

CANADIAN REGULATORS PROPOSE MODERNIZED RULES FOR MUTUAL FUNDS: ETFs, MONEY MARKET FUNDS, SHORT SELLING, FUND OF FUNDS

The Canadian Securities Administrators recently published proposed amendments designed to modernize the rules that apply to publicly offered mutual funds in Canada. The more significant proposals, if adopted, would

- Facilitate public offerings of exchange-traded mutual funds in Canada by codifying exemptions that are routinely granted by the CSA to these funds
- Impose new restrictions on money market funds
- Allow mutual funds to engage in limited short selling practices
- Allow mutual funds to use investments in money market funds as “cash cover” for derivative transactions
- Provide additional flexibility for mutual funds wishing to invest in other mutual funds and
- Exempt mutual fund dealers from certain CSA compliance obligations.

The proposals represent Phase 1 of the CSA’s project to modernize the product regulation of conventional mutual funds and other investment funds. Phase 2 will be to determine whether there are any market efficiency, fairness or investor protection issues that arise out of the differing regulatory regimes that apply to different types of investment funds and competing retail investment products. Additional changes may result, including changes to NI 81-102, although there is no indication as to when the CSA expects to complete Phase 2.

The comment period on the proposed amendments to National Instrument 81-102 *Mutual Funds*, National Instrument 81-106 *Investment Fund Continuous Disclosure* and the related prospectus rules, including National Instrument 81-101 *Mutual Fund Prospectus Disclosure* and National Instrument 41-101 *General Prospectus Requirements* ends on **September 24, 2010**. The proposals are available [[here](#)]. The proposed amendments do not include many technical drafting points that we have pointed out to the regulators over the years nor do they include other routine exemptions that we have obtained for our clients. We intend to provide comments on the proposals, including on additional items that we believe should be included, and we would be pleased to assist you in preparing your comments on the proposals.

INVESTMENT MANAGEMENT BULLETIN

Exchange-traded Mutual Funds

Exchange-traded mutual funds have unique features not shared by conventional mutual funds. To address the differences between these types of funds, the CSA routinely grant exemptive relief from certain provisions in NI 81-102 to exchange-traded mutual funds. The proposed amendments to NI 81-102 would codify much of this exemptive relief.

- Payment for purchases and redemptions of mutual fund securities in a combination of cash and securities would be permitted. While this will apply to all mutual funds, this will be particularly relevant to exchange-traded funds.
- An exchange-traded fund would be required to establish record dates for the purpose of determining the rights of its securityholders to receive a distribution in accordance with the rules of the exchange on which the fund is listed.
- For exchange-traded mutual funds in continuous distribution, the proposals would permit the redemption price for securities, if a securityholder redeems less than a prescribed number of securities, to be a price that is computed by reference to the closing price of the security on the exchange on which the fund is listed and posted for trading.

For exchange-traded mutual funds that are not in continuous distribution, the proposed amendments would permit

- A redemption price to be an amount that is less than the net asset value of the security otherwise determined.
- Redemption proceeds to be paid on a specified date that may be more than three days following the valuation date on which the redemption price was established.
- The borrowing of cash or the provision of a security interest over portfolio assets if the transaction is to finance the acquisition of portfolio securities and the outstanding amount of all borrowings will be repaid on the closing of the initial public offering.
- The fund to bear its organization costs.

Exchange-traded mutual funds not in continuous distribution that fall within the proposed new definition of “fixed portfolio exchange-traded mutual funds” would be exempt from the 10 percent concentration restriction for purchases of equity securities by the fund if made in accordance with its investment objectives.

The proposed amendments would not however provide other relief that has been routinely granted to exchange-traded mutual funds, including the following relief from requirements of NI 81-102 that would

INVESTMENT MANAGEMENT BULLETIN

- Permit purchase and redemption orders for securities of the funds to be transmitted to the exchange on which securities of the fund are listed, instead of to the order receipt offices of the funds.
- Exempt exchange-traded mutual funds from the requirement to file compliance reports otherwise required.

The CSA did not explain why this relief was not included in the proposed amendments. We intend to provide comments in this regard.

Money Market Funds

In October 2008, the CSA published CSA Consultation Paper 11-405 *Securities Regulatory Proposals Stemming from the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada*. The CSA outlined specific issues relating to money market funds in the Consultation Paper, including those funds that had invested in asset-backed commercial paper, and signaled their intention to consider revamping the rules for money market funds. Starting in September 2008, the Ontario Securities Commission also reviewed selected money market funds focusing on portfolio holdings, valuation of portfolio securities, portfolio concentration, counterparty exposure and redemption levels. The results of that review were summarized in OSC Staff Notice 33-733 *Report on Focused Reviews of Investment Funds, September 2008-September 2009*, which was released in January 2010.

The proposed amendments to NI 81-102 in respect of money market funds resulted from comments received on the Consultation Paper and the results of the OSC's review of money market funds. The proposed amendments would also codify routine exemptive relief granted to money market funds to permit investments in other money market funds. The new proposed requirements are as follows:

- **Liquidity requirement.** A money market fund would be required to have at least 5 percent of its assets in cash or securities that are readily convertible to cash within one day and 15 percent of its assets in cash or securities that are readily convertible to cash within one week.
- **Dollar-weighted average term to maturity limit.** A money market fund would be required, in addition to the current requirement of maintaining a portfolio with a dollar-weighted average term to maturity limit not exceeding 90 days (calculated on the basis that the term of a floating rate note is the period remaining to the date of the next rate setting of the note), to maintain a dollar-weighted average term to maturity limit not exceeding 120 days (calculated based on the actual term to maturity of all securities, including floating rate notes).
- **Investment restrictions.** A money market fund would be restricted from using specified derivatives or engaging in short selling.

INVESTMENT MANAGEMENT BULLETIN

New rules recently adopted by the United States Securities and Exchange Commission are more restrictive than the CSA's proposals. A U.S. taxable money market fund must have at least 10 percent of its portfolio assets invested in cash, U.S. Treasury securities or securities that convert into cash within one day. A U.S. money market fund must have at least 30 percent of its portfolio assets in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week. In addition, the "weighted average maturity" of the portfolio of a U.S. money market fund is subject to a 60-day limit, with a 120-day "weighted average life" maturity. The CSA ask for feedback on the proposed 90 and 120-day average term to maturity limits for Canadian money market funds, including whether there should be any limit on the money market funds' exposure to floating rate notes. The CSA also seek feedback on whether the proposed 90-day term to maturity limit should be reduced to a shorter time frame to be consistent with the 60-day limit adopted by the SEC.

Other Proposals

Other significant proposed amendments to NI 81-102 include

- **Short selling.** Mutual funds would be permitted to engage in limited short selling. The proposal to permit this practice is consistent with the conditions to the exemptions granted routinely over the past few years. However, notably, the CSA indicate that short selling cannot be used to create publicly offered "long-short funds", given the proposed restrictions on the use of the proceeds of a short sale.
- **Use of derivatives.** The definition of "cash cover" would be expanded to include evidences of indebtedness in addition to debt of governments and financial institutions, provided certain restrictions are adhered to. Consistent with prior exemptions, cash cover would also include securities of money market funds. In addition, the term limit on specified derivatives would be removed.
- **Investments in mutual funds.** A mutual fund would be permitted to continue to invest in another mutual fund even if the underlying fund ceases to offer its securities in the local jurisdiction, as long as the underlying fund remains a reporting issuer in the local jurisdiction. In addition, the definition of "index participation units" would be expanded to include securities traded on an exchange in the United Kingdom, which would permit a Canadian mutual fund to invest in an investment vehicle that issues such securities. As noted above, a money market fund would be able to invest in another money market fund.
- **Mutual fund dealers.** The exemption currently applicable to members of IIROC with respect to the restrictions on the commingling of client moneys, the requirements with respect to interest determination and allocation and the filing of compliance reports would be extended to members of the Mutual Fund Dealers Association of Canada and mutual fund dealers in Québec.
- **Use of mutual fund ratings in sales communications.** The use of performance ratings or rankings in sales communications would be clarified and additional disclosure would be required to ensure

INVESTMENT MANAGEMENT BULLETIN

that such ratings and rankings are not misleading. A definition of a “mutual fund rating entity” would be added to NI 81-102.

The proposed amendments to NI 81-106 include the following rule proposals, both designed to enhance the transparency of an investment fund.

- **No aggregation of short-term debt.** The amendments would discontinue the ability of an investment fund to aggregate certain types of short-term debt in the fund’s statement of investment portfolio.
 - **Public availability of NAV.** All investment funds would be required to make their net asset value available to the public at no cost and explain in the applicable prospectus documents how an investor can access this information.
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If you would like to discuss the proposed amendments and how they will affect you, or if you would like assistance in preparing a comment letter on the proposals, please contact your usual lawyer in BLG’s Investment Management Group, any of the authors of this Bulletin or any of the Investment Management Group leaders noted below.

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The Investment Management Group at Borden Ladner Gervais LLP consists of a team of over 50 lawyers located in offices across Canada who understand the business, regulatory and administrative issues that face participants in the Canadian investment management industry. We have the largest and most experienced investment management practice in Canada, having provided legal services to Canadian and international industry participants for over 50 years. Our clients, both Canadian and international, include open and closed-end investment fund complexes, providers of alternative investment, pooled and private equity products, investment advisers and dealers, financial institutions, service providers, securities regulators, self-regulatory organizations and industry trade associations. Our lawyers have long-standing working relationships with the Canadian securities regulators and other government officials, as well as with The Investment Funds Institute of Canada and key industry leaders.

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