

1.1.3 OSC Staff Notice 81-709 Report on Staff's Continuous Disclosure Review of Investment Funds (2008)

ONTARIO SECURITIES COMMISSION STAFF NOTICE 81-709 REPORT ON STAFF'S CONTINUOUS DISCLOSURE REVIEW OF INVESTMENT FUNDS (2008)

1. – Purpose

This notice summarizes the findings and comments as at March 31, 2008, arising from the Continuous Disclosure Review Program conducted by the Investment Funds Branch (the Branch) of the Ontario Securities Commission (OSC).

Continuous disclosure review has been an important element of our approach to securities regulation and aims to improve disclosure available to investors. In 2003, the Branch set out a framework for the continuous disclosure review of investment funds in OSC Staff Notice 81-705 *Implementation of a Continuous Disclosure Review Program for Investment Funds – Investment Funds Branch* (Staff Notice 81-705). The purpose of that notice was to communicate general features of the Continuous Disclosure Review Program.

Following the publication of Staff Notice 81-705, the Branch developed continuous disclosure rules specific to investment funds. The result was National Instrument 81-106 *Investment Fund Continuous Disclosure* (NI 81-106) which came into force on June 1, 2005. Subsequently, we conducted an issue-oriented review of general compliance with NI 81-106. This notice focuses on issues identified in the course of the review, aiming to assist preparers of financial statements and management reports of fund performance (MRFP) in improving their future continuous disclosure.

2. – Scope of Review

NI 81-106 sets out the requirements for:

- financial statements and MRFPs;
- quarterly portfolio disclosure;
- annual information forms (for funds not subject to National Instrument 81-101 *Mutual Fund Prospectus Disclosure*); and
- proxy voting records.

Our review focused on these requirements and the investment fund's public disclosure record including the fund manager's website and all prescribed regulatory filings on SEDAR. Our review predominantly covered financial year-ends in 2005 and 2006, but also captured some periods ending in 2007.

We reviewed a sample of investment funds and sent comment letters to fund managers who, in aggregate, manage approximately 45% of the industry's assets under management. We focused on conventional mutual funds because they are the investment vehicle of choice for most Canadian investors. Although our findings are mainly based on the review of disclosure of conventional mutual funds, other investment funds such as closed-end and exchange traded funds will also benefit from this notice, and its guidance can be applied to their continuous disclosure.

3. – Executive Summary

We noted the following areas for improvement which are discussed in more detail in the body of the notice.

Quality of the discussion

- **Results of operations.** Management's discussion of the investment fund's activities in the results of operations section should be more thorough and analyze and explain the nature of and reasons for changes in the fund.
- **Broad-based index.** Discussion of the relative performance of the investment fund as compared to a broad-based securities market index is required and cannot be replaced by a comparison to a narrow index or blended benchmark.
- **Discussion of relative performance.** A more thorough discussion of why the investment fund under- or over-performed the index should be provided.

Overall presentation

- **Plain language.** MRFPs should be written in plain language and avoid the use of jargon and technical language.
- **Investment subgroups.** Management should review the investment portfolio to determine if the most appropriate categories have been used when disclosing the summary of investment portfolio in the MRFP or quarterly portfolio disclosure, and whether the breakdown conveys the nature of the fund to readers.
- **Analytical review of financial statements.** Management should perform an analytical review of the financial statements to ensure that all significant changes have been explained in the results of operations.
- **Financial statement notes presentation.** Notes to the financial statements are part of continuous disclosure and should not be convoluted with inapplicable information.

Regulatory compliance

- **Commissions to related parties.** Unless exemptive relief has been obtained, a monthly report must be filed when a fund pays a fee to a related company on a purchase or sale of portfolio securities.
- **Financial highlights tables.** The format specified in Form 81-106F1 (the Form) for financial highlights and past performance is mandated.
- **Annual compound returns.** Certain information must be discussed including the performance of all series and changes in an index from the prior period. Discussion of past performance should be limited to the standard performance periods.
- **Mandatory notes to financial statements.** Certain information must be disclosed in the notes to the financial statements to provide consistent and comparable financial statements.

4. – Quality of the Discussion

4.1 – Results of Operations

The summary of results of operations in the MRFP is an area that requires more attention. The intent of the summary is to put the financial statements into words and provide context for the financial results. Part B, subsection 2.3(1) of the Form requires that the results of operations include a discussion of changes to an investment fund. The list in subsection 2.3(1) addresses changes in portfolio assets, revenue and expenses, and redemptions or sales which correspond to data in the financial statements and can be found specifically in the statement of net assets, statement of investment portfolio, statement of operations, and statement of changes in net assets. The list also covers changes to the economy and markets, and requires that these factors be related back to changes in the composition of the investment portfolio.

In our review, we found that approximately 40% of investment funds selected had financial statements that revealed significant changes in the fund which were not discussed in the results of operations section of the MRFP. Examples of significant changes over the prior year included: an increase in redemptions by 81%; custodian fees that tripled; and an 11% increase in the holdings of a specific sector. In response to our comment letters, fund managers were able to address our questions with comprehensive and insightful explanations. Most fund managers stated that they did not include such explanations because they did not believe that the information fell within the requirements of subsection 2.3(1), or the discussion was not warranted because it did not add useful information pertaining to the investor's investment.

While discussion and analysis of every financial statement item may not be warranted, we expect that the results of operations will focus on significant changes in the fund over the financial period and discuss the reasons for the changes. We remind preparers to review the list of items in subsection 2.3(1). Generally, these items are material and must be discussed in the summary of the results of operations, as applicable.

We also found that 25% of investment funds disclosed significant changes but provided very little explanation or analysis. For example, we expect a fund to discuss why expenses increased, rather than simply stating that expenses were higher. As explained in the Form, the management discussion of fund performance (which includes the results of operations) "provides the manager of an investment fund with the opportunity to discuss the investment fund's position and financial results for the relevant period. The discussion is intended to give a reader the ability to look at the investment fund through the eyes of management by providing both a historical and prospective analysis of the investment activities and operations of the investment fund. Coupled with the financial highlights, this information should enable readers to better assess the investment fund's performance and future prospects." In response to our comment letters, investment funds provided us with disclosure

that should have been included in the results of operations. We expect such information to be discussed in the MRFP, enabling readers to look through the eyes of management.

4.2 – Annual Compound Returns

(a) Broad-based securities market index

Approximately 65% of fund managers did not compare the relative performance of an investment fund to a broad-based securities market index. We remind preparers that the discussion of the relative performance of an investment fund as compared to a broad-based securities market index is a requirement under Part B, subsection 4.3(3) of the Form. Please note that instruction (3) to section 4.3 states that a narrowly-based securities index or a blended index may be used in addition to a broad-based securities market index. Neither a narrowly-based index or a blended index can be a substitute for the broad-based index.

Some investment funds only provided a discussion of the fund's performance relative to a narrowly-based securities index. One fund manager explained this decision by citing concerns that the comparison of an investment fund's performance to a broad-based index would not be fully appreciated by investors. We believe that investors are more likely to understand the broad-based index as it is more widely recognized than a narrow index. A comparison to the broad-based index will help readers understand the fund's performance relative to the movement of the market more generally. In the MRFP, a fund manager has the opportunity to explain variances between the fund's performance and the general market, which may be caused by factors such as different sector exposure, and there is always the option of expanding the discussion by adding a comparison to a narrowly-based index.

(b) Discussion of relative performance

Some investment funds should have provided a more thorough discussion of the relative performance of the investment fund as compared to the appropriate index. This issue was raised with 75% of fund managers. We do not believe simply stating that the fund under- or over-performed relative to the index is a suitable discussion. Instead, we expect an explanation as to why the fund under- or over-performed relative to the index.

Often, we saw disclosure that a fund's performance was due to over- and under-weight portfolio allocations. Investment funds should consider using percentages and quantitative measures when discussing over- and under-weight portfolio allocations; otherwise, based on the disclosure provided, the reader has no sense of the magnitude of the over- or under-weight positions in various industry sectors or countries.

(c) Discussion of past performance

While we have not taken issue with the discussion of an investment fund's performance relative to an index appearing in the results of operations section rather than the annual compound returns section of the MRFP, we remind preparers that all rules relating to past performance in Part B, item 4 of the Form must still be applied. In one example, the results of operations discussed the performance of a narrow index which was not disclosed in the annual compound returns table. If a discussion of past performance is included elsewhere in the MRFP, all rules governing the disclosure of past performance still apply, such as providing disclosure only for standard performance periods.

5. – Overall Presentation

5.1 – Plain Language

We remind investment funds of the requirement to use plain language, which is stated in the beginning of the Form. We noted the use of jargon and technical language in the management discussion of fund performance. Some examples include:

- “off-index allocations”
- “duration positioning”
- “fundamental bottom-up strategy with a top down country overlay”.

We believe that plain language will help investors understand an investment fund's disclosure documents so that they can make informed investment decisions. We strongly encourage investment funds to communicate as simply and directly as possible.

5.2 – Summary of Investment Portfolio

In our view, 17% of investment funds did not break down their investment portfolio into appropriate subgroups in the summary of investment portfolio, as required by Part B, paragraph 5(2)(a) of the Form. The instructions in this section state that an investment fund should use the most appropriate categories given the nature of the fund. An investment fund may use more than one breakdown, such as by security type, industry, or geographical locations, so as to provide the most meaningful information.

We reviewed a precious metals fund with the majority of its assets invested in Canada that provided a geographic breakdown of the investment portfolio. A breakdown by precious metals and precious metals activities would have been more meaningful given the nature of the fund, as opposed to a breakdown by geography.

We also raised a comment if we felt that one subgroup was too generic and obvious. For example, we saw over 40% of one fund classified as “Other” and 75% of another fund labelled as “Income Funds”. In such cases, we do not believe that the disclosure is meaningful nor does it provide the reader with additional information.

5.3 – Analytical Review

As discussed earlier in this notice, the management discussion of fund performance is an analysis and explanation designed to complement and supplement an investment fund’s financial statements. Management should perform an analytical review of the financial statements to ensure that the management discussion of fund performance is complete and explains the significant changes of the fund or any unusual events. In our review of financial statements, we found significant changes that were not addressed in management’s discussion. By performing an analytical review, it is likely that most items required to be discussed in the results of operations (Part B, subsection 2.3(1) of the Form) are identified.

5.4 – Financial Statement Notes Presentation

For two fund managers, certain notes to the financial statements were unrelated to the investment funds included in the bound document. One set of notes had been prepared for all the funds managed by the fund manager, but the financial statements were bound in different sets. As a result, some information in the notes related to investment funds that were not included in the particular set of financial statements. For example, the notes contained information on management fee changes, performance and incentive fees, and fund windups for individual funds regardless of whether those funds were included in that set of financial statements.

Inclusion of notes that do not relate to investment funds in the document is confusing. While subsection 7.1(2) of NI 81-106 allows notes to the financial statements to be combined when financial statements of investment funds are bound together in a document, in our view, notes should only be included if they actually relate to the investment funds in the document. Notes to the financial statements are part of continuous disclosure and should not be convoluted. We do not believe that it is appropriate to create one set of notes for the whole fund complex that is then attached to every set of financial statements without being modified for relevance. We remind preparers to review all notes to determine those relevant to the investment funds in the document.

5.5 – Websites

We found that approximately 40% of fund managers did not provide easily accessible links to continuous disclosure documents on their websites. In one example, a link to the fund prospectus was available on the fund manager’s website but not given much prominence. In another example, the financial statements, MRFPs, proxy voting records, and quarterly portfolio disclosure were not easily accessible from the fund’s webpage as they were posted under a menu option that did not seem to relate to these documents. We also found that in some cases excessive drilling down was required to reach documents. In these situations, we raised comments asking that the fund manager consider adding more intuitive links to the fund’s disclosure documents on their website.

Since NI 81-106 removed mandatory delivery of continuous disclosure documents to all unitholders, access to these documents by alternative methods should be made as simple as possible. Unitholders may not wish to receive paper copies of financial statements and MRFPs in the mail because they are opting to find this information online. In our view, funds should ensure that their websites are organized in a way that makes this information relatively easy to find (and is in keeping with the spirit of section 5.5 of NI 81-106).

5.6 – SEDAR Filings

Each MRFP should be filed on SEDAR only under the individual investment fund to which it pertains (and not under a group profile) as stated in item E-2 of CSA Staff Notice 81-315 *Frequently Asked Questions on National Instrument 81-106 Investment Fund Continuous Disclosure* (the FAQs). Further, if the financial statements and the accompanying notes for each fund are in a

separate document, the relevant statements should only be filed under the fund to which they pertain (consistent with item E-2 in the FAQs). Please note that only the disclosure relevant to a particular fund should be filed under that fund's profile on SEDAR.

In one example, a fund manager produced stand-alone financial statements for each fund, but filed all the financial statements and MRFPs under every fund's profile. This made it very difficult to find the disclosure applicable to the individual fund. In this case, we requested that future SEDAR filings be corrected.

6. – Regulatory Compliance

6.1 – Commissions to Related Parties

Where commissions were paid to brokerage firms that are affiliates of an investment fund, we asked for confirmation that the fund complied with the reporting requirement in paragraph 117(1)(c) of the *Securities Act* (Ontario). Investment funds must file a monthly report when a fund pays a fee to a related company on a purchase or sale of portfolio securities, unless the fund has obtained exemptive relief from this requirement. Some exemptive relief obtained in the past can no longer be relied upon as it was conditional on certain disclosure being provided in the statement of portfolio transactions, which is no longer required.

6.2 – Financial Highlights Tables

Part A, subsection 1(c) of the Form states that we do not generally mandate the use of a specific format for the MRFP, *except* for financial highlights and past performance as required by items 3 and 4 of Parts B and C of the Form. We found that approximately 40% of fund managers did not follow the set format of the financial highlights tables.

For example, with the implementation of Section 3855 of the CICA Handbook, some funds added a new line in the Fund's Net Asset Value (NAV) per Unit/Share table to represent the effect of the new accounting policy on NAV. We indicated in our comment letters that, while an explanation of the difference can be added to the MRFP, the tables' format must be maintained.

One fund manager added new ratios to the Ratios and Supplemental Data table, such as "MER excluding performance fee". In this manager's opinion, performance fees are not prevalent in the industry and it believes that additional ratios will benefit investors and provide fuller disclosure. Again, while an explanation can be added to the MRFP, additional lines cannot be included in the standard tables. The format of the financial highlights and past performance tables must be adhered to as mandated by the Form to ensure comparability between investment funds.

6.3 – Management Fees

The purpose of the requirement in Part B, section 3.3 of the Form is to promote transparency around the composition of management fees. The FAQs discuss our expectations with respect to management fee breakdown in items C-8 through to C-10. We remind investment funds that the purpose of the breakdown is to explain to investors what services are provided in exchange for the management fee. If services cannot be individually itemized, the nature of those services should at least be described qualitatively. For example, some funds did not indicate that the manager's fee for acting as trustee is included in the management fee. Even if trustee fees are not separately recorded, the management fee breakdown should disclose that these fees form part of the management fee.

Item C-8 in the FAQs states that the breakdown of management fees does not have to add to 100%, as the item requires disclosure of the *major* services paid for out of the management fee. We expect services to be expressed as an actual percentage of management fees, not as an estimate or a range, because the MRFP reports the prior period's activity. We also reiterate that the management fees breakdown must disclose any differences between classes or series.

REMINDERS

Some of the requirements of our rules were overlooked. Based on our review, we provide the following reminders.

MRFP

6.4 – Investment Objective and Strategies

Approximately 40% of fund managers should have provided a more concise summary of the investment objective and strategies of their investment funds. The disclosure must be a concise summary of the fundamental investment objective and strategies of the investment fund, and not merely copied from the prospectus (Part B, section 2.1 of the Form). For some funds, we found that the investment objectives and strategies disclosed in the MRFP and simplified prospectus had exactly the same wording.

6.5 – Risk

Approximately 40% of fund managers did not provide an adequate discussion of risk. A discussion of how changes to the investment fund have affected the overall level of risk associated with an investment in the investment fund is required (Part B, section 2.2 of the Form). We noted that some funds merely repeated the risk information contained in the fund's prospectus or annual information form, while others only examined the impact of the main risk factors during the financial period. In both examples, the disclosure is generally incomplete as the discussion of risk should be focused on explaining how changes to the investment fund have affected the overall level of risk. We expect investment funds to provide a commentary on whether changes in the fund have had an impact on risk, along with a discussion of whether the suitability of the investment has changed from what was previously disclosed in the prospectus.

6.6 – Annual Compound Returns

(a) Multiple series

Almost all investment funds with multiple series discussed the performance of only one series of the investment fund, typically the retail series. The Form requires a discussion of the performance of the investment fund relative to the broad-based securities market index (Part B, subsection 4.3(3)) and NI 81-106 states that the distinctions between the series must be disclosed in the MRFP (subsection 7.2(2)). At a minimum, investment funds must provide an explanation as to how the performance of all series differs from the specific series discussed.

(b) Change in index from prior period

If an index is different from the one included in the most recently filed MRFP, the reasons for the change must be explained and the requirements relating to annual compound returns must be disclosed separately for both the new and former indices for the financial year (Part B, subsection 4.3(4) of the Form). This means that both indices must appear in the annual compound returns table in the year of the change to help readers compare the fund's performance to the new and former indices. One investment fund showed a blend of the new and former indices, which does not fulfil the requirement.

(c) Non-standard performance periods

Part B, item 4 of the Form only allows the disclosure of past performance for the ten, five, three, one year, and since inception periods in the annual MRFP. Part C also allows for the inclusion of the interim period in the bar chart of the interim MRFP. We do not believe that the discussion of past performance should focus on non-standard performance periods such as the six-month return in the annual MRFP, or the quarterly return in the interim MRFP. In our comment letters, we asked that future discussions be limited to the standard performance periods.

6.7 – Interim MRFP

We remind preparers that the interim MRFP was specifically designed as an update to the last annual MRFP and was intended to be a shorter document. Interim MRFPs are not required to repeat all of the annual MRFP disclosure, but only update the required sections in Part C of the Form.

FINANCIAL STATEMENTS

6.8 – Mandatory Notes to Financial Statements

NI 81-106 lists items which must be disclosed in the notes to the financial statements (subsection 3.6(1)). We found that not all information required was disclosed. For example, the method used to allocate income and expenses, and realized and unrealized capital gains and losses to each class was sometimes not disclosed in the notes (item 2(d)). Also missing was the basis for determining cost of portfolio assets (item (1)). Almost all investment funds only discussed the basis for determining cost in the context that gains and losses on securities sold were determined on the basis of average cost. We remind investment funds to include a more general statement about the basis for determining the cost of portfolio assets.

OTHER MATTERS

6.9 – National Instrument 81-102 Mutual Funds Compliance Reports

Some investment funds did not file the compliance report from their custodian to the securities regulatory authority within 30 days after the filing of the annual financial statements (subsection 6.7(3) of National Instrument 81-102 *Mutual Funds* (NI 81-102)). In addition, some investment funds did not file the report describing compliance with Parts 9, 10 and 11 of NI 81-102, along with their auditor's compliance report, within the time limit as required by Part 12 of NI 81-102. We remind investment funds that the above reports must be filed on time.

6.10 - Annual Notification of Unitholders' Rights to Redemption

Fund managers are required to notify securityholders annually of their redemption rights (subsections 10.1(3) and 10.1(4) of NI 81-102). Some investment funds fulfilled this requirement in the past by including a note in the annual financial statements explaining the rights of securityholders with respect to redemption of securities. Under NI 81-106, investment funds are allowed to deliver certain continuous disclosure documents according to standing or annual instructions received from securityholders, which means that financial statements are not required to be sent to all securityholders anymore (sections 5.2 and 5.3 of NI 81-106). We remind investment funds that the requirements of NI 81-102 to provide all securityholders, at least annually, with a statement outlining rights with respect to redemptions may no longer be met by including it in the financial statements if those financial statements are not sent to every unitholder.

7. – Conclusion

Our findings suggest that investment funds can improve the quality of their continuous disclosure. Good disclosure is an opportunity to reach investors and advisors. We expect funds to consider the guidance in this notice when reviewing their continuous disclosure records to ensure their disclosure documents comply with NI 81-106. In future situations where disclosure requirements are not met, we will ask that the disclosure document be revised and refiled.

In some cases, staff is continuing to correspond with investment funds included in this review to obtain additional information and resolve the issues identified. On completion of this review, staff will expand our scope to include other investment funds such as closed-end funds, exchange traded funds, labour sponsored investment funds, limited partnerships, and scholarship plans. We will communicate our findings of the continuous disclosure of those types of investment funds in the future.

8. – Questions

Questions may be referred to:

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