

## COMPANION POLICY

81-102

### MUTUAL FUNDS

#### PART 1 PURPOSE

##### 1.1 Purpose

**Purpose** - The purpose of this Policy is to state the views of the Canadian securities regulatory authorities on various matters relating to National Instrument 81-102 Mutual Funds (the "Instrument"), including

- (a) the interpretation of various terms used in the Instrument;
- (b) recommendations concerning the operating procedures that the Canadian securities regulatory authorities suggest that mutual funds, or persons performing services for mutual funds, adopt to ensure compliance with the Instrument;
- (c) discussions of circumstances in which the Canadian securities regulatory authorities have granted relief from particular requirements of National Policy Statement No. 39 ("NP39"), the predecessor to the Instrument, and the conditions that those authorities imposed in granting that relief; and
- (d) recommendations concerning applications for approvals required under, or relief from, provisions of the Instrument.

#### PART 2 COMMENTS ON DEFINITIONS CONTAINED IN THE INSTRUMENT

##### 2.1 "asset allocation service"



**"asset allocation service"** - The definition of "asset allocation service" in the Instrument includes only specific administrative services in which an investment in mutual funds subject to the Instrument is an integral part. The Canadian securities regulatory authorities do not view this definition as including general investment services such as discretionary portfolio management that may, but are not required to, invest in mutual funds subject to this Instrument.

## 2.2 "cash equivalent"

**"cash equivalent"** - The definition of "cash equivalent" in the Instrument includes certain evidences of indebtedness of Canadian financial institutions. This includes banker's acceptances.

## 2.3 "clearing corporation"

**"clearing corporation"** - The definition of "clearing corporation" in the Instrument includes both incorporated and unincorporated organizations, which may, but need not, be part of an options or futures exchange.

## 2.4 "debt-like security"

**"debt-like security"** - Paragraph (b) of the definition of "debt-like security" in the Instrument provides that the value of the component of an instrument that is not linked to the underlying interest of the instrument must account for less than 80 percent of the aggregate value of the instrument in order that the instrument be considered a debt-like security. The Canadian securities regulatory authorities have structured this provision in this manner to emphasize what they consider the most appropriate manner to value these instruments. That is, one should first value the component of the instrument that is not linked to the underlying interest, as this is often much easier to value than the component that is linked to the underlying interest. The Canadian securities regulatory authorities recognize the valuation difficulties that can arise if one attempts to value, by itself, the component of an instrument that is linked to the underlying interest.

## 2.5 "fundamental investment objectives"



- (1) The definition of "fundamental investment objectives" is relevant in connection with paragraph 5.1(c) of the Instrument, which requires that the approval of securityholders of a mutual fund be obtained before any change is made to the fundamental investment objectives of the mutual fund. The fundamental investment objectives of a mutual fund are required to be disclosed in a simplified prospectus under Part B of Form 81-101F1 Contents of Simplified Prospectus. The definition of "fundamental investment objectives" contained in the Instrument uses the language contained in the disclosure requirements of Part B of Form 81-101F1, and the definition should be read to include the matters that would have to be disclosed under the Item of Part B of the form concerning "Fundamental Investment Objectives". Accordingly, any change to the mutual fund requiring a change to that disclosure would trigger the requirement for securityholder approval under paragraph 5.1(c) of the Instrument.
- (2) Part B of Form 81-101F1 sets out, among other things, the obligation that a mutual fund disclose in a simplified prospectus both its fundamental investment objectives and its investment strategies. The matters required to be disclosed under the Item of Part B of the form relating to "Investment Strategies" are not "fundamental investment objectives" under the Instrument.
- (3) Generally speaking, the "fundamental investment objectives" of a mutual fund are those attributes that define its fundamental nature. For example, mutual funds that are guaranteed or insured, or that pursue a highly specific investment approach such as index funds or derivative funds, may be defined by those attributes. Often the manner in which a mutual fund is marketed will provide evidence as to its fundamental nature; a mutual fund whose advertisements emphasize, for instance, that investments are guaranteed likely will have the existence of a guarantee as a "fundamental investment objective".
- (4) The Canadian securities regulatory authorities are of the view that whether the securities of a mutual fund are foreign property under the ITA is linked to the mutual fund's fundamental investment objectives. Therefore, a change in the method by which the mutual fund is managed that results in its securities going from being foreign property to being non-foreign property, or vice versa, would be likely due to a change in the mutual fund's fundamental investment objectives.

- (5) One component of the definition of "fundamental investment objectives" is that those objectives distinguish a mutual fund from other mutual funds. This component does not imply that the fundamental investment objectives for each mutual fund must be unique. Two or more mutual funds can have identical fundamental investment objectives.

## 2.6 "guaranteed mortgage"

**"guaranteed mortgage"** - A mortgage insured under the *National Housing Act* (Canada) or similar provincial statutes is a "guaranteed mortgage" for the purposes of the Instrument.

## 2.7 "hedging"

- (1) One component of the definition of "hedging" is the requirement that hedging transactions result in a "high degree of negative correlation between changes in the value of the investment or position, or group of investments or positions, being hedged and changes in the value of the instrument or instruments with which the investment or position is hedged". The Canadian securities regulatory authorities are of the view that there need not be complete congruence between the hedging instrument or instruments and the position or positions being hedged if it is reasonable to regard the one as a hedging instrument for the other, taking into account the closeness of the relationship between fluctuations in the price of the two and the availability and pricing of hedging instruments.
- (2) The definition of "hedging" includes a reference to the "maintaining" of the position resulting from a hedging transaction or series of hedging transactions. The inclusion of this component in the definition requires a mutual fund to ensure that a transaction continues to offset specific risks of the mutual fund in order that the transaction be considered a "hedging" transaction under the Instrument; if the "hedging" position ceases to provide an offset to an existing risk of a mutual fund, then that position is no longer a hedging position under the Instrument, and can be held by the mutual fund only in compliance with the specified derivatives rules of the Instrument that apply to non-hedging positions. The component of the definition that requires the "maintaining" of a hedge position does not

mean that a mutual fund is locked into a specified derivatives position; it simply means that the specified derivatives position must continue to satisfy the definition of "hedging" in order to receive hedging treatment under the Instrument.

- (3) Paragraph (b) of the definition of "hedging" has been included to ensure that currency cross hedging continues to be permitted under the Instrument. Currency cross hedging is the substitution of currency risk associated with one currency for currency risk associated with another currency, if neither currency is a currency in which the mutual fund determines its net asset value per security and the aggregate amount of currency risk to which the mutual fund is exposed is not increased by the substitution. Currency cross hedging is to be distinguished from currency hedging, as that term is ordinarily used. Ordinary currency hedging, in the context of mutual funds, would involve replacing the mutual fund's exposure to a "non-net asset value" currency with exposure to a currency in which the mutual fund calculates its net asset value per security. That type of currency hedging is subject to paragraph (a) of the definition of "hedging".

## 2.8 "illiquid asset"

**"illiquid asset"** - A portfolio asset of a mutual fund that meets the definition of "illiquid asset" will be an illiquid asset even if a person or company, including the manager or the portfolio adviser of a mutual fund or a partner, director or officer of the manager or portfolio adviser of a mutual fund or any of their respective associates or affiliates, has agreed to purchase the asset from the mutual fund. That type of agreement does not affect the words of the definition, which defines "illiquid asset" in terms of whether that asset cannot be readily disposed of through market facilities on which public quotations in common use are widely available.

## 2.9 "manager"

**"manager"** - The definition of "manager" under the Instrument only applies to the person or company that actually directs the business of the mutual fund, and does not apply to others, such as trustees, that do not actually carry out this function. Also, a "manager" would not include a person or company whose



duties are limited to acting as a service provider to the mutual fund, such as a portfolio adviser.

## 2.10 "option"

**"option"** - The definition of "option" includes warrants, whether or not the warrants are listed on a stock exchange or quoted on an over-the-counter market.

## 2.11 "performance data"

**"performance data"** - The term "performance data" includes data on an aspect of the investment performance of a mutual fund, an asset allocation service, security, index or benchmark. This could include data concerning return, volatility or yield. The Canadian securities regulatory authorities note that the term "performance data" would not include a rating prepared by an independent organization reflecting the credit quality, rather than the performance, of, for instance, a mutual fund's portfolio or the participating funds of an asset allocation service.

## 2.12 "public medium"

**"public medium"** - An "advertisement" is defined in the Instrument to mean a sales communication that is published or designed for use on or through a "public medium". The Canadian securities regulatory authorities interpret the term "public medium" to include print, television, radio, tape recordings, video tapes, computer disks, the Internet, displays, signs, billboards, motion pictures and telephones.

## 2.13 "purchase"

- (1) The definition of a "purchase", in connection with the acquisition of a portfolio asset by a mutual fund, means an acquisition that is the result of a decision made and action taken by the mutual fund.
- (2) The Canadian securities regulatory authorities consider that the following



types of transactions would generally be purchases of a security by a mutual fund under the definition:

1. The mutual fund effects an ordinary purchase of the security, or, at its option, exercises, converts or exchanges a convertible security held by it.
  2. The mutual fund receives the security as consideration for a security tendered by the mutual fund into a take-over bid.
  3. The mutual fund receives the security as the result of a merger, amalgamation, plan of arrangement or other reorganization for which the mutual fund voted in favour.
  4. The mutual fund receives the security as a result of the automatic exercise of an exchange or conversion right attached to another security held by the mutual fund in accordance with the terms of that other security or the exercise of that exchange or conversion right at the option of the mutual fund.
  5.
    - (a) The mutual fund has become legally entitled to dispose of the collateral held by it under a securities loan or repurchase agreement and to apply proceeds of realization to satisfy the obligations of the counterparty of the mutual fund under the transaction, and
    - (b) sufficient time has passed after the event described in paragraph (a) to enable the mutual fund to sell the collateral in a manner that maintains an orderly market and that permits the preservation of the best value for the mutual fund.
- (3) The Canadian securities regulatory authorities consider that the following types of transactions would generally not be purchases of a security by a mutual fund under the definition:
1. The mutual fund receives the security as a result of a compulsory acquisition by an issuer following completion of a successful take-over bid.

2. The mutual fund receives the security as a result of a merger, amalgamation, plan of arrangement or other reorganization that the mutual fund voted against.
3. The mutual fund receives the security as the result of the exercise of an exchange or conversion right attached to a security held by the mutual fund made at the discretion of the issuer of the security held by the mutual fund.
4. The mutual fund declines to tender into an issuer bid, even though its decision is likely to result in an increase in its percentage holdings of a security beyond what the mutual fund would be permitted under the Instrument to purchase.

#### **2.14 "restricted security"**

**"restricted security"** - A special warrant is a form of restricted security and, accordingly, the provisions of the Instrument applying to restricted securities apply to special warrants.

#### **2.15 "sales communication"**

- (1) The term "sales communication" refers to a communication to a securityholder of a mutual fund and to a person or company that is not a securityholder if the purpose of the communication is to induce the purchase of securities of the mutual fund. A sales communication therefore does not include a communication solely between a mutual fund or its promoter, manager, principal distributor or portfolio adviser and a participating dealer, or between the principal distributor or a participating dealer and its registered salespersons, that is indicated to be internal or confidential and that is not designed to be passed on by any principal distributor, participating dealer or registered salesperson to any securityholder of, or potential investor in, the mutual fund. In the view of the Canadian securities regulatory authorities, if a communication of that type were so passed on by the principal distributor, participating dealer or registered salesperson, the communication would be a sales communication made by the party passing on the communication if the recipient of the communication were



a securityholder of the mutual fund or if the intent of the principal distributor, participating dealer or registered salesperson in passing on the communication were to induce the purchase of securities of the mutual fund.

- (2) The term "sales communication" is defined in the Instrument such that the communication need not be in writing and includes any oral communication. The Canadian securities regulatory authorities are of the view that the requirements in the Instrument pertaining to sales communications would apply to statements made at an investor conference to securityholders or to others to induce the purchase of securities of the mutual fund.
- (3) The Canadian securities regulatory authorities are of the view that image advertisements that are intended to promote a corporate identity or the expertise of a mutual fund manager fall outside the definition of "sales communication". However, an advertisement or other communication that refers to a specific mutual fund or funds or promotes any particular investment portfolio or strategy would be a sales communication and therefore be required to include warnings of the type now described in section 15.4 of the Instrument.
- (4) Paragraph (b) of the definition of a "sales communication" in the Instrument excludes sales communications contained in certain documents that the mutual fund is required to prepare, including audited or unaudited financial statements (which include a statement of portfolio transactions), statements of account and confirmations of trade. The Canadian securities regulatory authorities are of the view that if information is contained in these types of documents that is not required to be included by securities legislation, any such additional material is not excluded by paragraph (b) of the definition of sales communication and may, therefore, constitute a sales communication if the additional material otherwise falls within the definition of that term in the Instrument.

## 2.16 "specified derivative"

- (1) The term "specified derivative" is defined to mean an instrument, agreement or security, the market price, value or payment obligations of



which are derived from, referenced to or based on an underlying interest. Certain instruments, agreements or securities that would otherwise be specified derivatives within the meaning of the definition are then excluded from the definition for purposes of the Instrument.

- (2) Because of the broad ambit of the lead-in language to the definition, it is impossible to list every instrument, agreement or security that might be caught by that lead-in language but that is not considered to be a derivative in any normal commercial sense of that term. The Canadian securities regulatory authorities consider conventional floating rate debt instruments, securities of a mutual fund or commodity pool, non-redeemable securities of an investment fund, American depositary receipts and instalment receipts generally to be within this category, and generally will not treat those instruments as specified derivatives in administering the Instrument.
- (3) However, the Canadian securities regulatory authorities note that these general exclusions may not be applicable in cases in which a mutual fund invests in one of the vehicles described in subsection (2) with the result that the mutual fund obtains or increases exposure to a particular underlying interest in excess of the limit set out in section 2.1 of the Instrument. In such circumstances, the Canadian securities regulatory authorities are likely to consider that instrument a specified derivative under the Instrument.

## 2.17 "standardized future"

**"standardized future"**- The definition of "standardized future" refers to an agreement traded on a futures exchange. This type of agreement is called a "futures contract" in the legislation of some jurisdictions, and an "exchange contract" in the legislation of some other jurisdictions (such as British Columbia and Alberta). The term "standardized future" is used in the Instrument to refer to these types of contracts, to avoid conflict with existing local definitions.

## 2.18 "swap"

**"swap"** - The Canadian securities regulatory authorities are of the view that the definition of a swap in the Instrument would include conventional interest rate



and currency swaps, as well as equity swaps.

## **PART 3 INVESTMENTS**

### **3.1 Evidences of Indebtedness of Foreign Governments and Supranational Agencies**

- (1) Section 2.1 of the Instrument prohibits mutual funds from purchasing a security of an issuer, other than a government security or a security issued by a clearing corporation if, immediately after the purchase, more than 10 percent of the net assets of the mutual fund, taken at market value at the time of the purchase, would be invested in securities of that issuer. The term "government security" is defined in the Instrument as an evidence of indebtedness that is issued, or fully and unconditionally guaranteed as to principal and interest, by any of the government of Canada, the government of a jurisdiction or the government of the United States of America.
- (2) Before the Instrument came into force, the Canadian securities regulatory authorities granted relief from the predecessor provision of NP39 to a number of international bond funds in order to permit those mutual funds to pursue their fundamental investment objectives with greater flexibility.
- (3) The Canadian securities regulatory authorities will continue to consider applications for relief from section 2.1 of the Instrument if the mutual fund making the application demonstrates that the relief will better enable the mutual fund to meet its fundamental investment objectives. This relief will ordinarily be restricted to international bond funds.
- (4) The relief from paragraph 2.04(1)(a) of NP39, which is replaced by section 2.1 of the Instrument, that has been provided to a mutual fund has generally been limited to the following circumstances:
  1. The mutual fund has been permitted to invest up to 20 percent of its net assets, taken at market value at the time of purchase, in evidences of indebtedness of any one issuer if those evidences of indebtedness are issued, or guaranteed fully as to principal and

interest, by supranational agencies or governments other than the government of Canada, the government of a jurisdiction or the government of the United States of America and are rated "AA" by Standard & Poor's, or have an equivalent rating by one or more other approved credit rating organizations.

2. The mutual fund has been permitted to invest up to 35 percent of its net assets, taken at market value at the time of purchase, in evidences of indebtedness of any one issuer, if those securities are issued by issuers described in paragraph 1 and are rated "AAA" by Standard & Poor's, or have an equivalent rating by one or more other approved credit rating organizations.
- (5) It is noted that the relief described in paragraphs 3.1(4)1 and 2 cannot be combined for one issuer.
  - (6) Despite subsection (4), the relief from paragraph 2.04(1)(a) of NP39, which is replaced by section 2.1 of the Instrument, provided to a mutual fund whose securities are a registered investment under the ITA or whose securities are not, and are described in the current prospectus or simplified prospectus of the mutual fund as not being foreign property under the ITA has generally been restricted to allowing the mutual fund to invest no more than 20 percent of its net assets, taken at market value at the time of purchase, in securities issued by issuers described in subsection (4) if the securities of those issuers are foreign property under the ITA.
  - (7) In addition to the limitation described in subsection (6), the relief from paragraph 2.04(1)(a) of NP39, which is replaced by section 2.1 of the Instrument, has generally been provided only if
    - (a) the securities that may be purchased under the relief referred to in subsections (4) and (6) are traded on a mature and liquid market;
    - (b) the acquisition of the evidences of indebtedness by the mutual fund is consistent with its fundamental investment objectives;
    - (c) the prospectus or simplified prospectus of the mutual fund disclosed the additional risks associated with the concentration of the net assets of the mutual fund in securities of fewer issuers,

such as the potential additional exposure to the risk of default of the issuer in which the fund has so invested and the risks, including foreign exchange risks, of investing in the country in which that issuer is located; and

- (d) the prospectus or simplified prospectus of the mutual fund gave details of the relief provided by the Canadian securities regulatory authorities, including the conditions imposed and the type of securities covered by the exemption.

### 3.2 Index Mutual Funds

- (1) An "index mutual fund" is defined in section 1.1 of the Instrument as a mutual fund that has adopted fundamental investment objectives that require it to
  - (a) hold the securities that are included in a permitted index or permitted indices of the mutual fund in substantially the same proportion as those securities are reflected in that permitted index or permitted indices; or
  - (b) invest in a manner that causes the mutual fund to replicate the performance of that permitted index or those permitted indices.
- (2) This definition includes only mutual funds whose entire portfolio is invested in accordance with one or more permitted indices. The CSA recognizes that there may be mutual funds that invest part of their portfolio in accordance with a permitted index or indices, with a remaining part of the portfolio being actively managed. Those mutual funds cannot avail themselves of the relief provided by subsection 2.1(5) of the Instrument, which provides relief from the "10 percent rule" contained in subsection 2.1(1) of the Instrument, because they are not "index mutual funds". The CSA acknowledge that there may be circumstances in which the principles behind the relief contained in subsection 2.1(5) of the Instrument is also applicable to "partially-indexed" mutual funds. Therefore, the CSA will consider applications from those types of mutual funds for relief analogous to that provided by subsection 2.1(5) of the Instrument.
- (3) It is noted that the manager of an index mutual fund may make a decision



to base all or some of the investments of the mutual fund on a different permitted index than a permitted index previously used. This decision might be made for investment reasons or because that index no longer satisfies the definition of "permitted index" in the Instrument. It is noted that this decision by the manager will be considered by the Canadian securities regulatory authorities generally to constitute a change of fundamental investment objectives, thereby requiring securityholder approval under paragraph 5.1(c) of the Instrument. In addition, this decision would also constitute a significant change for the mutual fund, thereby requiring an amendment to the simplified prospectus of the mutual fund and the issuing of a press release under section 5.10 of the Instrument.

### 3.3 Special Warrants

**Special Warrants** - A mutual fund is required by subsection 2.2(3) of the Instrument to assume the conversion of each special warrant it holds. This requirement is imposed because the nature of a special warrant is such that there is a high degree of likelihood that its conversion feature will be exercised shortly after its issuance, once a prospectus relating to the underlying security has been filed.

### 3.4 Investment in Other Mutual Funds

- (1) Subsection 2.5(1) of the Instrument contains restrictions on the ability of a mutual fund to invest in the securities of another mutual fund. Subsection 2.5(2) of the Instrument provides that subsection (1) does not apply to the purchase of a mutual fund that is listed and posted for trading on a stock exchange.
- (2) Subsection 2.5(2) of the Instrument removes from the fund of funds rules any security of an issuer that may technically be a mutual fund, such as a subdivided offering or an index participation unit, but that is not a conventional mutual fund and for which the fund of funds rules should not be applicable. Since those vehicles are generally listed on a stock exchange, the Canadian securities regulatory authorities have used this distinguishing feature to define the vehicles whose securities may be purchased by a mutual fund without regard to the fund of funds regime.



The purchase of those vehicles is, of course, subject to the other investment restrictions of the Instrument, including, without limitation, section 2.1 of the Instrument.

### **3.5 Instalments of Purchase Price**

**Instalments of Purchase Price** - Paragraph 2.6(d) of the Instrument prohibits a mutual fund from purchasing a security, other than a specified derivative, that by its terms may require the mutual fund to make a contribution in addition to the payment of the purchase price. This prohibition does not extend to the purchase of securities that are paid for on an instalment basis in which the total purchase price and the amounts of all instalments are fixed at the time the first instalment is made.

### **3.6 Purchase of Evidences of Indebtedness**

**Purchase of Evidences of Indebtedness** - Paragraph 2.6(f) of the Instrument prohibits a mutual fund from lending either cash or a portfolio asset other than cash. The Canadian securities regulatory authorities are of the view that the purchase of an evidence of indebtedness, such as a bond or debenture, a loan participation or loan syndication as permitted by paragraph 2.3(i) of the Instrument, or the purchase of a preferred share that is treated as debt for accounting purposes, does not constitute the lending of cash or a portfolio asset.

### **3.7 Securities Lending, Repurchase and Reverse Repurchase Transactions**

- (1) Section 2.12, 2.13 and 2.14 of the Instrument each contains a number of conditions that must be satisfied in order that a mutual fund may enter into a securities lending, repurchase or reverse repurchase transaction in compliance with the Instrument. It is expected that, in addition to satisfying these conditions, the manager on behalf of the mutual fund, in co-ordination with an agent, will ensure that the documentation evidencing these types of transactions contains customary provisions to protect the mutual fund and to document the transaction properly. Among other things, these provisions would normally include
  - (a) a definition of an "event of default" under the agreement, which



would include failure to deliver cash or securities, or to promptly pay to the mutual fund amounts equal to dividends and interest paid, and distributions made, on loaned or sold securities, as required by the agreement;

- (b) provisions giving non-defaulting parties rights of termination, rights to sell the collateral, rights to purchase identical securities to replace the loaned securities and legal rights of set-off in connection with their obligations if an event of default occurs; and
  - (c) provisions that deal with, if an event of default occurs, how the value of collateral or securities held by the non-defaulting party that is in excess of the amount owed by the defaulting party will be treated.
- (2) Section 2.12, 2.13 and 2.14 of the Instrument each imposes a requirement that a mutual fund that has entered into a securities lending, repurchase or reverse repurchase transaction hold cash or securities of at least 102 percent of the market value of the securities or cash held by the mutual fund's counterparty under the transaction. It is noted that the 102 percent requirement is a minimum requirement, and that it may be appropriate for the manager of a mutual fund, or the agent acting on behalf of the mutual fund, to negotiate the holding of a greater amount of cash or securities if necessary to protect the interests of the mutual fund in a particular transaction, having regard to the level of risk for the mutual fund in the transaction. In addition, if the recognized best practices for a particular type of transaction in a particular market calls for a higher level of collateralization than 102 percent, it is expected that, absent special circumstances, the manager or the agent would ensure that its arrangements reflect the relevant best practices for that transaction.
- (3) Paragraph 3 of subsection 2.12(1) of the Instrument refers to securities lending transactions in terms of securities that are "loaned" by a mutual fund in exchange for collateral. Some securities lending transactions are documented so that title to the "loaned" securities is transferred from the "lender" to the "borrower". The Canadian securities regulatory authorities do not consider this fact as sufficient to disqualify those transactions as securities loan transactions within the meaning of the Instrument, so long as the transaction is in fact substantively a loan. References throughout the Instrument to "loaned" securities, and similar references, should be



read to include securities "transferred" under a securities lending transaction.

- (4) Paragraph 6 of subsection 2.12(1) permits the use of irrevocable letters of credit as collateral in securities lending transactions. The Canadian securities regulatory authorities believe that, at a minimum, the prudent use of letters of credit will involve the following arrangements:
  - (a) the mutual fund should be allowed to draw down any amount of the letter of credit at any time by presenting its sight draft and certifying that the borrower is in default of its obligations under the securities lending agreement, and the amount capable of being drawn down would represent the current market value of the outstanding loaned securities or the amount required to cure any other borrower default; and
  - (b) the letter of credit should be structured so that the lender may draw down, on the date immediately preceding its expiration date, an amount equal to the current market value of all outstanding loaned securities on that date.
- (5) Paragraph 9 of subsection 2.12(1) and paragraph 8 of subsection 2.13(1) of the Instrument each provides that the agreement under which a mutual fund enters into a securities lending or repurchase transaction include a provision requiring the mutual fund's counterparty to promptly pay to the mutual fund, among other things, distributions made on the securities loaned or sold in the transaction. In this context, the term "distributions" should be read broadly to include all payments or distributions of any type made on the underlying securities, including, without limitation, distributions of property, stock dividends, securities received as the result of splits, all rights to purchase additional securities and full or partial redemption proceeds. This extended meaning conforms to the meaning given the term "distributions" in several standard forms of securities loan agreements widely used in the securities lending and repurchase markets.
- (6) Section 2.12, 2.13 and 2.14 of the Instrument make reference to the "delivery" and "holding" of securities or collateral by the mutual fund. The Canadian securities regulatory authorities note that these terms will include the delivery or holding by an agent for a mutual fund. In addition, the Canadian securities regulatory authorities recognize that under



ordinary market practice, agents pool collateral for securities lending/repurchase clients; this pooling of itself is not considered a violation of the Instrument.

- (7) Section 2.12, 2.13 and 2.14 of the Instrument require that the securities involved in a securities lending, repurchase or reverse repurchase transaction be marked to market daily and adjusted as required daily. It is recognized that market practice often involves an agent marking to market a portfolio at the end of a business day, and effecting the necessary adjustments to a portfolio on the next business day. So long as each action occurs on each business day, as required by the Instrument, this market practice is not a breach of the Instrument.
- (8) As noted in subsection (7), the Instrument requires the daily marking to market of the securities involved in a securities lending, repurchase or reverse repurchase transaction. The valuation principles used in this marking to market may be those generally used by the agent acting for the mutual fund, even if those principles deviate from the principles that are used by the mutual fund in valuing its portfolio assets for the purposes of calculating net asset value.
- (9) Paragraph 6 of subsection 2.13(1) of the Instrument imposes a requirement concerning the delivery of sales proceeds to the mutual fund equal to 102 per cent of the market value of the securities sold in the transaction. It is noted that accrued interest on the sold securities should be included in the calculation of the market value of those securities.
- (10) Section 2.15 of the Instrument imposes the obligation on a manager of a mutual fund to appoint an agent or agents to administer its securities lending and repurchase transactions, and makes optional the ability of a manager to appoint an agent or agents to administer its reverse repurchase transactions. A manager that appoints more than one agent to carry out these functions may allocate responsibility as it considers best. For instance, it may be appropriate that one agent be responsible for domestic transactions, with one or more agents responsible for off-shore transactions. Managers should ensure that the various requirements of sections 2.15 and 2.16 of the Instrument are satisfied for all agents.
- (11) It is noted that the responsibilities of an agent appointed under section



2.15 of the Instrument include all aspects of acting on behalf of a mutual fund in connection with securities lending, repurchase or reverse repurchase agreements. This includes acting in connection with the reinvestment of collateral or securities held during the life of a transaction.

- (12) Subsection 2.15(3) of the Instrument requires that an agent appointed by a mutual fund to administer its securities lending, repurchase or reverse repurchase transactions shall be a custodian or sub-custodian of the mutual fund. It is noted that the provisions of Part 6 of the Instrument generally apply to the agent in connection with its activities relating to securities lending, repurchase or reverse repurchase transactions. The agent must have been appointed as custodian or sub-custodian in accordance with section 6.1, and must satisfy the other requirements of Part 6 in carrying out its responsibilities.
- (13) Subsection 2.15(5) of the Instrument provides that the manager of a mutual fund shall not authorize an agent to enter into securities lending, repurchase or, if applicable, reverse repurchase transactions on behalf of the mutual fund unless there is a written agreement between the agent, the manager and the mutual fund that deals with certain prescribed matters. Subsection (5) requires that the manager and the mutual fund, in the agreement, provide instructions to the agent on the parameters to be followed in entering into the type of transaction to which the agreement pertains. The parameters would normally include
- (a) details on the types of transactions that may be entered into by the mutual fund;
  - (b) types of portfolio assets of the mutual fund to be used in the transaction;
  - (c) specification of maximum transaction size, or aggregate amount of assets that may be committed to transactions at any one time;
  - (d) specification of permitted counterparties;
  - (e) any specific requirements regarding collateralization, including minimum requirements as to amount and diversification of collateralization, and details on the nature of the collateral that may be accepted by the mutual fund;

- (f) directions and an outline of responsibilities for the reinvestment of cash collateral received by the mutual fund under the program to ensure that proper levels of liquidity are maintained at all times; and
  - (g) duties and obligations on the agent to take action to obtain payment by a borrower of any amounts owed by the borrower.
- (14) The definition of "cash cover" contained in section 1.1 of the Instrument requires that the portfolio assets used for cash cover not be "allocated for specific purposes". Securities loaned by a mutual fund in a securities lending transaction have been allocated for specific purposes and therefore cannot be used as cash cover by the mutual fund for its specified derivatives obligations.
- (15) A mutual fund sometimes needs to vote securities held by it in order to protect its interests in connection with corporate transactions or developments relating to the issuers of the securities. The manager and the portfolio adviser of a mutual fund, or the agent of the mutual fund administering a securities lending program on behalf of the mutual fund, should monitor corporate developments relating to securities that are loaned by the mutual fund in securities lending transactions, and take all necessary steps to ensure that the mutual fund can exercise a right to vote the securities when necessary. This may be done by way of a termination of a securities lending transaction and recall of loaned securities, as described in paragraph 11 of subsection 2.12(1) of the Instrument.
- (16) As part of the prudent management of a securities lending, repurchase or reverse repurchase program, managers of mutual funds, together with their agents, should ensure that transfers of securities in connection with those programs are effected in a secure manner over an organized market or settlement system. For foreign securities, this may entail ensuring that securities are cleared through central depositories. Mutual funds and their agents should pay close attention to settlement arrangements when entering into securities lending, repurchase and reverse repurchase transactions.

## PART 4



## USE OF SPECIFIED DERIVATIVES

### 4.1 Exercising Options on Futures

**Exercising Options on Futures** - Paragraphs 2.8(1)(d) and (e) of the Instrument prohibit a mutual fund from, among other things, opening and maintaining a position in a standardized future except under the conditions referred to in those paragraphs. Opening and maintaining a position in a standardized future could be effected through the exercise by a mutual fund of an option on futures. Therefore, it should be noted that a mutual fund cannot exercise an option on futures and assume a position in a standardized future unless the applicable provisions of paragraphs 2.8(1)(d) or (e) are satisfied.

### 4.2 Registration Matters

**Registration Matters** - The Canadian securities regulatory authorities remind industry participants of the following requirements contained in securities legislation:

1. A mutual fund may only invest in or use clearing corporation options and over-the-counter options if the portfolio adviser advising with respect to these investments
  - (a) is permitted, either by virtue of registration as an adviser under the securities legislation or commodity futures legislation of the jurisdiction in which the portfolio adviser is providing the advice or an exemption from the requirement to be registered, to provide that advice to the mutual fund under the laws of that jurisdiction; and
  - (b) has satisfied all applicable option proficiency requirements of that jurisdiction which, ordinarily, will involve completion of the Canadian Options Course.
2. A mutual fund may invest in or use futures and options on futures only if the portfolio adviser advising with respect to these investments or uses is registered as an adviser under the securities or commodity futures legislation of the jurisdiction in which the portfolio adviser is providing the advice, if this registration is required in that jurisdiction, and meets the



proficiency requirements for advising with respect to futures and options on futures in the jurisdiction.

3. A portfolio adviser of a mutual fund that receives advice from a non-resident sub-adviser as contemplated by section 2.10 of the Instrument is not relieved from the registration requirements described in paragraphs 1 and 2.
4. In Ontario, a non-resident sub-adviser is required, under the commodity futures legislation of Ontario, to be registered in Ontario if it provides advice to another portfolio adviser of a mutual fund in Ontario concerning the use of standardized futures by the mutual fund. Section 2.10 of the Instrument does not exempt the non-resident sub-adviser from this requirement. A non-resident sub-adviser should apply for an exemption in Ontario if it wishes to carry out the arrangements contemplated by section 2.10 without being registered in Ontario under that legislation.

#### 4.3 Leveraging

**Leveraging** - The Instrument is designed to prevent the use of specified derivatives for the purpose of leveraging the assets of the mutual fund. The definition of "hedging" prohibits leveraging with specified derivatives used for hedging purposes. The provisions of subsection 2.8(1) of the Instrument restrict leveraging with specified derivatives used for non-hedging purposes.

#### 4.4 Cash Cover

**Cash Cover** - The definition of "cash cover" in the Instrument prescribes the securities or other portfolio assets that may be used to satisfy the cash cover requirements relating to specified derivatives positions of mutual funds required by Part 2 of the Instrument. The definition of "cash cover" includes various interest-bearing securities; the definition includes interest accrued on those securities, and so mutual funds are able to include accrued interest for purposes of cash cover calculations.

## PART 5 LIABILITY AND INDEMNIFICATION



## 5.1 Liability and Indemnification

- (1) Subsection 4.4(1) of the Instrument contains provisions that require that any agreement or declaration of trust under which a person or company acts as manager of a mutual fund provide that the manager is responsible for any loss that arises out of the failure of it, and of any person or company retained by it or the mutual fund to discharge any of the manager's responsibilities to the mutual fund, to satisfy the standard of care referred to in that section. Subsection 4.4(2) of the Instrument provides that a mutual fund shall not relieve the manager from that liability.
- (2) The purpose of these provisions is to ensure that the manager remains responsible to the mutual fund and therefore indirectly to its securityholders for the duty of care that is imposed by the securities legislation of most jurisdictions, and to clarify that the manager is responsible to ensure that service providers perform to the level of that standard of care. The Instrument does not regulate the contractual relationships between the manager and service providers; whether a manager can seek indemnification from a service provider that fails to satisfy that standard of care is a contractual issue between those parties.
- (3) Subsection 4.4(5) of the Instrument provides that section 4.4 does not apply to any losses to a mutual fund or securityholder arising out of an action or inaction by a custodian or sub-custodian or by a director of a mutual fund. A separate liability regime is imposed, on custodians or sub-custodians by section 6.6 of the Instrument. Directors are subject to the liability regime imposed by the relevant corporate legislation.

## 5.2 Securities Lending, Repurchase and Reverse Repurchase Transactions

- (1) As described in section 5.1, section 4.4 of the Instrument is designed to ensure that the manager of a mutual fund is responsible for any loss that arises out of the failure of it, and of any person or company retained by it or the mutual fund to discharge any of the manager's responsibilities to the mutual fund, to satisfy the standard of care referred to in that section.
- (2) The retention by a manager of an agent under section 2.15 of the



Instrument to administer the mutual fund's securities lending, repurchase or reverse repurchase transactions does not relieve the manager from ultimate responsibility for the administration of those transactions in accordance with the Instrument and in conformity with the standard of care imposed on the manager by statute and required to be imposed on the agent in the relevant agreement by subsection 2.15(6) of the Instrument.

- (3) Because the agent is required to be a custodian or sub-custodian of the mutual fund, its activities, as custodian or sub-custodian, are not within the responsibility of the manager of the mutual fund, as provided for in subsection 4.4(5) of the Instrument. However, the activities of the agent, in its role as administering the mutual funds' securities lending, repurchase or reverse repurchase transactions, are within the ultimate responsibility of the manager, as provided for in subsection 4.4(6) of the Instrument.

## **PART 6 SECURITYHOLDER MATTERS**

### **6.1 Meetings of Securityholders**

**Meetings of Securityholders** - Subsection 5.4(1) of the Instrument imposes a requirement that a meeting of securityholders of a mutual fund called for the purpose of considering any of the matters referred to in section 5.1 of the Instrument must be called on notice sent at least 21 days before the date of the meeting. Industry participants are reminded that the provisions of National Policy Statement No. 41, or a successor instrument, may apply to any meetings of securityholders of mutual funds and that those provisions may require that a longer period of notice be given.

### **6.2 Limited Liability**

- (1) Mutual funds generally are structured in a manner that ensures that investors are not exposed to the risk of loss of an amount more than their original investment. This is a very important and essential attribute of mutual funds.





- (2) Mutual funds that are structured as corporations do not raise pressing liability problems because of the limited liability regime of corporate statutes.
- (3) Mutual funds that are structured as limited partnerships may raise some concerns about the loss of limited liability if limited partners participate in the management or control of the partnership. The Canadian securities regulatory authorities encourage managers of mutual funds that are structured as limited partnerships to consider this issue in connection with the holding of meetings of securityholders, even if required under section 5.1 of the Instrument. In addition, all managers of mutual funds that are structured as limited partnerships should consider whether disclosure and discussion of this issue should be included as a risk factor in simplified prospectuses.

### **6.3 Calculation of Fees**

**Calculation of Fees** - Paragraph 5.1(a) of the Instrument requires securityholder approval before the basis of the calculation of a fee or expense that is charged to a mutual fund is changed in a way that could result in an increase in charges to the mutual fund. The Canadian securities regulatory authorities note that the phrase "basis of the calculation" includes any increase in the rate at which a particular fee is charged to the mutual fund.

## **PART 7 CHANGES**

### **7.1 Integrity and Competence of Mutual Fund Management Groups**

- (1) Paragraph 5.5(1)(a) of the Instrument requires that the approval of the securities regulatory authority be obtained before the manager of a mutual fund is changed. Subsection 5.5(2) of the Instrument contemplates similar approval to a change in control of a manager.
- (2) In connection with each of these approvals, applicants are required by section 5.7 of the Instrument to provide information to the securities regulatory authority concerning the integrity and experience of the persons



or companies that are proposed to be involved in, or control, the management of the mutual fund after the proposed transaction.

- (3) The Canadian securities regulatory authorities would generally consider it helpful in their assessment of the integrity and experience of the proposed new management group that will manage a mutual fund after a change in manager if the application set out, among any other information the applicant wishes to provide
- (a) the name, registered address and principal business activity or the name, residential address and occupation or employment of
    - (i) if the proposed manager is not a public company, each beneficial owner of securities of each shareholder, partner or limited partner of the proposed manager, and
    - (ii) if the proposed manager is a public company, each beneficial owner of securities of each shareholder of the proposed manager that is the beneficial holder, directly or indirectly, of more than 10 percent of the outstanding securities of the proposed manager; and
  - (b) information concerning
    - (i) if the proposed manager is not a public company, each shareholder, partner or limited partner of the proposed manager,
    - (ii) if the proposed manager is a public company, each shareholder that is the beneficial holder, directly or indirectly, of more than 10 percent of the outstanding securities of the proposed manager,
    - (iii) each director and officer of the proposed manager, and
    - (iv) each proposed director, officer or individual trustee of the mutual fund.
- (4) The Canadian securities regulatory authorities would generally consider it helpful if the information relating to the persons and companies referred to



in paragraph (3)(b) included

- (a) for a company
  - (i) its name, registered address and principal business activity,
  - (ii) the number of securities or partnership units of the proposed manager beneficially owned, directly or indirectly, and
  - (iii) particulars of any existing or potential conflicts of interest that may arise as a result of the activities of the company and its relationship with the management group of the mutual fund; and
  
- (b) for an individual
  - (i) his or her name, birthdate and residential address,
  - (ii) his or her principal occupation or employment,
  - (iii) his or her principal occupations or employment during the five years before the date of the application, with a particular emphasis on the individual's experience in the financial services industry,
  - (iv) the individual's educational background, including information regarding courses successfully taken that relate to the financial services industry,
  - (v) his or her position and responsibilities with the proposed manager or the controlling shareholders of the proposed manager or the mutual fund,
  - (vi) whether he or she is, or within five years before the date of the application has been, a director, officer or promoter of any reporting issuer other than the mutual fund, and if so, disclosing the names of the reporting issuers and their business purpose, with a particular emphasis on relationships between the individual and other mutual funds,

- (vii) the number of securities or partnership units of the proposed manager beneficially owned, directly or indirectly,
  - (viii) particulars of any existing or potential conflicts of interest that may arise as a result of the individual's outside business interests and his or her relationship with the management group of the mutual fund, and
  - (ix) a description of the individual's relationships to the proposed manager and other service providers to the mutual fund.
- (5) The Canadian securities regulatory authorities would generally consider it helpful in their assessment of the integrity and experience of the persons or companies that are proposed to manage a mutual fund after a change of control of the manager, if the application set out, among any other information that applicant wishes to provide, a description of
  - (a) the proposed corporate ownership of the manager of the mutual fund after the proposed transaction, indicating for each proposed direct or indirect shareholder of the manager of the mutual fund the information about that shareholder referred to in subsection (4);
  - (b) the proposed officers and directors of the manager of the mutual fund, of the mutual fund and of each of the proposed controlling shareholders of the mutual fund, indicating for each individual, the information about that individual referred to in subsection (4);
  - (c) any anticipated changes to be made to the officers and directors of the manager of the mutual fund, of the mutual fund and of each of the proposed controlling shareholders of the mutual fund that are not set out in paragraph (b); and
  - (d) the relationship of the members of the proposed controlling shareholders and the other members of the management group to the manager and any other service provider to the mutual fund.

## 7.2 Mergers and Conversions of Mutual Funds

### Mergers and Conversions of Mutual Funds - Subsection 5.6(1) of the

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Instrument provides that mergers or conversions of mutual funds may be carried out on the conditions described in that subsection without prior approval of the securities regulatory authority. The Canadian securities regulatory authorities consider that the types of transactions contemplated by subsection 5.6(1) of the Instrument when carried out in accordance with the conditions of that subsection address the fundamental regulatory concerns raised by mergers and conversions of mutual funds. Subsection 5.6(1) is designed to facilitate consolidations of mutual funds within fund families that have similar fundamental investment objectives and strategies and that are operated in a consistent and similar fashion. Since subsection 5.6(1) will be unavailable unless the mutual funds involved in the transaction have substantially similar fundamental investment objectives and strategies and are operated in a substantially similar fashion, the Canadian securities regulatory authorities do not expect that the portfolios of the consolidating funds will be required to be realigned to any great extent before a merger. If realignment is necessary, the Canadian securities regulatory authorities note that paragraph 5.6(1)(h) of the Instrument provides that none of the costs and expenses associated with the transaction may be borne by the mutual fund. Brokerage commissions payable as a result of any portfolio realignment necessary to carry out the transaction would, in the view of the Canadian securities regulatory authorities, be costs and expenses associated with the transaction.

### **7.3 Regulatory Approval for Reorganizations**

- (1) Paragraph 5.7(1)(b) of the Instrument requires certain details to be provided in respect of an application for regulatory approval required by paragraph 5.5(1)(b) that is not automatically approved under subsection 5.6(1). The Canadian securities regulatory authorities will be reviewing this type of proposed transaction, among other things, to ensure that adequate disclosure of the differences between the funds participating in the proposed transaction is given to securityholders of the mutual fund that will be merged, reorganized or amalgamated with another mutual fund.
- (2) If a mutual fund is proposed to be merged, amalgamated or reorganized with a mutual fund that has a net asset value that is smaller than the net asset value of the terminating mutual fund, the Canadian securities regulatory authorities will consider the implications of the proposed transaction on the smaller continuing mutual fund. The Canadian

securities regulatory authorities believe that this type of transaction generally would constitute a significant change for the smaller continuing mutual fund, thereby triggering the requirements of paragraph 5.1(g) and section 5.10 of the Instrument.

#### **7.4 Significant Changes**

- (1) The Canadian securities regulatory authorities will not outline all changes in a mutual fund that could constitute a significant change for the mutual fund within the meaning of the Instrument. However, they wish to state their views of two matters in this Policy.
- (2) First, the Canadian securities regulatory authorities note that the change of portfolio adviser of a mutual fund will generally constitute a significant change for the mutual fund.
- (3) In addition, the departure of a high-profile individual from the employ of a portfolio adviser of a mutual fund may constitute a significant change for the mutual fund, depending on the circumstances. The definition of significant change is based on a change in the business, operations or affairs of a mutual fund that would be considered important by a reasonable investor or securityholder. Whether such a person would consider the departure of a high-profile individual to be important in this sense would likely depend substantially on how prominently the mutual fund featured that individual in its marketing. The Canadian securities regulatory authorities consider it unlikely that a mutual fund that emphasized the ability of a particular individual to encourage investors to purchase the fund could later take the position that the departure of that individual was immaterial to investors and therefore not a significant change.

### **PART 8 CUSTODIANSHIP OF PORTFOLIO ASSETS**

#### **8.1 Standard of Care**

**Standard of Care** - The standard of care prescribed by section 6.6 of the



Instrument is a minimum standard only. Similarly, the provisions of section 6.5 of the Instrument, designed to protect a mutual fund from loss in the event of the insolvency of those holding its portfolio assets, are minimum requirements. The Canadian securities regulatory authorities are of the view that the requirements set out in section 6.5 may require custodians and sub-custodians to take such additional steps as may be necessary or desirable properly to protect the portfolio assets of the mutual fund in a foreign jurisdiction and to ensure that those portfolio assets are unavailable to satisfy the claims of creditors of the custodian or sub-custodian, having regard to creditor protection and bankruptcy legislation of any foreign jurisdiction in which portfolio assets of a mutual fund may be located.

## 8.2 Book-Based System

- (1) Subsection 6.5(3) of the Instrument provides that a custodian or sub-custodian of a mutual fund may arrange for the deposit of portfolio assets of the mutual fund with a depository, or clearing agency, that operates a book-based system. Such depositories or clearing agencies include The Canadian Depository For Securities Limited, the Depository Trust Company or any other domestic or foreign depository or clearing agency that is incorporated or organized under the laws of a country or a political subdivision of a country and operates a book-based system in that country or political subdivision or operates a transnational book-based system.
- (2) A depository or clearing agency that operates a book-based system used by a mutual fund is not considered to be a custodian or sub-custodian of the mutual fund.

## 8.3 Compliance

**Compliance** - Paragraph 6.7(1)(c) of the Instrument requires the custodian of a mutual fund to make any changes periodically that may be necessary to ensure that the custodian and sub-custodian agreements comply with Part 6, and that there is no sub-custodian of the mutual fund that does not satisfy the applicable requirements of sections 6.2 or 6.3. The Canadian securities regulatory authorities note that necessary changes to ensure this compliance could include a change of sub-custodian.



## **PART 9 CONTRACTUAL PLANS**

### **9.1 Contractual Plans**

**Contractual Plans** - Industry participants are reminded that the term "contractual plan" used in Part 8 of the Instrument is a defined term in the securities legislation of most jurisdictions, and that contractual plans as so defined are not the same as automatic or periodic investment plans. The distinguishing feature of a contractual plan is that sales charges are not deducted at a constant rate as investments in mutual fund securities are made under the plan; rather, proportionately higher sales charges are deducted from the investments made during the first year, or in some plans the first two years.

## **PART 10 SALES AND REDEMPTIONS OF SECURITIES**

### **10.1 General**

**General** - Parts 9, 10 and 11 of the Instrument are intended to ensure that

- (a) investors' cash is received by a mutual fund promptly;
- (b) the opportunity for loss of an investors' cash before investment in the mutual fund is minimized; and
- (c) the mutual fund or the appropriate investor receives all interest that accrues on cash during the periods between delivery of the cash by an investor until investment in the mutual fund, in the case of the purchase of mutual fund securities, or between payment of the cash by the mutual fund until receipt by the investor, in the case of redemptions.

### **10.2 Interpretation**

- (1) The Instrument refers to "securityholders" of a mutual fund in several
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provisions, most notably in Parts 9 and 10 when referring to purchase and redemption orders received by a mutual fund or a participating dealer or principal distributor from "securityholders".

- (2) Mutual funds must keep a record of the holders of their securities. A mutual fund registers a holder of its securities on this record as requested by the person or company placing a purchase order or as subsequently requested by that registered securityholder. The Canadian securities regulatory authorities are of the view that a mutual fund is entitled to rely on its register of holders of securities to determine the names of such holders and in its determination as to whom it is to take instructions from.
- (3) Accordingly, when the Instrument refers to "securityholder" of a mutual fund, it is referring to the securityholder registered as a holder of securities on the records of the mutual fund. If that registered securityholder is a participating dealer acting for its client, the mutual fund deals with and takes instructions from that participating dealer. The Instrument does not regulate the relationship between the participating dealer and its client for whom the participating dealer is acting as agent. The Canadian securities regulatory authorities note however, that the participating dealer should, as a matter of prudent business practice, obtain appropriate instructions, in writing, from its client when dealing with the client's beneficial holdings in a mutual fund.

### 10.3 Receipt of Orders

- (1) A principal distributor or participating dealer of a mutual fund should endeavour, to the extent possible, to receive cash to be invested in the mutual fund at the time the order to which they pertain is placed.
- (2) A dealer receiving an order for redemption should, at the time of receipt of the investor's order, obtain from the investor all relevant documentation required by the mutual fund in respect of the redemption including, without limitation, any written request for redemption that may be required by the mutual fund, duly completed and executed, and any certificates representing the mutual fund securities to be redeemed, so that all required documentation is available at the time the redemption order is transmitted to the mutual fund or to its principal distributor for

transmittal to the mutual fund.

#### **10.4 Backward Pricing**

**Backward Pricing** - Sections 9.3 and 10.3 of the Instrument provide that the issue price or the redemption price of a security of a mutual fund to which a purchase order or redemption order pertains shall be the net asset value per security, next determined after the receipt by the mutual fund of the relevant order. For clarification, the Canadian securities regulatory authorities emphasize that the issue price and redemption price cannot be based upon any net asset value per security calculated before receipt by the mutual fund of the relevant order.

#### **10.5 Coverage of Losses**

- (1) Subsection 9.4(6) of the Instrument provides that certain participating dealers may be required to compensate a mutual fund for a loss suffered as the result of a failed settlement of a purchase of securities of the mutual fund. Similarly, subsection 10.5(3) of the Instrument provides that certain participating dealers may be required to compensate a mutual fund for a loss suffered as the result of a redemption that could not be completed due to the failure to satisfy the requirements of the mutual fund concerning redemptions.
- (2) The Canadian securities regulatory authorities have not carried forward into the Instrument the provisions contained in NP39 relating to a participating dealer's ability to recover from their clients or other participating dealers any amounts that they were required to pay to a mutual fund. If participating dealers wish to provide for such rights they should make the appropriate provisions in the contractual arrangements that they enter into with their clients or other participating dealers.

### **PART 11 COMMINGLING OF CASH**

#### **11.1 Commingling of Cash**



- (1) Part 11 of the Instrument requires principal distributors and participating dealers to account separately for cash they may receive for the purchase of, or upon the redemption of, mutual fund securities. Those principal distributors and participating dealers are prohibited from commingling any cash so received with their other assets or with cash held for the purchase or upon the sale of securities of other types of securities. The Canadian securities regulatory authorities are of the view that this means that dealers may not deposit into the trust accounts established under Part 11 cash obtained from the purchase or sale of other types of securities such as guaranteed investment certificates, government treasury bills, segregated funds or bonds.
- (2) Subsections 11.1(2) and 11.2(2) of the Instrument state that principal distributors and participating dealers, respectively, may not use any cash received for the investment in mutual fund securities to finance their own operations. The Canadian securities regulatory authorities are of the view that any costs associated with returned client cheques that did not have sufficient funds to cover a trade ("NSF cheques") are a cost of doing business and should be borne by the applicable principal distributor or participating dealer and should not be offset by interest income earned on the trust accounts established under Part 11 of the Instrument.
- (3) No overdraft positions should arise in these trust accounts.
- (4) Subsections 11.1(3) and 11.2(3) of the Instrument prescribe the circumstances under which a principal distributor or participating dealer, respectively, may withdraw funds from the trust accounts established under Part 11 of the Instrument. This would prevent the practice of "lapping". Lapping occurs as a result of the timing differences between trade date and settlement date, when cash of a mutual fund client held for a trade which has not yet settled is used to settle a trade for another mutual fund client who has not provided adequate cash to cover the settlement of that other trade on the settlement date. The Canadian securities regulatory authorities view this practice as a violation of subsections 11.1(3) and 11.2(3) of the Instrument.
- (5) Subsections 11.1(4) and 11.2(4) of the Instrument require that interest earned on cash held in the trust accounts established under Part 11 of



the Instrument be paid to the applicable mutual fund or its securityholders "pro rata based on cash flow". The Canadian securities regulatory authorities are of the view that this requirement means, in effect, that the applicable mutual fund or securityholder should be paid the amount of interest that the mutual fund or securityholder would have received had the cash held in trust for that mutual fund or securityholder been the only cash held in that trust account.

- (6) Paragraph 11.3(b) of the Instrument requires that trust accounts maintained in accordance with sections 11.1 or 11.2 of the Instrument bear interest "at rates equivalent to comparable accounts of the financial institution". A type of account that ordinarily pays zero interest may be used for trust accounts under sections 11.1 or 11.2 of the Instrument so long as zero interest is the rate of interest paid on that type of account for all depositors other than trust accounts.

## **PART 12 PUBLICATION OF NET ASSET VALUE PER SECURITY**

### **12.1 Publication of Net Asset Value per Security**

**Publication of Net Asset Value per Security** - Subsection 13.1(4) of the Instrument requires a mutual fund that arranges for the publication of its net asset value per security in the financial press to ensure that its current net asset value per security is provided on a timely basis to the financial press. This provision ensures that a mutual fund takes steps to calculate the net asset value per security as quickly as is commercially practicable following the valuation date or time, and to make the results of that calculation available to the financial press as quickly as is commercially practicable. A mutual fund should, to the extent practicable, attempt to meet the deadlines of the financial press for publication in order to ensure that its net asset values per security are publicly available as quickly as possible.

## **PART 13 PROHIBITED REPRESENTATIONS AND SALES COMMUNICATIONS**



## 13.1 Misleading Sales Communications

- (1) Part 15 of the Instrument prohibits misleading sales communications relating to mutual funds and asset allocation services. Whether a particular description, representation, illustration or other statement in a sales communication is misleading depends upon an evaluation of the context in which it is made. The following list sets out some of the circumstances, in the view of the Canadian securities regulatory authorities, in which a sales communication would be misleading. No attempt has been made to enumerate all such circumstances since each sales communication must be assessed individually.
  1. A statement would be misleading if it lacks explanations, qualifications, limitations or other statements necessary or appropriate to make the statement not misleading.
  2. A representation about past or future investment performance would be misleading if it is
    - (a) a portrayal of past income, gain or growth of assets that conveys an impression of the net investment results achieved by an actual or hypothetical investment that is not justified under the circumstances;
    - (b) a representation about security of capital or expenses associated with an investment that is not justified under the circumstances or a representation about possible future gains or income; or
    - (c) a representation or presentation of past investment performance that implies that future gains or income may be inferred from or predicted based on past investment performance or portrayals of past performance.
  3. A statement about the characteristics or attributes of a mutual fund or an asset allocation service would be misleading if
    - (a) it concerns possible benefits connected with or resulting from services to be provided or methods of operation and

does not give equal prominence to discussion of any risks or associated limitations;

- (b) it makes exaggerated or unsubstantiated claims about management skill or techniques; characteristics of the mutual fund or asset allocation service; an investment in securities issued by the fund or recommended by the service; services offered by the fund, the service or their respective manager; or effects of government supervision; or
- (c) it makes unwarranted or incompletely explained comparisons to other investment vehicles or indices.

4. A sales communication that quoted a third party source would be misleading if the quote were out of context and proper attribution of the source were not given.

- (2) Performance data information may be misleading even if it complies technically with the requirements of the Instrument. For instance, subsections 15.8(1) and (2) of the Instrument contain requirements that the standard performance data for mutual funds given in sales communications be for prescribed periods falling within prescribed amounts of time before the date of the appearance or use of the advertisement or first date of publication of any other sales communication. That standard performance data may be misleading if it does not adequately reflect intervening events occurring after the prescribed period. An example of such an intervening event would be, in the case of money market funds, a substantial decline in interest rates after the prescribed period.
- (3) An advertisement that presents information in a manner that distorts information contained in the preliminary prospectus or prospectus, or preliminary simplified prospectus and annual information form, of a mutual fund or that includes a visual image that provides a misleading impression will be considered to be misleading.
- (4) Any discussion of the income tax implications of an investment in a mutual fund security should be balanced with a discussion of any other material aspects of the offering.



- (5) Paragraph 15.2(1)(b) of the Instrument provides that sales communications may not include any statement that conflicts with information that is contained in, among other things, a simplified prospectus. The Canadian securities regulatory authorities are of the view that a sales communication that provides performance data in compliance with the requirements of Part 15 of the Instrument for time periods that differ from the time periods for which performance data is required to be provided in a simplified prospectus under National Instrument 81-101 is not thereby in violation of the requirements of paragraph 15.2(1)(b) of the Instrument.
- (6) Subsection 15.3(1) of the Instrument permits a mutual fund or asset allocation service to compare its performance to, among other things, other types of investments or benchmarks on certain conditions. Examples of such other types of investments or benchmarks to which the performance of a mutual fund or asset allocation service may be compared include consumer price indices; stock, bond or other types of indices; averages; returns payable on guaranteed investment certificates or other certificates of deposit; and returns from an investment in real estate.
- (7) Paragraph 15.3(1)(c) of the Instrument requires that if the performance of a mutual fund or asset allocation service is compared to that of another investment or benchmark, the comparison sets out clearly any factors necessary to ensure that the comparison is fair and not misleading. Such factors would include an explanation of any relevant differences between the mutual fund or asset allocation service and the investment or benchmark to which it is compared. Examples of such differences include any relevant differences in the guarantees of, or insurance on, the principal of or return from the investment or benchmark; fluctuations in principal, income or total return; any differing tax treatment; and, for a comparison to an index or average, any differences between the composition or calculation of the index or average and the investment portfolio of the mutual fund or asset allocation service.

## 13.2 Other Provisions



- (1) Subsection 15.9(1) of the Instrument imposes certain disclosure requirements for sales communications in circumstances in which there was a change in the business, operations or affairs of a mutual fund or asset allocation service during or after a performance measurement period of performance data contained in the sales communication that could have materially affected the performance of the mutual fund or asset allocation service. Examples of these changes are changes in the management, investment objectives, portfolio adviser, ownership of the manager, fees and charges, or of policies concerning the waiving or absorbing of fees and charges, of the mutual fund or asset allocation service; or of a change in the characterization of the mutual fund as a money market fund.
- (2) Paragraph 15.11(1)5 of the Instrument requires that no non-recurring fees and charges that are payable by some or all securityholders and no recurring fees and charges that are payable by some but not all securityholders be assumed in calculating standard performance data. Examples of non-recurring types of fees and charges are front-end sales commissions and contingent deferred sales charges, and examples of recurring types of fees and charges are the annual fees paid by purchasers who purchased on a contingent deferred charge basis.
- (3) Paragraphs 15.11(1)2 and 15.11(2)2 of the Instrument require that no fees and charges related to optional services be assumed in calculating standard performance data. Examples of these fees and charges include transfer fees, except in the case of an asset allocation service, and fees and charges for registered retirement savings plans, registered retirement income funds, registered education savings plans, pre-authorized investment plans and systematic withdrawal plans.
- (4) The Canadian securities regulatory authorities are of the view that it is inappropriate and misleading for a mutual fund that is continuing following a merger to prepare and use *pro forma* performance information or financial statements that purport to show the combined performance of the two funds during a period before their actual merger. The Canadian securities regulatory authorities are of the view that such *pro forma* information is hypothetical, involving the making of many assumptions that could affect the results.
- (5) Subsections 15.8(2) and (3) of the Instrument require disclosure of



standard performance data of a mutual fund, in some circumstances, from "the inception of the mutual fund". It is noted that paragraph 15.6(d) generally prohibits disclosure of performance data for a period that is before the time when the mutual fund offered its securities under a simplified prospectus or before an asset allocation service commenced operation. Also, Instruction (1) to Item 5 of Part B of Form 81-101F1 Contents of Simplified Prospectus requires disclosure of the date on which a mutual fund's securities first became available to the public as the date on which the mutual fund "started". Therefore, consistent with these provisions, the words "inception of the mutual fund" in subsections 15.8(2) and (3) should be read as referring to the beginning of the distribution of the securities of the mutual fund under a simplified prospectus of the mutual fund, and not from any previous time in which the mutual fund may have existed but did not offer its securities under a simplified prospectus.

- (6) Paragraph 15.6(a) of the Instrument contains a prohibition against the inclusion of performance data for a mutual fund that has been distributing securities for less than 12 consecutive months. The creation of a new class or series of security of an existing mutual fund does not constitute the creation of a new mutual fund and therefore does not subject the mutual fund to the restrictions of paragraph 15.6(a) unless the new class or series is referable to a new portfolio of assets.
- (7) Section 15.14 of the Instrument contains the rules relating to sales communications for multi-class mutual funds. Those rules are applicable to a mutual fund that has more than one class of securities that are referable to the same portfolio of assets. Section 15.14 does not deal directly with asset allocation services. It is possible that asset allocation services could offer multiple "classes"; the Canadian securities regulatory authorities recommend that any sales communications for those services generally respect the principles of section 15.14 in order to ensure that those sales communications not be misleading.
- (8) The Canadian securities regulatory authorities believe that the use of hypothetical or *pro forma* performance data for new classes of securities of a multi-class mutual fund would generally be misleading.

## PART 14

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## FINANCIAL DISCLOSURE MATTERS

### 14.1 Calculation of Management Expense Ratio

(1) Part 16 of the Instrument sets out the method to be used by a mutual fund in calculating its management expense ratio. The requirements contained in Part 16 are applicable in all circumstances in which a mutual fund calculates and discloses a management expense ratio.

- (2) Subsection 16.1(1) requires a mutual fund to use its "total expenses" before income taxes for the relevant period as the basis for the calculation of management expense ratio. Total expenses before income taxes will include interest charges and taxes of virtually all types, including sales taxes, GST and capital taxes, payable by the mutual fund. Income taxes, of course, would not be included in a calculation of total expenses before income taxes. In addition, Canadian GAAP would permit a mutual fund to deduct withholding taxes from the income to which they apply; therefore, withholding taxes would not be included as part of "total expenses".
- (3) Brokerage charges are not considered to be part of total expenses as they are included in the cost of purchasing, or netted out of the proceeds from selling, portfolio assets.
- (4) Subsection 16.1(4) of the Instrument makes reference to a mutual fund indicating, when providing management expense ratio information to a service provider that will arrange for public dissemination of the management expense ratio, whether management fees were waived or paid directly by investors during the relevant period. It is expected that the service providers will include this information in any disclosure of management expense ratio to the public in a manner that is clear and easily understandable by investors. Service providers may use symbols to inform the public of the different elements of a management expense ratio. If symbols are used, they should be accompanied by an explanatory legend.
- (5) Mutual funds are reminded to ensure that any management expense ratio provided to a service provider for public dissemination should be only the management expense ratio calculated as required by the

Instrument.

## **14.2 Financial Statement Requirements in Securities Lending, Repurchase and Reverse Repurchase Transactions**

**Financial Statement Requirements in Securities Lending, Repurchase and Reverse Repurchase Transactions** - Mutual funds are required to follow Canadian GAAP in preparing financial statements, as supplemented as applicable by the requirements of other applicable securities legislation. The Canadian securities regulatory authorities wish to provide their views on the appropriate application of Canadian GAAP in circumstances where mutual funds enter into securities lending, repurchase and reverse repurchase transactions. Sections 14.3, 14.4 and 14.5 reflect the views of the Canadian securities regulatory authorities as to the steps those mutual funds should take in order to ensure that their financial statements comply with Canadian GAAP.

## **14.3 Financial Statement Requirements Concerning Securities Lending Transactions**

- (1) A mutual fund, in the statement of investment portfolio included in the annual and interim financial statements of the mutual fund, or in the notes to that statement, should
  - (a) disclose the aggregate dollar value of securities that were lent in the securities lending transactions of the mutual fund that remain outstanding as at the date of the statement; and
  - (b) disclose the type and aggregate amount of collateral received by the mutual fund under securities lending transactions of the mutual fund that remain outstanding as at the date of the statement.
- (2) A balance sheet of a mutual fund that has received cash collateral in a securities lending transaction that remains outstanding as of the date of the balance sheet should fairly present
  - (a) the cash collateral received by it as an asset; and



- (b) the obligation to repay the cash collateral as a liability.
- (3) The asset and liability referred to in subsection (2) should be shown as separate line items in the balance sheet.
- (4) An income statement of a mutual fund should fairly present income from securities lending transactions as revenue and not as deductions from expenses.

#### **14.4 Financial Statement Requirements Concerning Repurchase Transactions**

- (1) A mutual fund, in the statement of investment portfolio included in the annual and interim financial statements of the mutual fund, or in the notes to that statement, should, for each repurchase transaction of the mutual fund that remains outstanding as at the date of the statement, disclose the date of the transaction, the expiration date of the transaction, the name of the counterparty of the mutual fund, the nature and market value of the securities sold by the mutual fund, the amount of cash received, the repurchase price to be paid by the mutual fund and the market value of the sold securities as at the date of the statement.
- (2) A balance sheet of a mutual fund that has entered into a repurchase transaction that remains outstanding as of the date of the balance sheet should fairly present the obligation of the mutual fund to repay the collateral as a liability.
- (3) The liability referred to in subsection (2) should be shown as a separate line item in the balance sheet.
- (4) An income statement of a mutual fund should fairly present income from the use of the cash received on repurchase transactions as revenue and not to offset expenses incurred in connection with the repurchase transaction.

#### **14.5 Financial Statement Requirements Concerning Reverse Repurchase Transactions**

- (1) A mutual fund, in the statement of investment portfolio included in the



annual and interim financial statements of the mutual fund, or in the notes to that statement, should for each reverse repurchase transaction of the mutual fund that remains outstanding as at the date of the statement, disclose the date of the transaction, the expiration date of the transaction, the name of the counterparty of the mutual fund, the total dollar amount paid by the mutual fund, the nature and value or principal amount of the securities received by the mutual fund and the market value of the purchased securities as at the date of the statement.

- (2) A balance sheet of a mutual fund that has entered into a reverse repurchase transaction that remains outstanding as of the date of the balance sheet should fairly present the reverse repurchase agreement relating to the transaction as an asset at market value.
- (3) The asset referred to in subsection (2) should be shown as a separate line item in the balance sheet.
- (4) An income statement of a mutual fund should fairly present income from reverse repurchase transactions as revenue and not as deductions from expenses.

## **PART 15 SECURITYHOLDER RECORDS**

### **15.1 Securityholder Records**

**Securityholder Records** - Section 18.1 of the Instrument requires the maintenance of securityholder records, including past records, relating to the issue and redemption of securities and distributions of the mutual fund. Section 18.1 does not require that these records need be held indefinitely. It is up to the particular mutual fund, having regard to prudent business practice and any applicable statutory limitation periods, to decide how long it wishes to retain old records.

## **PART 16 EXEMPTIONS AND APPROVALS**



## 16.1 Need for Multiple or Separate Applications

**Need for Multiple or Separate Applications** - The Canadian securities regulatory authorities note that a person or company that obtains an exemption from a provision of the Instrument need not apply again for the same exemption at the time of each prospectus or simplified prospectus refiling unless there has been some change in an important fact relating to the granting of the exemption. This also applies to exemptions from NP39 granted before the Instrument; as provided in section 19.2 of the Instrument, it is not necessary to obtain an exemption from the corresponding provision of the Instrument.

## 16.2 Exemptions under Prior Policies

- (1) Subsection 19.2(1) of the Instrument provides that a mutual fund that has obtained, from the regulatory or securities regulatory authority, an exemption from a provision of NP 39 before the Instrument came into force is granted an exemption from any substantially similar provision of the Instrument, if any, on the same conditions, if any, contained in the earlier exemption.
- (2) The Canadian securities regulatory authorities are of the view that the fact that a number of small amendments have been made to many of the provisions of the Instrument from the corresponding provision of NP39 should not lead to the conclusion that the provisions are not "substantially similar", if the general purpose of the provisions remain the same. For instance, even though some changes have been made in the Instrument, the Canadian securities regulatory authorities consider paragraph 2.2(1)(a) of the Instrument to be substantially similar to paragraph 2.04(1)(b) of NP39, in that the primary purpose of both provisions is to prohibit mutual funds from acquiring securities of an issuer sufficient to permit the mutual fund to control or significantly influence the control of that issuer.

## 16.3 Waivers and Orders concerning "Fund of Funds"

**Waivers and Orders concerning "Fund of Funds"** - The CSA in a number of jurisdictions have provided waivers and orders from NP39 and securities



legislation to permit "fund of funds" to exist and carry on investment activities not otherwise permitted by NP39 or securities legislation. Some of those waivers and orders contained "sunset" provisions that provided that they expired when legislation or a CSA policy or rule came into force that effectively provided for a new "fund of funds" regime. For greater certainty, the Canadian securities regulatory authorities note that the coming into force of the Instrument will not trigger the "sunset" of those waivers and orders.

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Modification

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