1.1.2 The Investment Funds Practitioner – July 2014

OSC

THE INVESTMENT FUNDS PRACTITIONER

From the Investment Funds and Structured Products 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 and Structured Products 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 12th edition of the Practitioner. Previous editions of the Practitioner are available on the OSC website www.osc.gov.on.ca under *Investment Funds*. 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.

Announcements

Branch Name Change

Effective May 26, 2014, the name of the Investment Funds Branch was formally changed to the *Investment Funds and Structured Products Branch*.

In the last few years, there has been an increase in structured investment products the OSC primarily oversees which are sold to retail investors. Accordingly, the new name intends to better reflect the expansion of these product offerings in the market and the work of the Branch. The name change is also intended to signal that the OSC intends to treat comparable products sold to retail investors in a consistent way, despite their technical definitions in the *Securities Act* (Ontario).

Topical Reference Guide to the Practitioner

We recently posted to the OSC website a Table of Contents of prior editions of the Practitioner, organized by topic. We expect the table will be a useful and quick reference guide for locating topics discussed in previous editions of the Practitioner.

The Table of Contents will be updated concurrent with the publication of each edition of the Practitioner going forward. The Table of Contents can be found at ***http://www.osc.gov.on.ca/en/InvestmentFunds_topical-reference-guide.htm***

Structured Products

Reference Asset Fee Disclosure

Staff have observed that some pricing supplements for linked notes, whose reference asset is a fund or exchange-traded fund (ETF), do not disclose the fees associated with the ownership of the reference asset.

We remind filers that fees charged by the reference asset reduce its return and therefore the return of the notes (which is normally based on the return of the reference asset). Staff expect that the *Fees and Expenses* section in a pricing supplement will disclose any fees charged by the reference asset that affect the return of the notes. This can be accomplished by disclosing the MER of the reference asset in the *Fees and Expenses* section of the supplement.

Autocall Notes Disclosure

In our reviews of prospectus supplements qualifying the distribution of linked notes, staff are increasingly scrutinizing linked notes that have autocall features (Autocall Notes).

Similar to many other linked notes, an Autocall Note is a note linked to the price return of one or more underlying assets, such as a market index, an investment fund or a basket of securities (the Reference Asset). However, unlike other linked notes, an Autocall Note is automatically called by the issuer of the note if the price level of the Reference Asset, on one or more particular dates, is greater than or equal to a pre-determined level. Therefore, if the Reference Asset performs well, it is likely that the Autocall Note will be called by the issuer.

When an Autocall Note is called, holders of the Autocall Notes generally receive repayment of their original principal investment in the Autocall Notes plus an interest payment, which may increase for each year that the Autocall Notes remained outstanding before being called. In this way, holders of Autocall Notes do not directly benefit from the positive performance of the Reference Asset, but rather receive interest payments if the Reference Asset performs well.

However, if Autocall Notes are not automatically called during their life, then, at maturity, the holder of an Autocall Note receives an amount calculated pursuant to a formula described in the Autocall Note's prospectus. Generally, this return is similar to the return the holder would have received by investing in the Reference Asset directly, with some limited downside protection. In this way, holders of Autocall Notes are exposed to the downside risk of the Reference Asset and they may lose substantially all their investment in the Autocall Note if the Reference Asset loses substantially all of its value.

Therefore, if the autocall feature is triggered, an Autocall Note typically behaves like a fixed income or money market security, in that it repays the principal amount plus interest. On the other hand, if the autocall feature is not triggered, the Autocall Note behaves like an equity security, as the payout at maturity will be based on the performance of the Reference Asset.

As a result of the interest payment, staff are concerned that an Autocall Note could be mistaken for (and sold as) an alternative to fixed income or money market securities, even though the holder of an Autocall Note has downside risk not usually present in fixed income or money market securities.

In order to alert investors and dealers to this issue, staff have begun to request that the front page of Autocall Note prospectus supplements include a textbox disclosing that the Autocall Notes entail downside risk and are not designed to be alternatives to fixed income or money market instruments.

Staff continue to consider this issue and the particular risk features of Autocall Notes and will provide further guidance as needed.

Applications

Representations in Merger Approval Decisions

Staff have observed recent applications which contemplate the merger of funds with significantly different investment objectives. In such applications, staff have required filers to make detailed representations in the decision document with respect to (1) the reason(s) for the merger; (2) the process that the fund manager undertook to choose the continuing fund; and (3) the reason(s) why the merger is in the best interests of securityholders versus alternatives such as terminating the fund. Staff are generally of the view that generic or boiler-plate statements about the reduction of operating expenses, increased diversification and/or a larger profile in the marketplace provide insufficient detail.

Prospectuses

Suspension of Redemptions for Short-Term Trading

Staff recently reviewed certain preliminary simplified prospectuses which disclosed the ability of the fund manager to address short-term trading by 'blocking' the investor's account from further transactions for a certain period of time. The fund managers subsequently confirmed that this would include the suspension of redemptions.

We remind filers that, except in the circumstances contemplated by Part 10.6 of NI 81-102 *Mutual Funds*, a fund manager may not suspend redemptions. While fund managers should be addressing the adverse impacts of short-term trading, staff's general view is that suspension of redemptions is not a mechanism for this purpose.

Default Rate Feature – Direct Payment of Ongoing Dealer Service Fees

Further to staff's continued focus on mutual fund fee structures and dealer compensation models, we have recently become aware of certain investment fund series that have a default rate feature attached to the direct payment by investors of ongoing dealer service fees. Staff have reviewed the disclosure documents of several fund families to evaluate the extent of this practice. While not all funds or fund managers have this practice, staff have seen similar disclosure among those that do.

As reflected in the disclosure, typically the fund manager does not pay trailing commissions for ongoing dealer services out of the management fee for these series. Instead, investors in these series pay their dealers directly and the fund manager facilitates this direct payment by regularly (typically, each quarter) redeeming investor holdings of the series and remitting the proceeds to the dealer.

In terms of the amount of the fee, the disclosure for these series typically provides that, in the absence of receiving instructions from the dealer as to the rate of the fee within a stated range (for example, 0 to 1.5% of average net asset value per security), the fund manager will apply a stated default rate, which may be as much as the maximum rate of the stated range (in our example, 1.5%).

We understand that fund managers may have introduced the default rate feature to help optimize the administrative efficiency of dealer back offices and assist dealers who may wish to transition from the embedded fee (i.e. trailing commission) model to a direct payment model of paying ongoing dealer service fees.

While we generally do not take issue with fund managers facilitating direct payment arrangements, and would expect that a maximum rate be disclosed where the fund manager facilitates such payments, staff are of the view that no such payment should be made pursuant to the application of a default rate. We further consider that disclosure related to the direct payment arrangement should be made in the "Fees and Expenses" section of a simplified prospectus in the table under "Fees and Expenses Payable Directly by You" rather than only in the "Dealer Compensation" section, as is often currently the case.

In staff's view, the default rate feature is inconsistent with a critical attribute of the direct payment series, namely the negotiation of the service fee, which is intended to provide investors with heightened transparency and a clear expectation of the services to be rendered in exchange for the negotiated fee. While the default rate feature may contribute to administrative efficiency, it may have the unintended consequence of replacing the negotiation of the service fee. Staff's view is that the default rate feature blurs the lines between the attributes of the direct payment series and the embedded fee (trailing commission) series and is potentially misleading for investors.

We have consulted with staff in the OSC's Compliance and Registrant Regulation Branch, who further note that ongoing dealer fees of this kind are "operating charges" that dealers must disclose to their clients under the provisions of Part 14 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*.

We have indicated to filers our expectation that new funds not have a default rate feature. Going forward, we anticipate that on the reviews of renewal prospectuses, we will be asking fund managers for enhanced disclosure on these facilitated, direct payment arrangements, and in instances where a default rate feature exists, for the fund manager to tell us what would be a reasonable transition period needed to remove the application of any default rate.

We continue to review and monitor developments on mutual fund fee structures and dealer compensation models and will provide further guidance as needed. Issuers and their counsel are encouraged to contact staff in the planning stage of any structure that may give rise to questions concerning this issue.

Continuous Disclosure

IFRS Implementation

Investment funds, subject to National Instrument 81-106 *Investment Fund Continuous Disclosure*, are required to adopt International Financial Reporting Standards (IFRS) for financial years beginning on or after January 1, 2014. The first IFRS financial statements required to be filed will be the interim financial statements for the period ended June 30, 2014, which are due by August 29, 2014. Staff will be conducting a continuous disclosure review of the first IFRS financial statements. In addition to looking for IFRS compliance, we will be asking preparers general questions, such as how they have dealt with certain IFRS implementation issues, and for justification of accounting treatments under IFRS, such as how they have classified the investment fund's portfolio assets into the four categories of financial instruments.

Review of High Management Expense Ratios

Recently, staff completed a review of investment funds with high management expense ratios (MERs). In selecting our sample, we focussed on investment funds domiciled in Ontario, excluding labour sponsored investment funds due to their different fee structure. We sent letters to seven fund managers, asking questions relating to 11 of their investment funds which, in aggregate, had a net asset value (NAV) of $43.2 million.

Approximately half of the investment funds in our sample were selected because they disclosed MERs in excess of 5%. In our comment letters, we asked the fund managers of these funds to explain the nature and appropriateness of expenses charged to their funds. The average NAV for funds in this category was $3.4 million. These fund managers consistently commented that most fund expenses are fixed and the small size of the investment funds contributed to high MERs. The fund managers are planning to make their funds grow by focussing on marketing and distribution channels going forward, in an effort to increase the fund size and reduce MER. While fixed expenses are higher in proportion to the NAV of new funds, if such funds are not able to demonstrate that they are viable after a reasonable period of time, we would expect fund managers to consider all options available to them in order to improve performance, increase fund size, manage fund costs, achieve efficiencies of scale and, ultimately, reduce MER.

For the other half of our sample, fund managers had absorbed a significant level of expenses in order to present MERs after absorptions consistent with the industry average. We asked the fund managers whether this level of absorption was sustainable and what their plan was to reduce MERs in the future. Consistently, we heard that funds in this category were new funds and each fund manager intended to absorb expenses until their NAV grew to a size associated with an MER that investors would feel is reasonable. While waiving fund expenses is within the rights of fund managers, a pattern of absorbing expenses for many years may set investor expectations. Fund managers should make sure that those expectations are managed appropriately so that investors understand that waivers or absorptions could cease in the future, potentially resulting in a higher MER.

Process Matters

Materiality Thresholds for Repayments to Investors

On occasion, a fund manager has miscalculated and overpaid fees from a fund's assets due to error and then proposes to make repayments to investors. In certain instances, fund managers have proposed to make repayment to affected investors only where the repayment amount exceeds a materiality threshold of $50 per investor. These fund managers have submitted that the costs of mailing and the administrative burden of tracking down affected investors are significant if the materiality threshold is set below $50, such that the actual cost to the fund manager of making those investors whole exceeds the amounts owed to them. Some fund managers have pointed staff to The Investment Funds Institute of Canada (IFIC) Bulletin 22 *Correcting Portfolio NAV Errors*, last updated in December 2009, as support for a $50 threshold.

Staff note that Bulletin 22 has been removed from IFIC's public website and caution fund managers against placing too much reliance on that policy as it may be outdated. Fund managers should use their judgement in determining whether a $50 threshold is appropriate in their particular situation and be mindful of their statutory duty as fund manager when selecting a materiality threshold. In staff's view, that duty requires that fund managers have the obligation to make full repayment to investors. We continue to consider whether use of a threshold is appropriate in any circumstance and whether it is appropriate not to fully repay any overpaid amounts to investors.

Review Process Upon Clearing for Final Filing

Staff typically update the SEDAR project status "clear for final" to signal that we have generally completed our review of a preliminary or pro forma prospectus or prospectus amendment. Staff will often request a cumulative blackline before we "clear for final". Staff may agree to "clear for final" on the understanding that while we have generally completed our review, there may be certain non-substantive changes left to be reviewed on final filing.

On occasion, filers have asked staff to "clear for final" even though the filer expected to make further substantive changes to the prospectus. We remind filers that no substantive changes should be made to the prospectus after the SEDAR project status is "clear for final". In extraordinary circumstances where substantive changes are necessary, these changes must be highlighted to staff for review and possible comment.