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Notices / News Releases

1.1 Notices

1.1.1 The Investment Funds Practitioner – September 2016

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 17th 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*.

ANNOUNCEMENTS

Stakeholder Outreach

Staff have in the past encouraged filers to meet with us in advance of planning novel/complex transactions. We continue to encourage you to speak with us in these instances, and to speak with us about trends, challenges and innovations in the industry from your point of view. Staff are also always interested in learning more about your business operations, history, current structure, culture and short and long-term goals.

To that end, we invite stakeholders to propose a meeting with us that includes an educational session and an opportunity for questions and informal discussion. We would like to meet with investment managers of all sizes, independent review committees and key service providers, such as portfolio managers, custodians, auditors, and other third-party service providers. We also welcome feedback from investors and investor advocates.

If you are interested in meeting with us, please contact John Mountain, Director, Investment Funds and Structured Products Branch, at jmountain@osc.gov.on.ca.

REPORTS

Publication of Final Harmonized Report of Exempt Distribution

On April 7, 2016, the OSC published final amendments to introduce a new, harmonized report of exempt distribution (the New Report). The New Report came into force on June 30, 2016 in all CSA jurisdictions and applies to issuers and underwriters who rely on certain prospectus exemptions to distribute securities.

The New Report introduces additional disclosure requirements for investment fund issuers, such as disclosure of the National Registration Database (NRD) number for the investment fund manager, general type of investment fund, size of the investment fund and net proceeds to the investment fund. The filing deadline for investment fund issuers that file annually has changed from financial year-end annual reporting to calendar year-end annual reporting. There is a transition period available to the New Report for investment fund issuers that file on an annual basis. Please refer to Annex H – *Transition to the New Report* of the CSA Notice of Amendments to National Instrument 45-106 *Prospectus Exemptions* relating to Reports of Exempt Distribution for more information.

CSA Staff Notice 45-308 (Revised) *Guidance for Preparing and Filing Reports of Exempt Distribution*, provides additional guidance on completing and filing the New Report including the transition periods available and the applicable deadlines in Table 2 to Annex 4.

PROSPECTUSES

Investment Funds Offering Currency Hedged Class or Series

Staff have observed recent developments in how a class or series of an investment fund is established for the purpose of employing currency hedging strategies (the Hedged Series).

Under subsection 1.3(1) of National Instrument 81-102 *Investment Funds* (NI 81-102), each class or series of an investment fund that is referable to a separate portfolio of assets is considered to be a separate fund. As gains and losses associated with Hedged Series derivatives used to deliver currency hedging are referable only to the Hedged Series and not to all classes or series of the fund, the Hedged Series portfolio may differ from that of other series offered by the fund. Historically, fund managers have offered Hedged Series to provide this attribute to investors in the fund in order to allow for greater operational efficiency. This practice has been based on expectations that fund managers:

(i) have systems in place to accurately track the currency hedging instruments used in a Hedged Series, separate from the other class or series of the fund,

(ii) properly apportion currency hedging costs to a Hedged Series, and

(iii) have structured a Hedged Series such that investors understand the features and performance of the Hedged Series versus the other classes or series of the fund.

While staff's acceptance of the Hedged Series was historically based on the expectation that the Hedged Series would hedge all or substantially all of the foreign currency exposure associated with the investment fund's portfolio, recently we have seen some variations on this concept. For example, we have seen a Hedged Series employing discretionary currency hedging where a portfolio manager hedges anywhere from 0% to 100% of the Hedged Series' foreign currency exposure. In such circumstances, staff question whether it continues to be appropriate to consider the Hedged Series to not be a separate investment fund. Other variations that could result in different series having differing levels of discretionary currency hedging also cause us to question the appropriateness of this structure. Accordingly, we may raise comments during our prospectus reviews with a view to better understanding how these concerns are addressed.

Also, in giving further consideration to this type of structure, staff are concerned that, as currency hedging is typically not disclosed as part of the investment objectives of an investment fund that offers a Hedged Series, the manager may take the view that it can change or eliminate the currency hedging employed by the Hedged Series without securityholder approval. Staff, however, take the view that currency hedging is an essential aspect of a Hedged Series, which may be further bolstered by the name of the Hedged Series, or the manner in which the Hedged Series is marketed.

Accordingly, staff will request, as part of our prospectus reviews, that a fund that has a Hedged Series include in its prospectus disclosure that prior approval of securityholders of the Hedged Series will be obtained before the currency hedging strategy of the Hedged Series is changed. This will ensure that securityholders who purchased the Hedged Series for the purpose of obtaining currency hedging are given an opportunity to vote on any changes to this fundamental aspect of their securities.

Staff will continue to review and monitor developments with respect to currency hedging strategies employed by investment funds and will consider whether additional guidance or rule-making is needed in this area. Filers are encouraged to consult with staff in structuring classes or series of securities that may give rise to these issues.

APPLICATIONS

Disclosing Tax Consequences of Fundamental Changes

Certain proposed fundamental changes to an investment fund, such as a proposed merger of funds or a proposed change in the investment objectives of a fund, may have tax consequences for the funds involved and their investors. In recent reviews, staff have raised questions about the adequacy of the disclosure of these potential tax consequences in the related information circular.

In staff's view, managers are in the best position to analyze and provide information as to the overall tax impact of a proposed change on the fund and investors in the fund. We appreciate that the manager's analysis is based on prevailing conditions and may change as conditions change. However, in staff's view, the potential for changing conditions may be addressed in the disclosure and does not preclude providing meaningful disclosure about the various potential tax consequences of the proposed change for the various types of investors in the fund.

To inform the investor's decision on the proposed change and avoid misleading investors, staff's view is that the disclosure in the information circular should provide a balanced discussion of the potential tax consequences of the change. For example, some fund mergers are effected on a "tax-deferred" rollover basis, but only after a portion of the terminating fund's portfolio has been liquidated before the merger. In circumstances where this pre-merger liquidation is expected to result in distributions for taxable investors, staff's view is that the information circular could mislead investors if it describes the merger as tax-deferred without also disclosing the expected tax consequences of the pre-merger liquidation, i.e. distributions for taxable investors.

Staff note that section 5.6 of NI 81-102 requires that the materials sent to investors in connection with a proposed merger include a circular that describes, amongst other things, the income tax considerations for the funds participating in the transaction and their investors. However, other types of fundamental changes may result in tax consequences for investors as well. For example, a proposed change in investment objectives could involve liquidations of portfolio securities expected to result in distributions for taxable investors. Staff view tax consequences arising from a fundamental change to be relevant information for investors. As such, our view is that the circular provided to investors in connection with a fundamental change should describe the income tax considerations for the funds participating in the transaction and provide sufficient detail to enable reasonable investors to make an informed decision.

Staff also expect that, when referring a proposed fundamental change to the IRC for its approval or recommendation, the investment fund manager would provide the IRC with the manager's analysis of the expected overall tax impact of the change on the fund and investors in the fund, so that the IRC may consider whether the proposed fundamental change, in its entirety, meets the standard for IRC approval or recommendation as set out in subsection 5.2(2) or subparagraph 5.3(1)(a) of National Instrument 81-107 *Independent Review Committee for Investment Funds*, as appropriate.

CONTINUOUS DISCLOSURE

Review of Fund-of-Funds Disclosure of Fees and Expenses

Last year, staff commenced an issue-oriented continuous disclosure review focused on the disclosure of fees and expenses for fund-of-funds. Our review had the following objectives:

- to determine whether the calculation of the management expense ratio (MER) and the trading expense ratio (TER) for fund-of-funds includes the expenses of underlying funds in compliance with National Instrument 81-106 *Investment Fund Continuous Disclosure*,

- to review fund manager policies and procedures regarding the prohibition on the duplication of fees for funds that invest in underlying funds, and

- to assess whether the disclosure about fees and expenses for funds that invest in underlying funds is clear and transparent.

Our review included 29 investment funds managed by 16 fund managers, consisting of conventional mutual funds, exchange-traded funds (ETFs) as well as pooled funds.

The main findings from our review are:

1. MER and TER Calculations

We found that a number of top funds that invest in underlying ETFs did not include the expenses of the ETFs in the calculation of MER and/or TER. Many of these top funds disclosed MERs and TERs that were materially understated. This resulted in re-filings of their management reports of fund performance to correct the MER and/or TER.

We remind fund managers to "look-through" the expenses in fund-of-funds when calculating the MER and the TER for top funds, including top funds that invest in third party conventional mutual funds and ETFs. Fund managers should use reasonable estimates when determining the expenses of underlying funds managed by third parties.

2. Duplication of Fees

Our review confirmed that fund managers generally have policies and procedures in place to ensure that there is no duplication of fees in fund-of-funds. We observed that top funds generally invest in a series of securities of affiliated mutual funds that do not have management fees or performance fees. However, we also observed top funds that invest in underlying funds with management fees and/or performance fees.

3. Prospectus Disclosure

For top funds with investment objectives to invest in underlying funds, we have seen prospectus disclosure of a minimal management fee even though the underlying funds have higher management fees. Staff are concerned that the management fee disclosure provided by top funds, particularly for new funds without historical MERs, may be misleading if there is no prospectus disclosure explaining that the underlying funds may have higher management fees. Staff expect the top fund to provide sufficient disclosure to clearly explain the impact of the expected management fees of the underlying funds on the top fund's MER.

Liquidity Risk Management

Staff continue to assess whether our rules and guidance remain up-to-date and responsive to industry trends and market developments. In the past, staff have conducted reviews focused on the potential mismatch between the redemption terms of funds and liquidity of the underlying fund assets. On June 25, 2015, staff published OSC Staff Notice 81-727 *Report on Staff's Continuous Disclosure Review of Mutual Fund Practices Relating to Portfolio Liquidity* (Staff Notice), which provided our observations and recommendations concerning industry liquidity risk management practices in place at the time. We encourage market participants to review the contents and use the guidance provided in the Staff Notice.

Staff continue to monitor global research and recommendations on the issue of liquidity risk management, including the recent consultation by the Financial Stability Board (FSB) entitled "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" published on June 22, 2016. Staff will also monitor the recommendations from the International Organization of Securities Commission (IOSCO) and Securities and Exchange Commission (SEC) concerning liquidity risk management in the coming months and respond to such recommendations. In addition to monitoring international and domestic developments, staff will seek to engage the investment fund stakeholders in constructive dialogue on the potential for guidance or reforms that may strengthen the ability of, and provide more tools for, investment funds to better manage liquidity risks.

PROCESS MATTERS

Materials to be Filed with Exemptive Relief Applications

Staff continue to see applications that are incomplete, which may delay staff's ability to review them, and in some cases, to even start the review. Filers should keep the following in mind when filing an exemptive relief application:

- ***Reference most recent previous decisions***

While previous decisions granted are not determinative, staff regularly compare applications to prior applications and are expected to explain to the decision maker how the application differs. The more recent the similar previous decision, the more likely it is reflective of the Commission's current view regarding the type of relief requested. An application should not only reference similar previous decisions that support granting the relief requested as contemplated by Part 5 of National Policy 11-203 (NP 11-203), but also should reference the most recent similar previous decisions.

- ***Address material similarities/differences***

The application should explain how the previous decisions referenced support granting the relief requested and address materially different key facts. Filers may wish to consider contacting staff if there is any question about whether particular facts are key, since a material difference in key facts may constitute a novel aspect of the application and impact the timing for review and outcome of the application.

- ***Provide adequate description of the facts***

The application should set out the specific provision from which relief is requested, the specific facts that trigger the application of that provision and an explanation of how those facts trigger that provision.

- ***Provide adequate and tailored submissions***

The application should set out submissions that make the case for the relief requested and form the basis on which staff can recommend the requested relief to the decision maker on the applicant's specific facts.

Filers should refer to the relevant legislative test that provides the decision maker with the jurisdiction to grant the requested relief and provide submissions that demonstrate how the test is met. For example, an application for relief from the conflicts of interest provisions in section 111 of the *Securities Act* (Ontario) (the Act) should provide submissions that demonstrate, rather than merely state, that the proposed investment represents the business judgment of responsible persons uninfluenced by considerations other than the best interests of the investment fund, or is in fact in the best interests of the investment fund as contemplated by section 113 of the Act.

In determining whether or not we can recommend the requested relief staff refer to the legislative test and consider the policy reasons for granting the relief (for example, whether the relief would promote market efficiency without prejudicing investors) and what key facts or other key elements of the application satisfy the policy reasons. Staff typically look for submissions that clearly describe the business necessity for the relief and the benefit to investors.

- ***Provide tailored draft decision***

Applications should provide a draft form of decision with relevant representations and proposed conditions for the requested relief, which are specific to the facts of the application. The form of decision should follow Annex A, B, C or D of NP 11-203, as appropriate.

- ***Timing***

As set out in section 5.2(5) of NP 11-203, filers should file application materials sufficiently in advance of any deadline to ensure that staff have a reasonable opportunity to complete the review and make recommendations for a decision. Applications for novel relief may take longer than the OSC's 40 business day service standard as, for example, the passport policy requires certain additional steps to take place, such as consultation with the other CSA jurisdictions.

INDEPENDENT REVIEW COMMITTEES (IRCs)

IRC Reporting under Section 4.5 of NI 81-107

Staff have received inquiries about whether a materiality threshold applies to the reporting requirement on Independent Review Committees (IRCs) pursuant to section 4.5 of National Instrument 81-107 *Independent Review Committee for Investment Funds* (NI 81-107).

Section 4.5 of NI 81-107 requires an IRC to provide written notice to the principal regulator when the IRC becomes aware of any instance in which the fund manager acted in certain conflict of interest matters[1] but did not comply with *a condition imposed by securities legislation or any IRC approval*. A similar requirement has also been included in exemptive relief decisions granting relief from the conflict prohibitions to permit, for example, interfund trading involving pooled funds or pooled fund purchases of securities of related issuers. Staff were recently asked whether IRCs who become aware of a breach of this type of condition are still required to notify the fund's principal regulator if the IRC or the fund manager consider the breach to be, in their view, 'inconsequential' or 'immaterial' to the fund or its securityholders.

Staff's view is that a materiality threshold should not be applied to the IRC's reporting requirement under section 4.5 of NI 81-107 or the mirrored requirement in exemptive relief decisions. If an IRC becomes aware of any instance involving a breach of

[1] The three conflict of interest matters are set out in subection 5.2(1) of NI 81-102, namely (i) interfund trading (ii) purchases of securities of a related issuer and (iii) investment in securities offerings underwritten by a related party.

condition imposed by securities legislation or IRC approval concerning conflict of interest matters, it is required to report it to the fund's principal regulator. Staff understand that, in the IRC or the fund manager's view, the consequence of the breach may not be material, but the reporting obligation enables staff to know why the compliance procedures of the fund manager may not have worked and how the fund manager proposes to avoid similar breaches in the future.

Staff expect the letter reporting such instances to come from the Chair of the IRC and to discuss (i) the circumstances and facts leading to the breach of condition, (ii) factors relevant to the IRC's consideration of the matter, (iii) how the breach was remedied, (iv) whether the IRC is satisfied with the fund manager's handling of the matter, and (v) how the fund manager plans to avoid similar instances in the future. Staff also remind IRCs of the requirement in section 4.4(1)(h) of NI 81-107 to disclose such instances in the IRC Report to Securityholders that is prepared annually for investment funds that are reporting issuers.

STRUCTURED PRODUCTS

Frequently Asked Questions – Structured Notes Distributed Under the Shelf Prospectus System

In January 2015, CSA staff published CSA Staff Notice 44-305 – 2015 *Update – Structured Notes Distributed Under the Shelf Prospectus System* (the Notice) to provide further guidance regarding disclosure that issuers should consider in offering documents for structured notes. Since that time, we have received several questions with respect to the Notice to which we wish to respond as well as discuss some other issues. Our responses to these questions are set out in the attached Appendix.

APPENDIX

Frequently Asked Questions and Other Issues concerning Structured Notes

Q: *Can I use the term "estimated value" of the note as opposed to the "estimated fair value"?*

A: We received some questions regarding whether issuers may refer to the "estimated value" of a note as opposed to the term "estimated fair value" which we used in the Notice. Our primary objective in the Notice was to encourage issuers to be more transparent regarding the estimated value of the notes which they internally prepared and the potential profit to be made on a note, but not mandate specifically how the estimates should be calculated or to impose specific fair value accounting concepts. We believe this approach to be consistent with the approach taken in the U.S. by the Securities and Exchange Commission (SEC). We leave it to issuers to decide which term they are more comfortable using when disclosing their estimates.

Q: *What discount rate should I use when estimating the value of a zero coupon bond?*

A: We received questions regarding whether there was a staff view on which discount rate issuers should use for the valuation of the zero coupon bond that issuers partially hedge their exposure under the notes with. As discussed above, staff did not express a view in the Notice regarding specifically how estimates should be prepared. As such, issuers should continue to use the reasonably selected discount rate they have been using. We expect, however, that issuers will disclose what discount rate they have used and why.

Q: *Can I include contingent costs in my estimate of a note's value?*

A: It is our understanding that industry practice is not to include contingent costs in the estimate of a note's value. The estimate is generally based upon the valuation of the note's bond and derivative components. If an issuer does choose to include contingent costs, we expect it to disclose what contingent costs are included and why those costs are included in the calculation.

Q: *Can I disclose a straight line depreciation of the difference between the note's issue price and its estimated value or fair value?*

A: It is our understanding that industry practice is not to disclose a straight line depreciation of the difference between the issue price of the notes and their estimated fair value. Also, in our view, this information may be of limited assistance and cannot fairly be compared against annual management fees investors must pay in connection with other investment products such as mutual funds.

Q: *Where on the cover page should I disclose the note's estimated value or estimated fair value?*

A: We encourage issuers to include the disclosure on the first page of the pricing supplement in a prominent location or, if formatting is an issue, in the introductory paragraph that immediately follows the description of the notes offered.

Q: *How should I disclose the estimated value or fair value for Delta-1 notes?*

A: In instances where banks offer notes that are linked to a particular strategy, usually a quantitative model, and that have no derivative component that either boosts the return, calls the note or provides some downside protection, there may not be an embedded profit in their offering price. As such, the fair value estimate is typically the offering price minus the dealer costs. In instances where banks are offering such notes, we ask for additional disclosure to be included in the paragraph on the cover page that discloses the fair value estimate. We have requested that the additional disclosure be bolded and state that the estimated value or fair value does not include the other fees (i.e. management fee, withholding taxes, etc.) that will be charged to the notional portfolio over the term of the notes and reference the fees and expenses section in the pricing supplement.

Q: *What disclosure is expected to explain why the estimated value may be different than the price at which an investor can sell the note in the secondary market?*

A: As noted in section 1.1 of the Notice, issuers are expected to include an explanation as to why the estimated value of the note and the initial secondary market price will differ (the Delta). In order to satisfy this disclosure expectation, the disclosure should focus on the Delta immediately once the note is issued rather than the Delta once time elapses and market forces affect the note's price.

Q: *Should I disclose the note's estimated value or fair value in the note's marketing documents?*

A: Staff note that the marketing documents that are typically used to sell notes often do not include disclosure of the estimated value or fair value of the notes. We encourage issuers to include the disclosure of the estimated value or fair value and a brief explanation of its meaning in marketing materials going forward.

OTHER ISSUES

Hedging Activities

UBS Settlement and market price movements as a result of hedging activities by the issuer

Staff are aware that some issuers may hedge the liability under their notes sold by purchasing and/or selling the reference asset in the market. Staff are concerned that such hedging activity, if conducted prior to the notes notionally buying/selling those same reference assets, could, in some instances, materially affect the notional purchase or selling price that is used in calculating the return on the notes. This could be of particular concern when the reference asset is thinly traded or illiquid.

We encourage issuers to review the settlement agreement entered into between UBS and the SEC[2] and consider whether they have adequate systems and procedures in place to help ensure:

- their hedging activities do not have a material adverse impact on the value of the note's return,
- the value of the different inputs that comprise the return on the note are derived as objectively as possible, and
- all relevant costs associated with the note are adequately disclosed.

Pre-Clearance Process

Staff remind filers that, in order to expedite the pre-clearance process, to please include in the accompanying pre-clearance cover letter the information noted section 3.2 of the Notice. Failure to do so may substantially delay staff's review.

Fees

Staff remind filers to ensure that the $500 fee required for the filing of a prospectus supplement in relation to a specified derivative (as noted in Appendix C to OSC Rule 13-502 – *Fees*) is paid in connection with each new (i.e. not amended) pricing supplement filing. Staff conducted an audit of the fees paid and found some deficiencies.

[2] See: https://www.sec.gov/litigation/admin/2015/33-9961.pdf