before filing an application.

Mergers and Reorganizations

We have recently noted a number of recurring issues in connection with mutual fund mergers and reorganizations:

- **Not factoring securities regulatory approval into the transaction planning process:** Some filers have not properly factored securities regulatory approval into their transaction planning process. In a couple of instances, this put the planned closing dates for the transactions at risk. We remind filers that mergers or reorganizations of mutual funds that do not meet the pre-approval criteria in section 5.6 of NI 81-102 require the approval of the securities regulatory authority under section 5.5 before the transaction is implemented. If the transaction requires securityholder approval, staff may review the information circular that will be sent to securityholders as part of the review of the application. Accordingly, it is generally a good idea to file the application for regulatory approval before materials are sent to securityholders.
- **Applications missing required information:** Section 5.7 of NI 81-102 sets out the basic information that should be included in an application for securities regulatory approval including a description of those elements of the proposed transaction that make section 5.6 inapplicable. Recently, we have found that some applications lack the required information. In some instances, filers have sought to rely upon staff to conduct this analysis on their behalf. We remind filers of their responsibility to provide all of the information set out in section 5.7 including their analysis of the elements of the proposed transaction that make section 5.6 inapplicable.

- **Materials to be sent to securityholders:** Section 5.6(f) of NI 81-102 sets out what must be included in the materials sent to securityholders including, if not previously sent to securityholders, the current simplified prospectus. We remind filers of the requirement to send the simplified prospectus and financial statements. We note that, historically, the Director has only provided limited relief from this requirement to facilitate filers sending a tailored prospectus, rather than relief from the requirement in its entirety.
- **IRC review of fund mergers:** We have been raising comments on merger approval applications to question whether the fund manager has submitted the merger to the funds' independent review committee for its review and recommendation as we generally view a merger to be a conflict of interest matter referable to the funds' IRC under NI 81-107.

Fund on Fund Relief and the Conflicts Provisions

The Director sometimes grants relief under NI 81-102 to facilitate fund on fund arrangements that do not comply with all of the conditions in section 2.5(2) of NI 81-102. Such applications are sometimes accompanied by a parallel application for relief from the conflicts of interest prohibitions under the Act. This second application is normally filed out of concern that the exemption codified under section 2.5(7) of NI 81-102 may not apply in instances where the fund on fund arrangement is exempt from some of the conditions in section 2.5(2). We generally do not request that applicants file the parallel Act application. We intend to amend section 2.5(7) at the next available opportunity to clarify that it still applies even where a fund has obtained an exemption from some of the conditions in section 2.5(2).

Prospectuses

Timing for obtaining a Prospectus Receipt

We remind filers and their advisors wishing to receive a receipt for either a preliminary prospectus or a prospectus on a specific day that the preliminary prospectus or prospectus and all accompanying material should be received by us in acceptable form on or before 12:00 noon on the day the receipt is required. If you are filing a prospectus for an investment fund during peak filing periods, please note that it may take longer to issue a final receipt. In those cases, we will use our best efforts to issue a final receipt within 24 hours.

If materials are filed after 12:00 noon, the receipt will normally be issued before noon on the next business day and dated as of that day.

For more information, please refer to OSC Staff Notice 41-701 *Issuance of Receipts for Preliminary Prospectuses and Prospectuses*.

We have recently noted an increasing number of requests in connection with closed-end and exchange traded funds for us to issue final receipts by either the last Thursday or Friday of a month in order to accommodate the underwriters' desire to book offerings as business for that particular month. We do not generally consider this to be a compelling reason to expedite our prospectus review process. We encourage filers and their underwriters that wish a final receipt by a particular month-end to file their preliminary materials and any necessary applications for exemptive relief sufficiently in advance of month-end to allow for review and resolution of any regulatory issues that may arise.

At a minimum, filers and their underwriters should consider filing their preliminary materials and any necessary applications for exemptive relief in the month before the month-end they wish to go final. You may also wish to review the service standards posted on our website which provide that we will use our best efforts to complete our review of investment fund prospectuses within 40 working days. Our reviews may take longer than this period when a fund is novel or includes novel features.

Two-tiered Structured Products – Top and Bottom Fund Prospectuses

We have recently advised filers seeking prospectus receipts for top and bottom funds in two-tiered structures, where the returns of the top fund are tied to the investments of the bottom fund, to submit the prospectuses for both funds at the same time for staff's review. This is because changes to the bottom fund's prospectus as a result of staff's comments may need to be reflected in the prospectus of the top fund. Filers should factor into their overall transaction timelines that both the top and bottom fund prospectuses need to be reviewed and receipted.

Two-tiered Structured Products - Continuous Disclosure Undertakings

We have been raising comments on prospectuses filed for structured products where one fund obtains economic exposure to another through the use of a forward agreement. The comments are aimed at ensuring that investors will also receive on-going disclosure regarding the fund that forms the underlying interest under the forward agreement because this is where the actual substantive portfolio of the top fund is held. Filers have typically resolved these comments by agreeing to file an undertaking to

provide investors with the option of also receiving continuous disclosure of the underlying interest and providing disclosure to that effect in the prospectuses.¹

Yield Disclosure

We have been raising comments in connection with indicative portfolio and yield disclosure in long form prospectuses for bond or dividend funds. The following responses have generally resolved the comments and, in our view, resulted in more balanced disclosure:

- Removing the indicative portfolio and any yield information from the cover page or summary and including it in the body of the prospectus only.
- Including cautionary disclosure about the differences there may be between the indicative portfolio and the fund's actual portfolio with respect to composition and yield.
- Removing any disclosure that describes what an investor would have earned on the investment had the fund been invested in the indicative portfolio for some past period of time.
- Including disclosure regarding the risk of default for bonds shown in an indicative bond portfolio in proximity to the indicative portfolio.

Filers may also wish to review the discussion contained in the Fall 2007 edition of the Practitioner regarding the disclosure of performance data.

Lapse Dates

We remind filers of section 2.7(4) of the Companion Policy to NI 81-101. This provision notes that an amendment to a prospectus of a mutual fund, even if it amends and restates the prospectus, does not change the date under Canadian securities legislation by which the mutual fund must renew the prospectus.

90 Day Limit between Prelim and Final

We remind filers that NI 41-101 and NI 81-101 prohibit a final prospectus from being filed more than 90 days after the preliminary receipt was issued. We encourage filers to keep track of this 90 day period.

In some cases, the Director has granted relief to allow filers to file the final prospectus beyond the 90 day period. These applications are more easily dealt with if the application is filed in a timely manner prior to the expiration of the 90 day period.

Auditor Consents

We remind filers of the requirements to file auditor consents contained in sections 2.6(1)(a) and 2.6(2) of NI 81-101. Section 2.6(2) also includes a requirement to file a consent in connection with future statements incorporated by reference at the time those future financial statements are filed.

The following is a general summary of some staff practices relating to the filing of auditor consents under NI 81-101 in connection with an amendment to a simplified prospectus and/or AIF.

- For slip-sheet amendments and amended and restated simplified prospectuses and AIFs, if new annual financial statements have been incorporated by reference since the date of filing the simplified prospectus and AIF, we will generally issue a comment regarding the filing of a new auditor's consent letter in respect of the new audited annual financial statements if the consent letter wasn't filed concurrently with the annual financial statements (see section 2.6 of NI 81-101).
- If there have been no new annual financial statements filed since the date of the simplified prospectus and AIF, but the slip-sheet amendment or the amended and restated simplified prospectus and AIF refers to a correction to the annual financial statements or contains amended information derived from annual financial statements, we will generally raise a comment regarding the filing of a new auditor's consent letter.

Best Efforts Offerings

We have noted a couple of recurring issues recently involving best efforts offerings. We remind long-form prospectus filers that conduct best-efforts offerings of the new 90 day limit to complete a best efforts offering. This limit is imposed under section 8.2 of NI 41-101.

¹ See, for instance, the disclosure provided in the prospectuses filed by Horizons AlphaPro Fiera Tactical Bond Fund dated June 29, 2009 and Marret High Yield Strategies Fund dated May 28, 2009 at pages 60 and 44 respectively.

Flow-Through LP Rollovers

- **IRC Review:** Prospectuses filed by flow-through LPs typically disclose that they will roll their assets into a related mutual fund and provide investors with units of the related mutual fund. This provides investors with a source of liquidity upon the termination of the flow-through LP. We have been raising comments to ask whether the manager of the mutual fund intends to refer the mutual fund's acquisition of the flow-through LP's assets to the mutual fund's IRC as we generally view the rollover to be a conflict of interest matter referable to the IRC of the mutual fund under NI 81-107.
- **Rollover Funds that are not Reporting Issuers:** As noted in the April 2007 edition of the Practitioner, we are continuing to raise comments if the flow-through LP discloses that it will roll its assets into a mutual fund that is not a reporting issuer due to our concerns with non-reporting issuers distributing securities to retail investors that may not otherwise qualify as exempt purchasers.

Unit Offerings and Calculation of Diluted NAV

We have been raising comments on unit offerings where the unit consists of a unit and a sweetener warrant that is exercisable at a set price for a limited period of time. The comments generally seek to confirm whether the fund intends to calculate and publish both a basic NAV and a diluted NAV.

Use of Consultants

We have noted an increasing trend of funds using consultants and managers marketing funds based upon the fund's relationship with a particular consultant. The fund's name often includes the name of the consultant and the prospectus discloses that the consultant will be providing the fund or the portfolio manager with varying forms of advice. We have been raising comments regarding whether the consultant is registered as an adviser. We encourage filers to think about this issue before filing a prospectus particularly when the fund is being prominently marketed based on its relationship with the consultant.

Continuous Disclosure

Review of NI 81-107 Related Disclosure

Investment Funds staff have started to review, on an issue-oriented basis, a sample of investment funds to evaluate compliance with the disclosure obligations introduced by NI 81-107. Our review began in Fall, 2009 and letters informing selected fund managers and funds of our review will be sent in due course.

Investment funds selected for review will be selected based on criteria designed to ensure a fair representation of fund family size and fund type.

Split Shares – MER Disclosure

We remind filers of the requirement contained under section 15.1(4) of NI 81-106 to calculate the MER for each class of securities. In the case of investment funds having capital shares and preferred shares outstanding, section 15.1(4) requires that MER be calculated for each of the capital shares and the preferred shares. We recognize that the preferred shares do not normally bear any costs until the net asset value of the capital shares has diminished completely. Preferred shares may also be considered as a liability to the capital shares and any distribution made to the preferred shares as interest costs to the capital shares. Consequently, we have been raising comments on both prospectus and continuous disclosure reviews to confirm whether a filer will be calculating MERs for each of the capital and preferred shares and whether the MER for the capital shares will include distributions paid on the preferred shares.

Public Inquiries

Related Party Underwritings of Approved Rating Debt Securities

We have received several inquiries regarding the meaning of approved rating under paragraph 4.1(4)(b) of NI 81-102. Section 4.1(4) provides an exemption from the prohibition contained under section 4.1(1) subject to several conditions including IRC approval and, if the securities underwritten are debt securities, the securities have been given and continue to have an approved rating by an approved rating organization.

Consistent with exemptive relief granted prior to the codification of the exemption under section 4.1(4), approved rating is intended to mean approved rating as defined under NI 44-101 and not approved credit rating as defined under NI 81-102.