Chapter 1

Notices / News Releases

1.1 Notices

1.1.1 The Investment Funds Practitioner – November 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 exemptive 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 13th 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.

Prospectuses

Fee-Based Series with Dual Dealer Compensation

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 intended for fee-based accounts that have a trailing commission embedded in the ongoing cost of the fund series.

In staff's view, a series intended for fee-based accounts with this type of dual compensation structure is inconsistent with a critical attribute of the fee-based series, namely the negotiation of the dealer's compensation, which is intended to provide investors with heightened transparency of the cost of the dealer's services and a clear expectation of the services to be rendered in exchange for the negotiated fee. Having a trailing commission embedded in a fee-based series, in staff's view, blurs the lines between the attributes of a fee-based 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 this practice may raise the issue of double charging by dealers, which is contrary to a dealer's general duty to deal fairly, honestly and in good faith with its clients under OSC Rule 31-505 *Conditions of Registration*. Investment fund managers should be mindful of their duty to act in the best interests of their funds, and ultimately their investors, when structuring and establishing dealer compensation models.

We have indicated to filers our expectation that new funds with fee-based series not have an embedded trailing commission. Going forward, we anticipate that on the reviews of renewal prospectuses where such series are identified, staff will be asking fund managers to tell us what would be a reasonable transition period needed to: (a) cease all new investments in the series, and (b) switch or redeem current investors out of this series or remove this dual compensation structure from the series.

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.

Minimum and Maximum Offering Amounts

In the November 2012 edition of the Practitioner, we reminded filers that the disclosure requirements set out in Form 41-101F2 for long form prospectuses and Forms 81-101F1 and 81-101F2 for simplified prospectuses apply to both the preliminary prospectus and the final prospectus unless otherwise specifically stated. We noted preliminary prospectuses with bulleted placeholders for items that should be disclosed at the time of the preliminary filing, such as the auditor's name in an audit report, the minimum offering amount on the cover page of a long form prospectus, expenses and fees, and the name of the custodian. In the March 2014 edition of the Practitioner, we further clarified that the management fee payable by the investment fund was included in this list, and reiterated staff's view that a preliminary prospectus should contain all material information before it is receipted at the preliminary stage.

Staff continue to review preliminary long form prospectuses that do not specify the offering size. In every case, staff expect a minimum offering amount to be disclosed in the preliminary prospectus, even if this amount is the minimum listing requirement. Filing a preliminary prospectus without a specified minimum offering amount may delay the issuance of the preliminary receipt.

We understand that it may not be possible to disclose a maximum offering size at the time the preliminary prospectus is filed, but where an investment fund manager can reasonably anticipate an offering size, that amount should be disclosed. Where a maximum offering has not been disclosed, but the investment fund manager has made certain assumptions about the offering size for the purpose of other disclosure provided in the preliminary prospectus, staff is of the view that those assumptions should be very clearly disclosed in the preliminary prospectus.

Redemption of Closed-End Fund Securities

On September 22, 2014, subsection 10.3(4) of NI 81-102 *Investment Funds* (NI 81-102) came into force, which requires that the redemption price of a security of a non-redeemable investment fund (NRIF) not be a price that is more than the net asset value (NAV) of the security determined on a redemption date specified in the NRIF’s prospectus or annual information form.

The purpose of this provision is to prevent dilution of the value of the other securities of an NRIF when the redemption price paid is higher than NAV. Currently, certain NRIFs permit securityholders to request, on a monthly basis, that the NRIF redeem the securities tendered for redemption at a price determined with reference to the market price of the securities (the Monthly Redemption Amount). However, this type of pricing mechanism could result in the Monthly Redemption Amount being more than the NAV of the security redeemed and, in such a situation, the NRIF would contravene subsection 10.3(4) of NI 81-102 if it honoured the monthly redemption requests.

To ensure that the calculation of the Monthly Redemption Amount is consistent with subsection 10.3(4) of NI 81-102, staff have asked in recent prospectus reviews for newly launched NRIFs, that the disclosure regarding the Monthly Redemption Amount include a statement that, in any event, the Monthly Redemption Amount will not be an amount that is more than the NAV of the investment fund.[1]

In staff’s view, such disclosure does not mean that the Monthly Redemption Amount is being calculated with reference to the NAV of the NRIF. Accordingly, an NRIF whose prospectus included such disclosure would not be considered by staff to be a ‘mutual fund’ under Ontario securities law.

Currency Hedging in Investment Objectives

Staff are aware that many investment funds employ currency hedging as a strategy to reduce foreign currency risk for investors. Sometimes the ability to employ currency hedging is discretionary and the investment fund’s prospectus discloses that the portfolio manager may hedge the foreign currency exposure and that the hedge may be anywhere from 0% to 100% of the fund’s foreign currency exposure. However, for other funds, the prospectus discloses that all or substantially all of the fund’s foreign currency exposure will be hedged, and that the hedging is not at the portfolio manager’s discretion.

In the second scenario discussed above, staff’s view is that the currency hedging described is an essential feature of the investment fund, and, therefore, should be disclosed in the fund’s investment objectives (as required by Instruction (3) to Item 6

1 For an example of such disclosure, see the prospectus of *Energy Leaders Plus Income Fund* dated September 24, 2014.

of Form 81-101F1 and Instruction (3) to Item 5.1 of Form 41-101F2). Accordingly, in our prospectus reviews, we have been indicating this expectation to filers.

T+2 Settlement Cycle for European Securities

On October 6, 2014, the majority of European Economic Area markets moved to a T+2 settlement cycle for all transactions executed on trading venues. This move was made in anticipation of the implementation of new Central Securities Depositories Regulation which will require T+2 settlement in Europe as of January 1, 2015.

Since transactions in Canadian investment fund securities settle on a T+3 basis, the move to T+2 in Europe creates a time discrepancy between the settlement of transactions at the fund level and the settlement of transactions in underlying portfolio securities exchanged on European markets. This mismatch between the respective settlement cycles may raise liquidity management issues for investment funds.

We expect investment fund managers to be evaluating their ability to accommodate T+2 settlement of transactions in European securities. Specifically, investment fund managers should be mindful of the leverage restriction in paragraph 2.6(a) of NI 81-102 which limits an investment fund's borrowings to settle portfolio transactions to no more than 5% of the fund's net asset value. The provision further requires that each borrowing effected for this purpose be a temporary measure.

In consultation with staff in the OSC's Compliance and Registrant Regulation Branch, we have conveyed to filers that we are of the view that borrowings effected by a fund within the 5% limit of paragraph 2.6(a) of NI 81-102 specifically to settle trades in European securities, and that as a whole, cause the fund to be in a state of overdraft over a prolonged period of time, will not be offside the restriction in paragraph 2.6(a). If, however, the borrowings effected in connection with T+2 settlement are expected to cause a fund to exceed the 5% borrowing restriction in paragraph 2.6(a), staff expect the fund to seek exemptive relief. We will consider applications for such exemptive relief on a case-by-case basis.

Staff request that as investment fund managers and portfolio managers gain experience and data operating under the T+2 settlement cycle for European securities, they share their experiences with us in order that we may better assess the impact of this change on Canadian investment funds and determine whether any regulatory action is necessary.

Disclosure of Securities Lending

On September 22, 2014, new prospectus and annual information form disclosure requirements with respect to securities lending by investment funds came into force.[2] These requirements apply to both mutual funds and non-redeemable investment funds and mandate disclosure of, among other items, the identity of the fund's securities lending agent, whether the securities lending agent is an affiliate or associate of the fund's manager, and the essential terms of the fund's securities lending agreement(s). We remind investment funds and their managers of these new requirements and advise that staff will be reviewing prospectus filings for this disclosure.

Continuous Disclosure

IFRS Release No. 1

In September 2014, staff commenced an issue-oriented continuous disclosure review focusing on the transition to International Financial Reporting Standards (IFRS). We reviewed the first IFRS financial statements required to be filed under National Instrument 81-106 *Investment Fund Continuous Disclosure*, which were the interim financial reports of investment funds with a calendar year-end. On September 30, 2014, staff issued IFRS Release No. 1 (the Release) to provide guidance to investment funds that had yet to file their first IFRS interim financial reports and related MRFPs. The Release outlined the types of deficiencies that had been identified in the course of our continuous disclosure review.

The Release is the first in a series of releases expected to be issued by staff. Upon completion of this first phase of our reviews, staff will publish our findings either by way of a release, an OSC staff notice, or another appropriate form of communication. As we expand our reviews by examining the interim financial reports of other investment funds with non-calendar year-ends and audited annual financial statements, we will issue further releases with additional guidance, as needed, in order to assist investment funds and their advisers with their IFRS filings.

[2] For the prospectus disclosure requirements, see the amendments to (i) Item 5(1) of Part A of Form 81-101F1, (ii) Item 4(1) of Part B of Form 81-101F1, and (iii) Item 3.4(1) of Form 41-101F2, as well as the new Item 19.11 of Form 41-101F2. For the annual information form disclosure requirements, see the new Item 10.9.1 of Form 81-101F2.

Asset Classes Susceptible to Liquidity Concerns

The continuous disclosure review program in the Investment Funds and Structured Products Branch uses a risk-based approach in selecting issuers for review and determining areas of focus. Our program aims to be responsive to current market conditions and trends. As market conditions change, we target areas where we foresee a potential change in risk exposure. Staff are currently conducting a series of targeted reviews focused on asset classes that may be more susceptible to liquidity issues, and in particular, funds with exposure to high yield fixed income, small cap equity and emerging market issuers.

As part of our targeted reviews, we are asking fund managers to provide information about:

- their policies and procedures concerning the evaluation of liquidity levels of individual fund holdings and how the fund holdings fit within the illiquid asset restrictions for mutual funds under NI 81-102;

- the specific factors and metrics they use to assess liquidity levels, the steps that may be taken should any particular holdings run afoul of internal thresholds for such metrics, as well as information concerning the frequency of such monitoring;

- from a risk management perspective, any stress testing and scenario analysis fund managers may have conducted for their fund portfolios; and

- the valuation of illiquid assets, the valuation policies and procedures and whether there is any oversight by the fund's independent review committee.

Upon completion of our reviews, we expect to publish our findings and provide guidance on best practices for liquidity assessment protocol, portfolio risk management and disclosure.

Senior Loans

As part of our ongoing continuous disclosure reviews focused on fixed income investment funds, as mentioned in the March 2014 edition of the Practitioner, staff have also focused on funds with exposure to senior loans. We are increasingly focused on the liquidity of senior loans and how such assets appropriately fit within the regulatory framework for investment funds, given that senior loans are not investment grade debt and have longer transaction settlement times than traditional debt securities, which can result in a mismatch between the settlement time for a senior loan and the time in which the investment fund must settle redemption requests for its securities.

As a result of our CD reviews, on recent prospectus filings, staff have been focused on the following key areas:

1. **Textbox disclosure:** Investment funds that have a specific mandate or invest the majority of their assets in senior loans have been asked by staff to add a textbox to the cover page of the prospectus under the name of the fund. We would expect, at a minimum, the textbox to disclose that: (a) the investment fund invests in senior loans, which are not investment grade debt, (b) settlement periods for senior loan transactions may be longer than for other types of debt securities such as corporate bonds, and (c) senior loans are not an alternative to holding cash or money market securities. Staff may also ask that this textbox disclosure be added to the summary disclosure documents for these funds, such as the Fund Facts or the summary disclosure document for exchange-traded funds.

2. **Management liquidity assessments:** Staff expect fund managers and portfolio managers to tell us how they will actively assess the liquidity levels of senior loan holdings, including utilizing specific metrics that can be referenced to measure liquidity. Factors and metrics that may be used to assess liquidity levels of senior loan holdings may include: (a) the frequency of trades and quotes for the particular holding, (b) the size of bid-offer spreads, (c) data freshness, (d) the size of the loan issue, (e) the credit rating of the issue, (f) the number of dealers willing to purchase or sell the holding and the number of potential purchasers, and (g) the mechanics of the transfer.

3. **Stress testing and scenario analysis:** We expect fund managers and portfolio managers to engage in stress testing of individual fund holdings, as well as senior loans as an asset class. Investment funds should consider and be prepared to meet higher than normal redemption demands, especially at a time when the senior loan market may be dislocated or stressed. As such, fund managers should always consider including in the mutual fund's portfolio, assets that settle within three days or less, including cash, to minimize redemption settlement mismatches.