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 18th edition of the Practitioner. Previous editions of the Practitioner are available on the OSC website www.osc.gov.on.ca under *Investment Funds & Structured Products* on the *Industry* tab. 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.*

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Portfolio Disclosure Practices of Exchange-Traded Funds

Staff have recently reviewed the practices of managers of exchange-traded mutual funds (ETFs) for disclosing the portfolio holdings of their ETFs. We have focused our review on instances where ETF managers disclose the daily portfolio holdings of their ETFs to authorized dealers, but not to the public.

Authorized dealers play a critical role in an ETF's liquidity. They are dealers who have entered into agreements with ETF managers that give them the ability to subscribe for securities in large blocks from the ETF at the net asset value per security calculated at the end of the day. Knowledge of the portfolio holdings of an ETF enables authorized dealers to assess whether there is a discrepancy between the market price of the ETF's securities and the underlying market value of the ETF's portfolio holdings (the underlying value) and to determine hedges for their positions. Where there is a divergence in these two values, authorized dealers carry out arbitrage trades that bring the market price of the ETF's securities closer to the ETF's underlying value. While investors who are not authorized dealers cannot engage in arbitrage trades with precise portfolio knowledge and the ability to transact directly with the ETF, the arbitrage activities generally help the ETF's securities to trade close to their underlying value with narrower bid-ask spreads.

Staff questioned whether disclosing an ETF's daily portfolio holdings to authorized dealers without concurrently disclosing the same information to the public creates a material information asymmetry between the authorized dealers and other investors, particularly retail investors. We focused on whether the information advantage that authorized dealers possess may make it possible for them to engage in unfair trading against other investors that is not consistent with market making activities to provide liquidity. As part of our review, we met with ETF managers, the Investment Industry Regulatory Organization of Canada (IIROC), the Toronto Stock Exchange, and other market participants to discuss our concerns and to better understand ETF portfolio disclosure practices and their impact.

We found that most ETF managers are disclosing portfolio holdings to the public daily and that the issue of asymmetric information is confined to a comparatively small segment of ETFs that are actively managed, where the ETF managers consider portfolio holdings to be proprietary.[1] This segment is, by our estimate, approximately 3% of the ETF market, comprising $3.5 billion in assets as of June 2016.

ETF managers submitted that entering into agreements with multiple authorized dealers for an ETF reduces the possibility of an authorized dealer unfairly benefitting from the portfolio holdings information, because competition for trades among the authorized dealers will narrow the quoted spread on the ETF's securities and bring the market price of the ETF's securities in line with their underlying value. We also heard submissions that ETF portfolio holdings information may be of limited use for retail investors, who are more concerned with the identity of the portfolio manager and the investment objectives, strategies and performance of the ETF.

[1] ETFs may be broadly classified into "index" ETFs that track a transparent index or asset and "non-index" ETFs that do not. Within the "non-index" group, there are (a) "rules-based" ETFs: ETFs that generally hold a portfolio that is rebalanced periodically in accordance with a rules-based investment methodology, and (b) "actively managed" ETFs: ETFs that have discretion to invest without regard to any index or rules-based methodology.

Staff had extensive discussions with IIROC about the risks that may arise from the authorized dealers' possession of the portfolio holdings information of actively managed ETFs. IIROC currently conducts market surveillance and trading reviews of trades of all securities, including ETF securities. We understand that IIROC, as part of its Trading Conduct Compliance (TCC) reviews, will examine the appropriateness of supervisory controls an authorized dealer has implemented to monitor the use of portfolio holdings information.

Based on our review and discussions to date, we believe that access to actively managed ETFs affords additional choices to investors, and that any risks from asymmetric information can be limited by IIROC's oversight through its TCC reviews. Staff, along with IIROC, will continue to monitor these practices and other developments in the industry, including the introduction of platform trading for mutual funds by various exchanges, which may offer a new avenue for managers of actively managed ETFs to offer their products without the need to disclose daily portfolio holdings to authorized dealers. If the product landscape changes and we find any harm to investors or the public interest as a result of the current portfolio disclosure practices, staff will recommend appropriate regulatory action, including further action to regulate such practices, or any other remedy required by the circumstances.

Review of Scholarship Plans

Staff have started to review, on an issue-oriented basis, scholarship plans registered as Registered Education Savings Plans, to obtain further information on their general operational practices. The scope of our review concerns methods of allocating income earned, practices concerning accumulated income payments, disclosure practices, investment restrictions and the implementation of the key elements of the Undertaking[2] for those providers which have executed an Undertaking. Staff's review began in November 2016 with letters sent to all of the scholarship plan providers in Ontario.

Staff will communicate our findings from this review in a future communication, as appropriate.

Independent Review Committees (IRCs)

Consideration of Different Securityholder Interests

An investment fund manager's duty of care is set out in s.116 of the *Securities Act* (Ontario). Members of an Independent Review Committee (IRC) have a similar duty with respect to conflict of interest matters referred to them by the investment fund manager. Section 3.9(1) of National Instrument 81-107 *Independent Review Committee for Investment Funds* imposes a fiduciary duty on a member of an IRC to (a) act honestly and in good faith, with a view to the best interests of the investment fund, and (b) exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

To act in the best interests of the investment fund, IRC members should have a good undertstanding of the broad investor groups invested in the fund. Staff encourage IRC members to conduct their analyses of the issues presented by fund managers not only by considering the interest of the investment fund itself, but also the interests of the securityholders of the fund. While conducting these analyses the interests of the investors in the fund should not be considered at an individual level but rather, take into account the impact of the proposed action on different groups of securityholders invested in the fund. For example, the analysis could consider the impact of the proposed action on taxable versus non-taxable investors, on newer investors versus longer term investors in the fund, and on

[2] A discussion of the Undertaking is provided in *The Investment Funds Practitioner* dated May 2013 under *Scholarship Plans*.

investors who purchased under a deferred sales charge versus investors who purchased on a front-end load basis.

Staff remind IRC members of the need to balance and consider the varied interests of securityholders when determining whether a proposed action concerning a conflict of interest matter is in the best interests of the investment fund.

Applications

Relief to Use Notice-and-Access Procedures for Securityholder Meetings

Staff have recently recommended exemptive relief from the requirement to deliver an information circular in connection with an investment fund securityholder meeting in order to deliver a "notice-and-access" document in connection with a notice-and-access procedure.[3] This relief allows an investment fund to deliver a notice-and-access document, which is a notice that provides basic information about the subject matter of the securityholder meeting, as well as instructions for how a securityholder can access the information circular online or request delivery of the information circular.

The terms of the relief are intended to be comparable to the notice-and-access procedure that non-investment fund reporting issuers are already permitted to use in connection with a securityholder meeting, under National Instrument 51-102 *Continuous Disclosure Obligations* (NI 51-102) (for communication with registered owners) or National Instrument 54-101 *Communication with Beneficial Owners of Securities of a Reporting Issuer* (NI 54-101) (for communication with beneficial owners). Both NI 51-102 and NI 54-101 specifically exclude investment funds from using the notice-and-access procedures available under those instruments. Staff's recommendation of this relief recognizes that, in appropriate circumstances, the notice-and-access procedures can be adapted for an investment fund securityholder meeting. Staff are comfortable that, in certain situations, permitting the use of notice-and-access procedures will help to mitigate the costs of holding securityholder meetings without impacting the disclosure available to investors.

The terms of this relief have generally followed the same requirements for the use of notice-and-access procedures under NI 54-101 and NI 51-102, with slight modifications to reflect the nature of investment fund securityholder meetings. The terms of the relief also require that fund managers be cognizant of their fiduciary duty to the investment funds they manage in considering whether the use of notice-and-access procedures is appropriate in respect of a particular investment fund securityholder meeting.

Relief to Use Cleared Swaps

Staff have previously recommended exemptive relief to facilitate the use by mutual funds of over-the-counter (OTC) swaps that are subject to mandatory clearing under the *Dodd-Frank Wall Street Reform Act* or similar legislation in Europe. More recently, we have been asked to consider expanding this relief so that it also applies to swaps that are cleared on a voluntary basis, as well as those subject to mandatory clearing, provided the same procedures are used.[4] Staff have recommended granting this expanded relief because we are comfortable that the infrastructure for clearing derivatives offers appropriate safeguards and protections in

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[3] See *Brandes Investment Partners & Co. et al.* dated December 5, 2016.

[4] See *In the Matter of RBC Global Asset Management Inc.* dated October 7, 2016 and also *In the Matter of Sun Life Global Investments Canada Inc.* dated May 10, 2016. In these decisions, the "cleared swaps" relief has also been granted for swaps cleared on a voluntary basis.

the trading of OTC swaps. Accordingly, the policy rationale for granting such relief is not affected by whether or not the OTC swaps are subject to mandatory clearing or are cleared on a voluntary basis.

Although the recent relief is more expansive, the terms and conditions of the relief remain the same. Accordingly, filers who wish to apply for this relief for OTC swaps that are cleared on a voluntary basis should ensure that such swaps use the same clearing infrastructure as OTC swaps subject to mandatory clearing.

Prospectuses

Scholarship Plans – Certificate of Annual Compliance with the Undertaking

In the May 2013 edition of the *Investment Funds Practitioner*, staff reported on our efforts to work with scholarship plan providers to consider the terms and conditions on which CSA staff would permit, by way of an Undertaking, scholarship plans to make limited investments of the income portion of the plans in equity securities, otherwise not contemplated by National Policy 15. This was in response to feedback that in the current low-interest rate environment, it has been difficult to obtain sufficient rates of return on plan investments that are currently limited to fixed income securities. To date, certain scholarship plan providers in Ontario have executed Undertakings which permit limited investments in equity securities.

Among the conditions of the Undertaking is that, on an annual basis, the manager will confirm the plans' compliance with the terms of the Undertaking by filing the Undertaking on SEDAR no later than the date of the final renewal prospectus for the plans. The Undertaking is to be filed as a public document on SEDAR and incorporated by reference into each plan's prospectus and the prospectus will state this fact. As an additional measure to certifying compliance, scholarship plan providers are reminded of their obligation to also file an *Annual Certificate of Compliance with the terms of the Undertaking.* This certificate, to be executed by the manager's Chief Executive Officer, Chief Financial Officer and Chief Compliance Officer, should be filed with a copy of the original Undertaking when the plan provider files a final renewal prospectus.

Any questions regarding the certificate or its contents can be directed to staff.

Reports

Guidance on Mutual Fund Sales Practices

The Compliance and Registrant Regulation Branch of the Ontario Securities Commission has completed a focused review of mutual fund sponsored conferences organized and presented by investment fund managers to assess compliance with Part 5 of National Instrument 81-105 *Mutual Fund Sales Practices* (NI 81-105).

Based on the results of this focused review, we wish to provide the following guidance relating to the selection of representatives attending mutual fund sponsored conferences.

Paragraph 5.2(b) of NI 81-105 permits an investment fund manager to provide a non-monetary benefit to a representative of a participating dealer by allowing the representative to attend a conference or seminar that the investment fund manager has organized if the selection of the participating representatives is made exclusively by the participating dealer, uninfluenced by the investment fund manager.

Paragraph 7.3(2) of the companion policy to NI 81-105 clarifies that the identification of specific representatives of a participating dealer by an investment fund manager to that participating dealer does not constitute compliance with section 5.2 of NI 81-105. The requirement in paragraph 5.2(b) of NI 81-105 reflects the CSA's position that investment fund managers should generally be dealing with participating dealers, rather than individual dealing representatives, in connection with mutual fund sponsored conferences. This permits participating dealers to maintain better supervisory control over their representatives and reduces the potential conflicts that may arise between the duties owed to clients by representatives and the benefits provided by investment fund managers to those representatives.

To avoid non-compliance with the requirements of paragraph 5.2(b) of NI 81-105, investment fund managers should put a process in place that will require the investment fund manager to:

> a) first, contact a participating dealer's head office requesting its involvement in the selection of representatives to attend the investment fund manager's mutual fund sponsored conference and request that the participating dealer distribute the mutual fund sponsored conference invitation to its representatives;
>
> b) ensure the opportunity to attend the mutual fund sponsored conference is available to all representatives;
>
> c) ensure the mutual fund sponsored conference is widely advertised (for example, in the advisor section of an investment fund manager's website and/or through widely known industry publications); and
>
> d) ensure that attendance is filled in a manner that does not influence the selection of representatives (for example, attendance is filled on a first come first served basis).

Staff will continue to monitor compliance with these requirements going forward.