

1.1.2 OSC Staff Notice 81-717 – Report on Staff’s Continuous Disclosure Review of Portfolio Holdings by Investment Funds

**OSC STAFF NOTICE 81-717
REPORT ON STAFF’S CONTINUOUS DISCLOSURE REVIEW OF
PORTFOLIO HOLDINGS BY INVESTMENT FUNDS**

Purpose of the Notice

This notice reports the findings and recommendations of staff of the Investment Funds Branch of the Ontario Securities Commission (**Staff** or **we**) arising from a targeted review of portfolio holdings and other related disclosure filed by investment funds. This notice supplements the guidance and interpretations provided in National Instrument 81-106 *Investment Fund Continuous Disclosure (NI 81-106)*, National Instrument 81-101 *Mutual Fund Prospectus Disclosure (NI 81-101)*, and Form 81-101F3 *Contents of Fund Facts Document (Form 81-101F3)*.

Objective and Scope of Review

Disclosure of a fund’s investment portfolio provides key information to investors in assessing consistency and performance against the fund’s stated investment objectives and strategies. As part of our continuous disclosure review program, we recently sought to assess how effectively the categorization of a fund’s investment portfolio in its disclosure reflects the fund’s investment objective and to assess regulatory compliance in the fund’s on-going disclosure.

Between August 2011 and June 2012, staff reviewed portfolio disclosure of a sample of investment funds as presented in their annual or interim Management Reports of Fund Performance (**MRFPs**), Fund Facts as applicable, and Statements of Investment Portfolio. These items were reviewed against the investment objectives set out in the prospectus of each fund.

We reviewed disclosure of a sample of 203 investment funds managed by 40 different fund managers with a head office in Ontario, covering annual financial periods ending in 2010 and interim periods ending in 2011. Fund managers included in the sample were selected for review based on criteria designed to reflect a fair representation of fund family size and type.

Of the 40 fund managers reviewed,

- 24 were fund managers of conventional mutual funds representing 52.5% of total assets under management of all conventional mutual funds
- 5 were fund managers of exchange-traded funds (**ETFs**) representing approximately 98.7% of the total market capitalization of ETFs listed on the TSX
- 6 were fund managers of closed-end funds
- 3 were fund managers of flow-through limited partnerships; and
- 2 were fund managers of labour sponsored investment funds.

Summary of Findings and Comments

Our findings indicate that the portfolio disclosure presented in a fund’s MRFP, Statement of Investment Portfolio and Fund Facts can be improved to provide more meaningful information to investors about the composition of the portfolio and how the fund’s investments align with the investment objectives set out in the fund’s prospectus. Specifically, we observed three key trends:

- the use of portfolio categories that did not reflect the unique characteristics of the fund as set out in its investment objectives;
- inconsistencies in the categories used across different disclosure documents of the fund to describe the investments in the portfolio; and
- the use of broad, generic categories instead of more discrete, specific categories that would provide more meaningful information on portfolio composition and the alignment of portfolio investments with the fund’s investment objectives.

We sent comment letters to all 40 fund managers in our sample. Of the 203 funds we reviewed, we issued comments on 120 funds. No funds were required to refile or restate any disclosure documents as a result of our review. However, the fund managers that received a comment letter committed to improve future disclosure as follows:

- 33% will improve the portfolio listing in their financial statements;
- 36% will improve portfolio categorization in their MRFP; and
- 26% will improve the categorization of the investment mix in their Fund Facts.

Our findings are discussed below.

1. Statement of Investment Portfolio – Financial Statements

1.1 Existing Requirements in NI 81-106

NI 81-106 sets out the minimum disclosure requirements for an investment fund's financial statements.¹ For example, section 3.5 of NI 81-106 requires investment funds to separate long and short portfolio holdings and to aggregate disclosure for portfolio assets having the same description and issuer.²

Staff take the view that the portfolio holdings disclosed in the fund's financial statements should be presented in a way that is meaningful and understandable to readers and that the statement of investment portfolio should be clearly organized. In our view, subtotals should be provided so that investors can understand their exposure immediately, without having to perform calculations.

In addition, we remind investment funds of the guidance provided by the Canadian Institute of Chartered Accountants (CICA)³ which has indicated that the statement of investment portfolio should provide a profile of securities, summarized by type and/or other groupings considered the most meaningful to users. One of the suggested groupings is classification by investment objective.

1.2 Choice of Portfolio Classification in view of Investment Objectives

From our review of the statement of investment portfolio in the financial statements, we saw that the majority of fund managers rely on common portfolio breakdowns. As a result, many funds in the same fund family break down their portfolios using the same categories regardless of the type or unique characteristics of the fund.

Staff generally expect the statement of investment portfolio to break down the portfolio into the most discrete, specific categories given the nature and unique characteristics of the fund. For example, we observed one fund focused on investing in equity securities of issuers connected to global financial infrastructure which categorized its portfolio by country. In our view, further classification of the portfolio into specific categories such as sector or company type would have better demonstrated how the fund's investments aligned with its investment objectives.

Staff look to the investment objectives and strategies of an investment fund, as disclosed in the prospectus, to determine its key characteristics. Since the investment objectives and strategies outline what the fund will primarily invest in and how it will distinguish itself from similar funds, we generally expect the objectives to be reflected in the categories selected. This will allow an investor to better understand if the fund holds what it set out to invest in, or whether over time its investments have drifted from the stated objectives.

Some fund managers expressed the view that since the statement of investment portfolio is part of the financial statements, they choose to classify the portfolio by asset class, consistent with the purpose of the financial statements. Other fund managers thought it would be more beneficial to use standard classifications from service providers such as Bloomberg or Standard & Poors, which are widely available and would offer comparability when reviewing financial statements of similar funds across fund families. A number of fund managers expressed the view that groupings based on investment objectives would only detract from the clarity of the existing disclosure.

In Staff's view, it is critical that an investor be provided with disclosure that shows how the investments made by the fund are consistent with the fund's investment objectives. Presenting breakdowns strictly by asset class may be of limited utility to investors. Classification by the categories reflected in a fund's investment objectives is important because it is likely that the fund was sold to the investor based on the distinguishing characteristics described in the fund's investment objectives and strategies.

¹ Section 2.1(2) of Companion Policy 81-106CP.

² Section 3.5(2) and (3) of NI 81-106.

³ The Research Report *Financial Reporting by Investment Funds* in 1997, which was subsequently updated in 2009. The Study Group was comprised primarily of auditors and members of the investment fund industry.

Market Capitalization

Some funds stated in their investment objectives or strategies that they would invest in companies of a certain market capitalization, only to fail to break down their portfolio by issuer size in the financial statements.

Again, we generally expect that if the fund or the name of the fund indicates a focus on market capitalization, a break down by company size should be included to demonstrate to investors that the investment objectives and strategies have been followed. While we recognize that the industry has not standardized definitions for small, medium, and large capitalization, we encourage portfolio managers to consider using their own categories which can be explained in the disclosure. We also encourage fund managers to revisit the wording in the prospectus to ensure clarity and plain meaning.

1.3 Other Disclosure Documents

Some fund managers stated that the additional classifications we requested in the financial statements were already provided in other parts of the fund's continuous disclosure record, such as in the MRFP, Fund Facts, or the fund's website. We remind issuers that while the MRFP is intended to supplement the financial statements, funds are not required to bind or deliver the two documents together,⁴ and that each continuous disclosure document must be considered independent of any other document. In light of this, fund managers should consider whether the specific portfolio categories used in the MRFP should also be mirrored in the financial statements. We note that this approach is consistent with the principles underlying Canadian generally accepted accounting principles (**Canadian GAAP**) which discuss the concepts of reliability, relevance and understandability.⁵

1.4 Inconsistency in Disclosure Documents

In some cases, we identified inconsistency between the disclosure in the financial statements and the fund's other documents. For example, one fund's results of operations in the MRFP discussed how the fund's performance was affected by sector and investments in different countries, yet the portfolio categorization in the financial statements was based only on geography. We generally take the view that classifications in the statement of investment portfolio should provide the same level of insight in the financial statements as is available in the MRFP, especially since investors may not review or receive both documents.

1.5 Broad Categories

As part of our review, we commented on categories in the statement of investment portfolio we considered to be too broad or generic. For example, we reviewed a fund identified as a gold and precious metals fund by its name, which classified over 96% of its portfolio as "Mining and Precious Metals" without any further classification. While we did not consider the heading Mining and Precious Metals to be incorrect, the presentation of the portfolio would have been enhanced by use of more discrete, specific categories providing a more detailed description of the fund's portfolio investments, for example, by type of precious metal. Staff expect that the categories used will reflect the unique composition of a fund's portfolio. We also generally expect that fund managers will consult with their portfolio managers on how the fund's portfolio should be categorized to effectively demonstrate how the fund's investments are aligned with its investment objectives.

In another case, we observed that a fund's classifications had not been updated to reflect a change in the portfolio mix and, as a result, a number of companies with varying business models were grouped together under the broad heading "Business", which we found to be vague and confusing. Staff expect funds to perform periodic reviews to ensure that the categories initially selected in the Statement of Investment Portfolio remain applicable and relevant to the fund and its investment objectives.

2. Management Report of Fund Performance

2.1 Existing Requirements in Form 81-106F1

Form 81-106F1 *Contents of Annual and Interim Management Report of Fund Performance (Form 81-106F1)* includes a number of requirements to ensure that the MRFP is in a format that assists readability and comprehension.⁶ It also specifies that care should be taken to ensure that the information in the Summary of Investment Portfolio is presented in an easily accessible and understandable way⁷.

Form 81-106F1 further requires that an investment fund should use the most appropriate categories to break down its summary of investment portfolio given the nature of the fund. If appropriate, more than one breakdown can be used according to type, industry, geographical locations, etc.⁸

⁴ Refer to National Instrument 81-106, Part 5 – *Delivery of Financial Statements and Management Reports of Fund Performance*.

⁵ Section 1000 of the CICA Handbook.

⁶ Item 1(c) – Part A of Form 81-106F1.

⁷ Instruction 1 to Item 5 – Part B of Form 81-106F1.

⁸ Instruction 2 to Item 5 – Part B of Form 81-106F1.

2.2 Summary of Investment Portfolio

In our review of funds' MRFPs, we observed the same trends and raised the same comments discussed above under *Choice of Portfolio Classification in view of Investment Objectives and Broad Categories*.

2.3 Top 25 Holdings – Labour Sponsored Investment Funds (LSIFs)

We observed that the two labour-sponsored investment funds we reviewed did not list their top 25 holdings in their MRFPs. One of these LSIFs considered the obligation to disclose the fund's top 25 positions to only apply if the fund held more than 25 positions.

LSIFs are reminded of the requirement in Instruction 10 to Item 5 – Part B of Form 81-106F1 to disclose the fund's top 25 positions. If the LSIF holds fewer than 25 positions, we take the view that these positions should be disclosed in the Summary of Investment Portfolio in the MRFP.

3. Fund Facts

3.1 Inconsistency in Portfolio Categorization – Fund Facts versus the MRFP

As part of our review, we compared the categories used to break down fund portfolios in the Fund Facts against those disclosed in the funds' MRFP. In most cases, at least one of the categories used in the MRFP to break down the portfolio was reflected in the Fund Facts.

However, we also observed some inconsistencies. We saw portfolio breakdowns in the Fund Facts of some funds that were based on categories not used in the MRFP. In these instances, we viewed the categories used in the MRFP as more reflective of the investment objectives of the fund as well as more appropriate for use in the Fund Facts. For example, a life sciences and technology mutual fund categorized its Investment Mix in the Fund Facts by generic sectors such as information technology, health care, cash, and telecommunication services among other categories. The fund's MRFP, however, used specific categories more suitable to life sciences and technology such as software, communications equipment, computers and peripherals, internet software and services.

In another example, an asset allocation fund categorized its portfolio in the MRFP by sectors such as Canadian equities, Canadian fixed income, global fixed income, cash and cash equivalents, international equities and U.S. equities. The Investment Mix, however, was categorized by the type of underlying funds in which the fund invested.

We also observed a small number of mutual funds that used two or more categories in their MRFP to break down the fund's portfolio while the Fund Facts used only one of these categories. In Staff's view, the Investment Mix of each fund would have better reflected the fund's investment objective if an additional categorization, consistent with that of the MRFP, had also been included. This approach would have resulted in an Investment Mix composed of two pie charts or tables in the Fund Facts, as permitted by Form 81-101F3⁹, instead of one. Fund managers of these funds indicated that they would consider using the mirrored basis for portfolio categorization in the Fund Facts and MRFP. Staff's view is that fund managers should consider using more than one pie chart or table in the Fund Facts when doing so would better display how the fund's investments align with its investment objectives.

We remind fund managers of the requirement in Form 81-101F3 *Contents of Fund Facts Document (Form 81-101F3)* to ensure consistency between the basis for portfolio categorization in the Fund Facts and the MRFP¹⁰.

3.2 Absence of a 'Look-Through' to the Holdings of Related Underlying Funds

In our review of the Fund Facts, we also observed that the Investment Mix disclosure of certain mutual funds which invested in related underlying funds did not "look-through" to the actual holdings of the underlying funds. Instead, the Investment Mix of the top fund specified only the types of related underlying funds. In our view, the Investment Mix of the top fund would have provided more meaningful disclosure to investors if it had used categories based on the actual holdings of its related underlying funds.

Staff remind fund managers that where a top fund is substantially invested in a single underlying fund, Form 81-101F3 requires that there should be a look-through to the holdings of the underlying fund as appropriate¹¹.

We acknowledge that Form 81-101F3 does not currently require a "look-through" to portfolio holdings where one top fund invests in multiple, related or unrelated, underlying funds. However, where a top fund is invested in underlying funds managed

⁹ Item 3(5) – Part I of Form 81-101F3.

¹⁰ Instruction 11 to Item 3 – Part I of Form 81-101F3.

¹¹ Instruction 9 to Item 3 – Part I of Form 81-101F3.

by the same fund manager, we encourage fund managers to consider an Investment Mix that looks through to the holdings of the related underlying funds. Given the common management of top and bottom funds, Staff would expect a fund manager to have access to the portfolio holdings of the underlying funds and, accordingly, be in a position to provide meaningful information to investors in the Investment Mix on the exposure to various securities resulting from the fund-of-funds structure.

3.3 Broad Categories

Our review of the Fund Facts highlighted the same trends discussed above under *Broad Categories* that were observed with respect to the MRFP and the Statement of Investment Portfolio.

3.4 General Compliance – Top 10 Holdings

In our review, we found a high level of compliance with Item 3(4) – *Investments of the Fund* of Form 81-101F3 which mandates Fund Facts disclosure of a mutual fund's top 10 investments. We did, however, find one fund that inadvertently provided the top 10 industry sectors in which the fund had invested, instead of the top 10 positions held by the mutual fund. The fund manager agreed to make the appropriate change to the issuer's Fund Facts.

CONCLUSION

Our review indicates that investment funds can further improve the quality of their continuous disclosure relating to portfolio holdings. Useful, relevant disclosure is critical to maintaining and strengthening investor confidence and efficient capital markets. In our view, the categorization of a fund's portfolio should be directly connected to the specific asset classes and unique characteristics of the funds as set out in its investment objectives. Each of the Fund Facts, MRFP and financial statements of the fund should be considered independent of each other and provide investors with meaningful information to assess how closely the investment objectives of the fund are being implemented over time.

We encourage fund managers to consider the guidance in this notice when preparing their continuous disclosure to ensure it complies with securities rules and regulations.

Questions may be referred to:

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