MSC NOTICE 2002-32

NOTICE OF PROPOSED AMENDMENTS TO

NATIONAL INSTRUMENT 81-102
AND COMPANION POLICY 81-102CP MUTUAL FUNDS

AND TO
NATIONAL INSTRUMENT 81-101 MUTUAL FUND PROSPECTUS DISCLOSURE
AND
FORM 81-101F1 CONTENTS OF SIMPLIFIED PROSPECTUS
AND
FORM 81-101F2 CONTENTS OF ANNUAL INFORMATION FORM

Introduction

The Canadian Securities Administrators (the "CSA"), with this Notice, are publishing for comment proposals that would modify the current regulatory framework for fund of funds structures contained in National Instrument 81-102 *Mutual Funds* ("NI 81-102"). These proposals would also impose certain disclosure requirements specific to fund of funds structures through amendments to National Policy 81-101 *Mutual Fund Prospectus Disclosure* ("NI 81-101") and its related Forms 81-101F1 *Contents of Simplified Prospectus* ("Form 81-101F1") and 81-101F2 *Contents of Annual Information Form* ("Form 81-101F2").

The proposed amendments (the "Fund of Funds Amendments") would:

- allow a top fund to invest a percentage of its net assets in a bottom fund or a RSP clone fund in excess of the 10 percent concentration restriction that is prescribed by subsection 2.1(1) of NI 81-102;

- allow a top fund to purchase more than 10 percent of the securities issued by a bottom fund or a RSP clone fund in excess of the 10 percent control restriction that is prescribed by subsection 2.2(1) of NI 81-102;

- remove the current restriction contained in subsection 2.5 (1) of NI 81-102 that prohibits a mutual fund from investing more than 10 per cent of its net assets in securities of other mutual funds;

- permit a top fund to invest only in a bottom fund to which NI 81-102 and NI 81-101 apply;

- prohibit the payment of sales charges, redemption fees or other fees by a top fund in relation to its purchase or sale of the securities of other mutual funds;

- prohibit duplication of management fees, including incentive fees, between a top fund and other mutual funds;

- prohibit a top fund from voting the securities of other mutual funds if the funds are under common management;

- require a top fund to disclose in its simplified prospectus that it may purchase securities of other mutual funds, the percentage of net assets dedicated to these purchases and the process or criteria of selection of mutual funds;

- where more than 10% of the securities of a bottom fund or RSP clone fund are held by a top fund, require the bottom fund or RSP clone fund to disclose in the simplified prospectus the risks associated with a possible massive redemption requested by the top fund;

- restrict multiple layering of fund of funds structures;

- provide for a transition period of one year after the coming into force of the Fund of Funds Amendments for a mutual fund that has obtained a prior exemption, waiver or approval in connection with a fund of funds structure.

In addition to the Fund of Funds Amendments, the CSA also propose to make a number of miscellaneous amendments (the "Miscellaneous Amendments") to NI 81-102, Companion Policy 81-102CP ("81-102CP"), NI 81-101 and Form 81-101F1. The substance and purpose of the Miscellaneous Amendments are described below.

Substance and Purpose of the Fund of Funds Amendments

Current Regulatory Regime

For many years, mutual funds have applied for and received on occasion exemptive relief (collectively, the "Existing Decisions") from sections 2.1, 2.2 and 2.5 of NI 81-102 (and from their precursors in "National Policy Statement No.39 Mutual Funds") and from conflict of interest provisions in the securities legislation of various jurisdictions to permit fund of funds structures. The exemptive relief has been granted subject to numerous conditions. Several fund of funds structures currently exist in Canada for different purposes, including asset allocation programs, foreign exposure, branding of third party funds, mirroring of mutual fund trusts by corporate funds and RSP clone funds.

Under the current regulatory regime, investors in the securities of a top fund are treated *as if they themselves purchased the securities of the bottom fund.* The CSA have re-considered the current approach of the Existing Decisions.

Fundamental Principle of Proposed Approach

The proposed amendments are based on the principle that a mutual fund is one of many potential investments that a portfolio adviser may make with the assets of a top fund. The portfolio adviser of the top fund in a fund of funds structure should be able to determine, at any given time, how much to invest in one or more bottom funds in order to meet the investment objective of the top fund. Subject to certain exceptions, a mutual fund should be able to pursue its investment

objectives indirectly (i.e. through another mutual fund) as it could do directly. This means that the bottom funds should be subject to the same rules as the top fund.

Active Management of Bottom Funds

As mentioned above, the Existing Decisions are based on the principle that securityholders of a top fund should be treated as if they had directly invested in each bottom fund. As a result, the Existing Decisions restrict the ability of portfolio advisors to change investments in bottom funds from what is disclosed in the top fund's simplified prospectus. The existing structures have been termed "passive" fund of funds because the simplified prospectus discloses the fixed percentages invested in each bottom fund. In addition, 60 days notice to unitholders and an amendment to the simplified prospectus of the top fund is required to change bottom funds or their fixed percentages.

We propose that the portfolio manager(s) of a top fund be permitted to actively manage the top funds investments in bottom funds. The portfolio manager(s) of a top fund will then be able to make investment decisions in accordance with the investment objectives and strategies of the top fund.

Concentration and Control Restrictions

The Existing Decisions have provided relief from the concentration and control restrictions in sections 2.1 and 2.2 of NI 81-102 subject to conditions. We propose that a top fund would be exempt from these restrictions with respect to bottom funds or a RSP clone fund that are NI 81-101 mutual funds.

Investments Limited to NI 81-101 Funds and Index Participation Units ("IPUs")

The proposal provides that a top fund would only be able to invest in a bottom fund if that bottom fund was qualified for sale in the same jurisdiction as the top fund under a simplified prospectus and annual information form filed pursuant to NI 81-101. This is the current approach in section 2.5(1)(c) of NI 81-102.

Currently, exchange traded mutual funds ("ETFs") are exempt from the fund of funds restrictions in section 2.5 of NI 81-102. However, investments in ETFs remain subject to both the concentration and control restrictions. It is proposed that this be changed so that a mutual fund cannot invest in ETFs (other than IPUs which would remain subject to the concentration and control restrictions).This is because many ETFs have received exemptions from the restrictions and requirements of NI 81-102 which would not have been granted if those funds were distributed pursuant to NI-81-101.

Multiple Layering

The CSA believe that multiple layering of mutual fund investments must be limited. Without limits on layering it could be impossible for a potential investor in a top fund to determine at what level the actual investment decisions are being made. In addition, if multiple layering were

permitted, the disclosure of what assets are being held by the top fund would be less transparent and more confusing for investors. There would also be less transparency with respect to fees paid by investors.

One exception to this prohibition is for investments by a top fund in an RSP clone fund. An RSP clone fund represents a one-to-one tracking of a foreign property mutual fund in order to maintain 100 percent eligibility for registered tax plans. RSP clone funds use derivatives to mirror an underlying fund solely for tax purposes. The CSA believe that lack of transparency would not be an issue if a top fund invested in RSP clone funds.

Massive Redemption

The proposal does not impose restrictions on the size of purchases or redemptions by a top fund in a bottom fund. The CSA believe that by limiting multiple layering, the likelihood of a systemic redemption crisis due to cross ownership of different mutual funds based on fund of funds structures will be reduced. The risk of large redemptions is addressed by requiring additional disclosure of any risk associated with possible massive redemptions by large investors.

Voting Rights and Disclosure Materials of Bottom Funds

Consistent with the principle that an investment in a bottom fund should be treated as an investment like any other (subject to limited additional rules) it is proposed that the voting rights and disclosure materials of bottom funds no longer need to be passed through to investors in the top fund. However, the manager of a top fund would be prohibited from voting the securities of the other mutual fund when the fund is managed by the same manager or an affiliate of the manager of the top fund. This restriction is intended to address the conflict of interest inherent in such cases.

Fee Rebates and Trailer Fees

It is proposed that all fees and expenses rebated by the bottom fund must be paid to the top fund. This restriction is intended to eliminate the conflicts of interest that could result if rebates are paid directly to the manager. Payments of fees of any kind, including trailer fees, cannot be paid in connection with an investment by a top fund in a bottom fund. This is to ensure that the decision to invest in another mutual fund is made solely because it is in the best interests of security holders of the top fund.

Prospectus Disclosure

The proposed amendments to NI 81-101 amend certain items included in Form 81-101 F1 and Form 81-101F2 to improve the disclosure of fund of funds strategies. The proposed amendments would require a top fund to disclose in its simplified prospectus and in its annual information form relevant information about the fund of funds structure, including the process or criteria used to select the other mutual funds and the prohibition of duplication of management fees.

Transition Period

The Fund of Funds Amendments provide for a transition period of one year after the coming into force of the amendments for a mutual fund that has obtained a prior exemption, waiver or approval from National Policy Statement No. 39 or from NI 81-102 in connection with a fund of funds structure. This provision overrides "sunset" provisions which may be included in certain Existing Decisions. The purpose of proposed section 19.3 is to definitively revoke all Existing Decisions and ensure that all mutual funds employing a fund of funds strategy comply with the same rules.

Substance and Purpose of the Proposed Miscellaneous Amendments

Since the introduction of NI 81-102 and NI 81-101, the CSA have received a number of useful comments on the practical application of those rules from the mutual fund industry. In an effort to address certain of the issues that have been brought to the attention of the CSA, the CSA are proposing certain miscellaneous amendments to NI 81-102, 81-102CP, NI 81-101 and Form 81-101F1. The following paragraphs describe the proposed Miscellaneous Amendments. Section references, unless otherwise noted, are sections or proposed sections of NI 81-102, 81-102CP and Form 81-101F1.

Definitions

The following definitions in section 1.1 of NI 81-102 are proposed to be amended:

- "*approved credit rating*" and "*approved credit rating organization*": updated to reflect consolidation among rating organizations;

- "*guaranteed mortgage*": to include privately insured mortgages;

- "*permitted gold certificate*": to provide for the purchase of such certificates from Schedule III banks;

- "*short position*": to clarify that a swap includes a short position which obliges the mutual fund to deliver the underlying interest or pay cash;

- "*synthetic cash*": to accommodate the introduction of standardized futures contracts based on one issuer;

Swaps – Investment Restrictions, Valuation and Financial Statements

The CSA received comments that the current swap provisions in NI 81-102 should be clarified. It was submitted that the current wording of the provision makes it difficult for a mutual fund to be satisfied that it is complying with NI 81-102. The proposed amendments address these technical concerns. The CSA's regulatory approach has not changed. Mutual funds are permitted to enter into swaps to gain market exposure to underlying interests so long as the mutual fund does not create leverage through those transactions.

Index Mutual Funds – Removal of Transitional Provisions and Change to Investment Objective Disclosure

The proposed amendments remove from subsection 2.1(6) the 60 day notice requirement for index funds. The provision was a transitional measure to facilitate the introduction of the index fund amendments which came into force May 2, 2001 and is no longer necessary.

Further, with respect to Form 81-101F1, we propose that the requirement to disclose the constituent securities of a permitted index which had weightings in excess of 10% of that index over the last 12 month period be moved so that disclosure is made under the investment strategies (Item 7) rather than under the investment objectives (Item 6).

Securities Lending, Repurchase and Reverse Repurchase Transactions – Notice Requirement for New Funds

The proposed amendments create a new subsection 2.17(3) to clarify that mutual funds need not provide security holders 60 days notice if the required disclosure concerning securities lending is contained in the mutual fund's prospectus from its inception.

Introducing New Fees and Fees Paid Directly – Securityholder Approval

Section 5.1 would be amended to clarify that securityholder approval is required prior to introducing or increasing fees or expenses charged to the mutual fund or directly to its security holders in connection with the holding of securities of the mutual fund. Section 6.3 of 81-102CP is also amended to reflect this proposed change.

Availability of Securityholder List – Notice Requirements for Change of Control of Manager

The proposed amendments would create new subsections 5.8(1.1), (1.2) and (1.3). These provisions require a mutual fund manager that is the target of a hostile takeover bid to provide the names and addresses of the securityholders of its mutual funds to the offeror. The purpose of this requirement is to enable the offeror to send the 60 day notice required by clause 5.8(1)(a).

Permitted Custodians – Schedule III Banks

Section 6.2 is proposed to be amended to permit Schedule III Banks to act as custodians or sub-custodians of mutual funds.

Sale and Redemption Timelines - Service Providers

The proposed amendments would clarify that the requirements in Parts 9 and 10 of NI 81-102 on participating dealers and principal distributors to provide information within a specified period of time similarly apply to service providers used by such participating dealers and principal distributors.

Trust Accounts – Advising Financial Institutions

Section 11.3 is proposed to be amended to make it applicable not only to a participating dealer or a principal distributor, but also to a person or company providing services to the participating dealer or principal distributor. In addition, the requirement to advise a financial institution of the matters set out in section 11.3 when depositing funds into a trust account would not only be imposed at the time of the opening of the account but also annually thereafter.

Commingling of Cash and Compliance Reports - Update for Current Registration Regime

Subsections 11.4(1) and 12.1(4) are proposed to be amended to reflect the current registration regime for investment dealers.

Financial Disclosure After a Fund Merger

It is proposed that Item 13.1 of Part B of Form 81-101F1 be amended to clarify the appropriate information to disclose after a fund merger has occurred.

Specific Questions of the CSA Concerning the Fund of Funds Amendments

1. Qualification of the bottom fund in the local jurisdiction

Proposed section 2.5(1)(c) of NI 81-102 requires that the bottom fund or the RSP clone fund in which the top fund invests be qualified for distribution under a simplified prospectus in the local jurisdictions in which the top fund is qualified for distribution. This requirement already exists in NI 81-102. The purpose of this requirement is to ensure that the local jurisdiction has control over both the top and the bottom fund, both funds being reporting issuers in the local jurisdiction.

The CSA invite comments on whether this practice should continue or whether a top fund should be able to invest in a bottom fund as long as the bottom fund is qualified in any of the local jurisdictions in Canada. If so, what parameters should be developed to ensure that local jurisdiction keeps its jurisdiction over the bottom fund in the event of wrongdoing by the bottom fund or the person that manages it?

2. Investments in funds other than those to which NI 81-101 and NI 81-102 apply

The definition of "bottom fund" in proposed section 1.1 of NI 81-102 requires that the bottom fund be a mutual fund to which both NI 81-102 and NI 81-101 apply, and that it not be a top fund. The purpose of this requirement is to ensure that a top fund's investments are appropriately diversified and that it is sufficiently liquid to meet redemption demands. This is similar to the requirement currently found in section. 2.5 of NI 81-102.

The CSA invite comments on whether the investment options for a top fund should be expanded to include other types of mutual funds and investment funds such as pooled

funds or commodity pools. If so, should there be any limit to the amount a top fund could invest in these other funds? Should they be treated as if they were illiquid assets to which section. 2.4 of NI 81-102 applied?

3. Requirement to be a Top Fund and removing the existing 10% investment provision in section 2.5 of NI 81-102

The definition of "top fund" proposed in section. 1.1 of NI 81-102 requires that the fund have a fundamental investment objective allowing it to invest in bottom funds or RSP clone funds (as defined in the proposed amendments). A fundamental investment objective is one that defines both the fundamental nature of the mutual fund and the fundamental investment features of the fund that distinguishes it from other mutual funds. A fund's investment strategies must be consistent with its fundamental investment objective, which can be changed only with unitholder approval.

The effect of this definition is that mutual funds that do not include investing in other mutual funds in their fundamental investment objectives will not be permitted to invest any amount into other mutual funds. One benefit of the existing regime is that mutual funds that occasionally determine it would be appropriate for the fund to achieve its investment objectives by investing a portion of its portfolio into other mutual funds, can do so, so long as they do not invest more than 10% of the fund's net assets (and they comply with the rest of section 2.5). Currently, this type of investing need not necessarily be disclosed as a fundamental investment objective or a strategy.

The CSA invite comments on this definition and specifically whether any mutual fund should be allowed to invest at least a portion of its assets in other mutual funds as a strategy to achieve its fundamental investment objective, whether or not investing in other funds is specifically identified as part of its fundamental objective.

The CSA also invite comment on whether mutual funds and investors would benefit if the existing 10% limit was retained? Would removing this provision cause any hardship to any existing funds of funds?

4. Control of the bottom fund by the top fund

i) Removal of the concentration and control restrictions

The proposed amendments permit the top fund to invest more than 10% (up to 100%) of its assets in a bottom fund. The proposed amendments also permit a top fund to purchase more than 10% of the voting, or equity, securities of a bottom fund.

The CSA invite comment on whether this approach appropriate. Should there be a limit on the percentage of net assets invested in one bottom fund? Should a limit be placed on the percentage of voting, or equity, securities of a bottom fund that a top fund can acquire? The CSA is concerned with ensuring efficient capital

markets while providing adequate protection for investors. Please provide an explanation why such limits should, or should not, be imposed and provide us with the recommended percentage limits.

ii) Massive redemption

The proposed amendments remove the limit on the percentage of securities that a top fund can hold in the bottom fund or RSP clone fund. It permits a mutual fund to hold more than 10% of the voting or equity securities and to actively manage those holdings. However, a bottom fund or a RSP clone fund must disclose in its simplified prospectus the risks associated with a possible massive redemption due to a top fund holding more than 10% of the securities of that fund. Because the proposed amendments eliminate the control and concentration restrictions for fund of funds, it is possible that a massive redemption by the top fund could impact the bottom fund and its securityholders.

The CSA invite comments on whether restrictions should be imposed on the top fund to ensure that the bottom fund has sufficient time to sell its assets and pay the top fund in an orderly manner.

5. Prohibition against Sales and Redemption Charges

NI 81-102, securities legislation and the existing exemptive relief for funds of funds currently prohibit top funds from paying any sales charges in connection with a purchase of securities of a bottom fund, and similarly prohibits redemption fees being charged by the bottom fund for redemptions made by a top fund. This prohibition exists whether the top and bottom fund are related or unrelated.

Mutual fund managers have a duty to act in the best interests of the fund. As a result, the manager must ensure that its fund (top fund or bottom fund) is paying or receiving fees that are appropriate for any services being provided to the fund, or in connection with any investment the fund may make. In the fund of fund context (and absent the existing prohibitions we described), this requires that fund managers consider, as part of the decision to invest in other funds, what sales and redemption fees are charged by those other funds. In an arms length transaction, such as where the top and bottom fund are unrelated, both fund managers would be free to negotiate an appropriate arrangement for their funds in accordance with market demands.

Where the funds are related, the fund manager has competing interests that may make it difficult to comply with this requirement. For example, where the top and bottom fund manager are the same, it may be in the best interests of the fund complex overall to have fees paid by the top fund to the bottom fund. Because of the relationship, the manager may be unable to balance the competing interests of the securityholders in top fund against the interests of the fund complex as a whole.

Given the existing obligations on fund managers, the CSA invite comment about whether these prohibitions against the payment of sales charges or redemption fees are necessary. Is your view the same for both related and unrelated funds of funds?

6. Voting rights of top fund securityholders in bottom fund matters

The proposed amendments no longer provide for a pass through of bottom fund voting rights which is currently mandated by the Existing Decisions. The top fund's manager will now be responsible for voting those rights in accordance with its fiduciary obligations to its securityholders. However, when the manager of the top fund is related to the manager of the bottom fund, the voting rights held by the top fund cannot be exercised due to concerns relating to conflict of interests.

i) The CSA invite comment on whether the proposed approach is appropriate for the investors in the top fund or the bottom fund. Should the current requirement in the Existing Decisions, to pass the voting rights attached to the securities of the bottom fund to the securityholders of the top fund in order to vote on fundamental changes, be continued in the future?

ii) Furthermore, the CSA invite comment on whether precluding a related manager of a top fund from voting securities of a bottom fund would be detrimental to its securityholders or the securityholders of the bottom fund since an important portion of the voting rights may not be exercised.

7. Active management and prospectus disclosure

The proposed amendments provide greater flexibility to the portfolio manager of the top fund to modify its holdings in bottom funds by permitting "active" management of bottom funds. The Existing Decisions mandated a "passive" investment approach.

The proposed amendments also provide relief from the concentration and control restrictions in NI 81-102 for fund of funds investments.

Since the simplified prospectus of the top fund may not disclose each investment, and each modification on an ongoing basis, investors in a top fund will not be able to determine the top funds actual holding by reviewing the simplified prospectus. The CSA seek comment on whether this situation is problematic. Furthermore, if the top fund replaces its holdings in one "important" bottom fund, for another one, should the investors be notified of this change.

The CSA seek comment on this issue as well as suggestions on how, and whether, investors should have access to the updated holdings of the top fund. Should the simplified prospectus be amended, or a notice provided, every time an important bottom fund is changed?

Alternatives Considered

The CSA considered maintaining the current fund of fund rules in NI 81-102 and continuing with ad hoc relief. The CSA also considered codifying the current ad hoc exemptive relief regime. However, these alternatives were rejected as contrary to the fundamental regulatory principle behind the proposed Fund of Funds Amendments. Also, it was concluded that these alternatives would result in detailed and complicated rules which would be less efficient for regulators, investors and industry participants. These amendments represent the CSA's views on the appropriate rules for fund of funds structures.

With respect to the Miscellaneous Amendments, the CSA considered maintaining the status quo. It was concluded that this was not a practical alternative as it would not address issues concerning on the practical application of NI 81-102, NI 81-101 and the related Companion Policies and Forms

Related Instruments

The proposed amendments relate to NI 81-102, 81-102CP, NI 81-101, Form 81-101F1 and Form 81-101F2.

Unpublished Materials

In proposing the amendments to NI 81-102, 81-102CP, NI 81-102, Form 81-101F1 and Form 81-101F2, the CSA have not relied on any significant unpublished study, report, decision or other written materials.

Comments

Interested parties are invited to make written submissions with respect to the proposed amendments. Submissions received by October 17, 2002 will be considered.

Submissions should be sent to the CSA care of:

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If you are not sending your comments by e-mail, please send us two copies of your letter, together with a diskette containing your comments (in either Word or WordPerfect format). We cannot maintain confidentiality of submissions because securities legislation in certain provinces requires us to publish a summary of written comments received during the comment period.

Questions may be referred to any of the following:

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