CSA STAFF NOTICE NO. 81-306

DISCLOSURE BY MUTUAL FUNDS OF CHANGES IN CALCULATION OF MANAGEMENT EXPENSE RATIO

Background

On February 1, 2000, National Instrument 81-102 Mutual Funds (the "National Instrument") came into force across Canada. Section 16.1 of the National Instrument changes the method of calculation of management expense ratios (MER) for mutual funds and has the effect of requiring mutual funds to re-calculate MERs for financial periods that ended before the National Instrument came into force. Subsection 17.2(2) of the National Instrument and the prospectus form requirements of National Instrument81-101 Mutual Fund Prospectus Disclosure require a mutual fund to disclose its MER for the last five completed financial years in its financial statements and its simplified prospectus.

The National Instrument was published in final form in November 1999. After that publication, the staff of the Canadian Securities Administrators (CSA) received submissions from The Investment Funds Institute of Canada (IFIC) and fund companies to the effect that calculating MERs for financial periods that ended before February 1, 2000 in accordance with section 16.1 of the National Instrument would be very difficult, and in some cases, virtually impossible due to the lack of data.

The CSA considered these submissions and determined to amend the National Instrument to provide that restatement of MER in accordance with section 16.1 is not mandatory for financial periods of mutual funds that ended before February 1, 2000.On January 28, 2000[(1)], the CSA published for comment a series of amendments to the National Instrument, primarily to propose a regime permitting mutual funds to lend their securities and use repurchase agreements, but also to deal with certain issues concerning MERs.

The Proposed Amendments to the National Instrument

The Notice accompanying the publication for comment of the January 28 amendments stated that the CSA propose to add section 16.3 to the National Instrument, along with a revised section 20.3 of the National Instrument.

Proposed section 16.3 of the National Instrument states that the MER calculation in section 16.1 does not apply to the disclosure and calculation of the MER for a financial period that ended before February 1, 2000. Mutual funds will have the option of restating MERs for prior periods in accordance with the National Instrument or disclosing MERs for those periods as calculated in accordance with securities legislation in force as at January 31, 2000. The proposed revisions to section 20.3 of the National Instrument will clarify that the National Instrument does not apply to reports to security holders (as defined in the National Instrument) that include only financial statements that relate to financial periods that ended before the National Instrument came into force.

Purpose of CSA Staff Notice

The CSA outlined in the January 28 Notice that they are examining the implications of this proposed rule amendment in the context of Canadian generally accepted accounting principles (GAAP) and mutual fund financial statement presentation. The Notice indicated also that the CSA would be reviewing what guidance could be given to mutual funds by the CSA on the need to disclose the effect of a change to the calculation of MER when the MER for prior periods is not restated.

CSA staff propose to recommend that the CSA amend the Companion Policy to provide this guidance, however in the interim, CSA staff are publishing this CSA Staff notice. CSA staff are of the view that mutual funds must provide consistent disclosure concerning changes in the calculation of MERs in order to assist investors in understanding the change and to assist them in comparing the MERs of different mutual funds.

Staff Guidance

Staff are of the view that the change in the method of calculating the MER of a mutual fund required by the National Instrument should be treated in a manner which is similar to a change in accounting policy under section 1506 of the CICA Handbook. Under Canadian GAAP, a change in accounting policy requires a retroactive restatement of the financial information for all periods shown. The CICA Handbook acknowledges however that there may be circumstances where the data needed to restate the financial information is not reasonably determinable. Proposed section 16.3 permits a mutual fund to follow the guidance set out in the CICA Handbook without violating the National Instrument.

If a mutual fund retroactively restates its MER for the five years required to be shown in its financial statements and simplified prospectus, the mutual fund should describe this restatement in the first such documents released in which the restated amounts are reported.

If a mutual fund does not restate its MER for prior periods because, based on its specific facts and circumstances, the information required to do so is not reasonably determinable, the MER for all financial periods ending after February 1, 2000 must be calculated in accordance with the National Instrument. The mutual fund must also disclose:

- that the method of calculating MER has changed, specifying for which periods the MER has been calculated in accordance with the change;
- that the mutual fund has not restated the MER for specified prior periods;
- the impact the change would have had if the mutual fund had restated the MER for the specified prior periods. For example, would the MER have increased or decreased if the MER had been restated? If possible, provide an estimate of the increase or decrease if the MER had been restated; and
- a description of the main differences between an MER calculated in accordance with the National Instrument and one calculated in accordance with NP 39.

The disclosure outlined above should be provided for all periods presented until such time as all MERs presented are calculated in accordance with the National Instrument.

As outlined in the January 28 Notice, the CSA are seeking comments on the proposed amendments. Mutual fund industry participants should provide comments if they have continuing concerns on the impact of the change in the method of calculating MER.

Income Taxes

CSA staff have considered other inquiries regarding the proper calculation of MER as required by the National Instrument and are outlining their views on the following questions raised.

1. Should the MER include foreign withholding taxes on dividends?

Section 16.1 of the National Instrument requires a mutual fund to express its “total expenses" for a financial year "as shown on its income statement" as a percentage of its average net assets for that year. Staff are of the view that Canadian GAAP would permit a mutual fund to deduct withholding taxes from the income to which they apply. Accordingly, withholding taxes would not be recorded as "total expenses" on the mutual fund's income statement and need not be included in its MER calculation.

2. Does a mutual fund corporation have to include capital taxes and income taxes in its MER calculation?

Mutual fund trusts generally distribute all taxable income and sufficient net realized capital gains in order that the trust is not subject to income taxes. However, this tax treatment is not available to mutual fund corporations. Staff accept that the MER calculations for mutual fund trusts and mutual fund corporations should be carried out in a way that causes their MERs to be comparable. This comparability is achieved when a mutual fund corporation excludes income taxes from its calculation of the MER.

However, staff are of the view that Canadian GAAP would require a mutual fund corporation to include capital taxes as an expense of the mutual fund. Accordingly, capital taxes should be taken into account in that fund's calculation of MER.

Questions on the matters outlined in this CSA Staff Notice should be directed to:

Noreen Bent
Senior Legal Counsel
British Columbia Securities Commission
(604) 899-6741
or 1-800-373-6393 (in BC)
nbent@bcsc.bc.ca

Christopher Birchall
Senior Securities Analyst
British Columbia Securities Commission
(604) 899-6722
or 1-800-373-6393 (in BC)
cbirchall@bcsc.bc.ca

Wayne Alford
Legal Counsel
Alberta Securities Commission
(403) 297-2092
Wayne.Alford@seccom.ab.ca

Bob Bouchard
Director, Capital Markets and Chief Administrative Officer
The Manitoba Securities Commission
(204) 945-2555
bbouchard@cca.gov.mb.ca

Rebecca Cowdery
Manager, Investment Funds
Capital Markets
Ontario Securities Commission
(416)593-8129
rcowdery@osc.gov.on.ca

Anne Ramsay
Accountant, Investment Funds
Capital Markets
Ontario Securities Commission
(416)593-8243
aramsay@osc.gov.on.ca

Pierre Martin
Legal Counsel, Service de la reglementation
Commission des valeurs mobilieres du Quebec
(514) 940-2199 ex. 4557
pierre.martin@cvmq.com

Jacques Doyon
Analyst
Commission des valeurs mobilieres du Quebec
(514) 940-2199 ex. 4357
jacques.doyon@cvmq.com

1. In Ontario, at (2000) 23 OSCB (Suppl.)