

**Notice of Amendments to
National Instrument 81-102 *Mutual Funds*
and Companion Policy 81-102CP**

and to

National Instrument 81-106 *Investment Fund Continuous Disclosure*

and to

National Instrument 81-101 *Mutual Fund Prospectus Disclosure*

and to

National Instrument 41-101 *General Prospectus Requirements*

February 9, 2012

Introduction

The Canadian Securities Administrators (the CSA or we), are making amendments (the Amendments) to the following rules and policy:

- National Instrument 81-102 *Mutual Funds* (NI 81-102) and Companion Policy 81-102CP – *To National Instrument 81-102 Mutual Funds* (81-102CP);
- National Instrument 81-106 *Investment Fund Continuous Disclosure* (NI 81-106);
- National Instrument 81-101 *Mutual Fund Prospectus Disclosure* (NI 81-101);
- National Instrument 41-101 *General Prospectus Requirements* (NI 41-101).

Subject to Ministerial approval requirements, the Amendments come into force or into effect on April 30, 2012.

Adopting the Amendments completes the first phase of the CSA's project to modernize the product regulation of publicly offered investment funds (the Modernization Project). The Amendments to NI 81-101 and NI 81-102 only affect mutual funds that are reporting issuers, while the Amendments to NI 81-106 and NI 41-101 affect all investment funds that are reporting issuers.

The Modernization Project is a two-phase project whose mandate is to review the product regulation of publicly offered investment funds and to consider whether our current regulatory approach sufficiently addresses product and market developments in the Canadian investment fund industry, and continues to adequately protect investors.¹

¹ The two phases of the Modernization Project, along with anticipated timelines, were recently discussed in CSA Staff Notice 81-322 – *Status Report on the Implementation of the Modernization of Investment Fund Product Regulation Project and Request for Comment on Phase 2 Proposals* published on May 27, 2011.

The Amendments for this first phase of the Modernization Project were published for comment on June 25, 2010 (the 2010 Proposal) and codify exemptive relief that has been frequently granted by the CSA to recognize market and product developments over the years, particularly the proliferation of exchange-traded mutual funds (ETFs). The Amendments also update the rules to reflect developing global standards in mutual fund product regulation, in particular, requirements related to money market funds.

The objective of the second phase of the Modernization Project is to identify and address any market efficiency, investor protection or fairness issues that arise out of the differing regulatory regimes that apply to different types of publicly offered investment funds. With a view to achieving fair and consistent product regulation across the retail investment fund spectrum, the CSA intend to propose new restrictions and operational requirements for non-redeemable investment funds (such as closed-end funds), that are similar to existing requirements for mutual funds and ETFs under NI 81-102.

The Amendments have been, or are expected to be, adopted by each member of the CSA.

The text of the Amendments follows this Notice and can be obtained on the websites of members of the CSA.

Substance and Purpose of the Amendments

The Amendments codify exemptive relief that we frequently grant to mutual funds and exchange-traded mutual funds under NI 81-102 and other investment fund rules. They reflect the current views of the CSA and help to modernize our investment fund rules by making the requirements more effective and relevant in today's more diverse and increasingly innovative retail fund marketplace. The Amendments also include a number of minor drafting changes generally intended to clarify and update NI 81-102.

ETFs

Since the coming into force of NI 81-102 in February 2000, the range of publicly-offered investment fund products governed by the NI 81-102 regime has expanded. ETFs in continuous distribution have proliferated, with assets under management growing from approximately \$6 billion in December 2000 to approximately \$40 billion in September 2011. ETFs not in continuous distribution, which are mutual funds that issue a finite number of securities under an initial public offering, have also gained popularity with retail investors.

The Amendments are intended to accommodate the different operations and distribution of ETFs within the NI 81-102 regime. They achieve this by eliminating the need for ETFs to routinely seek exemptive relief from certain prescribed purchase and redemption processes and other operational requirements designed primarily for open-end conventional mutual funds sold through the mutual fund dealer network. We anticipate the Amendments will benefit ETFs and their investors by eliminating the regulatory costs and delays associated with obtaining exemptive relief. This more expeditious access to market will promote market efficiency.

Short-selling and specified derivatives

The Amendments add new section 2.6.1 of NI 81-102 which permits mutual funds to short sell securities subject to a cap of 20% of their net asset value. The ability to use this investment strategy, previously permitted through exemptive relief, may be beneficial for mutual funds by giving them the potential to earn returns in declining markets. In connection with this change, we are adding a custodial requirement relating to short sales, and are amending the relevant prospectus forms under NI 81-101 and NI 41-101 to require disclosure of the use of short-selling strategies and of the related risks.

The Amendments also provide mutual funds with more flexibility in their use of specified derivatives by expanding what qualifies as cash cover for such purposes and by removing term limits on specified derivatives. The expanded range of cash cover, which now includes securities of money market funds and certain floating rate notes, will allow mutual funds to more effectively manage their cash cover by enabling them to hold additional instruments that are diversified, cost-effective and that potentially have a higher yield.

Fund of fund

The Amendments revise section 2.5 of NI 81-102 to now permit mutual funds to invest in underlying mutual funds that are reporting issuers in the local jurisdiction, as opposed to only those with a current offering prospectus. They also give mutual funds the ability to invest in a two-tier mutual fund provided this fund is a 'clone fund' whose objective is to track the performance of one underlying mutual fund.

Money market funds

The Amendments introduce new investment restrictions for money market funds under new section 2.18 of NI 81-102. That section includes new liquidity provisions requiring a money market fund to have at least 5% of its assets in cash or readily convertible to cash within one day and 15% of its assets in cash or readily convertible to cash within one week. It also includes a new dollar-weighted average term to maturity limit of 180 days that is to be calculated based on the actual term to maturity of all securities in a money market fund portfolio.

These new requirements are intended to respond to the 2008/2009 credit crisis and its specific impact on Canadian money market funds and also keep pace with similar regulatory changes implemented for money market funds in other major markets. We anticipate the new requirements will benefit Canadian money market funds by making them more resilient to certain short-term market risks, including interest rate risk, liquidity risk and credit risk. The CSA will continue to monitor ongoing regulatory developments impacting money market funds in other global jurisdictions and consider the need for similar changes in Canada.

Related to the new money market fund requirements is an amendment to NI 81-106 which now no longer permits an investment fund to aggregate certain types of short-term debt in the fund's statement of investment portfolio. This change will increase the transparency of investment fund portfolio holdings and allow investors to better evaluate the risks associated with an investment fund's short-term holdings.

Mutual fund dealers

The Amendments exempt principal distributors and participating dealers that are members of the MFDA, as well as mutual fund dealers in Québec, from the requirements of sections 11.1 and 11.2 of NI 81-102, which include the requirement to segregate client money relating to mutual fund transactions from sums relating to other types of investment transactions, as well as the requirement to allocate and pay out interest earned on such client money held in a trust account. Under MFDA rules however, these principal distributors and participating dealers will continue to hold client assets in a trust account and separate from their own assets. They will also have discretion as to whether to pay interest on client cash held in trust, subject to conditions.²

The Amendments also exempt those same principal distributors and dealers from the requirement under section 12.1 of NI 81-102 to annually report their compliance with the applicable requirements of Parts 9, 10 and 11 of NI 81-102. The MFDA will however continue to assess its members' compliance with such requirements.

Sales communications

The Amendments introduce new requirements in section 15.3 of NI 81-102 intended to ensure that mutual fund ratings and rankings used in sales communications are objective and consistent, and accompanied by disclosure intended to ensure that the sales communication will not be misleading.

Continuous disclosure

The Amendments introduce a requirement under section 14.2 of NI 81-106 that an investment fund make its net asset value and net asset value per security readily available to the public. This will boost the transparency of fund performance and make it easier for current and prospective investors to determine the net asset value/net asset value per security of an investment fund. The Amendments further require that an investment fund that short sells securities calculate its net asset value on a daily basis.

Other

Finally, the Amendments include a number of minor drafting changes generally intended to clarify and update NI 81-102.

The key changes made to the 2010 Proposal since its publication for comment are discussed in detail in the Summary of Changes at Annex A to this Notice.

Summary of Written Comments Received by the CSA

During the comment period on the 2010 Proposal, we received submissions from 24 commenters. We have considered every comment received and thank all of the commenters for

² See proposed amendments to MFDA Rule 3.3.2 *Segregation of Client Property – Cash* published for comment June 25, 2010. Those amendments remove the existing restrictions in Rule 3.3.2 to hold client cash for investment in mutual funds separately from client cash for other investments, and further replace the requirements in respect of the distribution of interest on client cash held in trust with a requirement that Members disclose whether interest will be paid and, if so, at what rate. These amendments are expected to be finalized upon the adoption of the Amendments to Parts 11 and 12 of NI 81-102.

their input. A summary of their comments, together with our responses, is contained in Annex B to this Notice.

Summary of Changes to the 2010 Proposal

After considering the comments received and engaging in additional consultations, we have made some revisions to the materials that were published for comment under the 2010 Proposal. Those revisions are reflected in the amending instruments we are publishing concurrently with this Notice. As these changes are not material, we are not republishing the Amendments for a further comment period. See Annex A to this Notice for a summary of the key changes made to the 2010 Proposal.

Transition

Money market fund requirements

To ease money market funds' transition to the new requirements of section 2.18 of NI 81-102, we are providing a 6-month transition period during which money market funds may gradually realign their portfolios as necessary to comply with the new provisions. We refer you to section 44 of the Amendments to NI 81-102 at Annex C which provides that the new money market fund provision will come into force 6 months after the amendments to NI 81-102 come into force.

Short-selling provision

Upon the coming into force of the Amendments, mutual funds intending to short-sell securities for the first time will first have to comply with the applicable notice and prospectus disclosure requirements prescribed under the Amendments. Mutual funds that currently short-sell securities in accordance with the terms of exemptive relief granted under NI 81-102 may continue their short-selling strategies in accordance with the new short-selling provision in section 2.6.1 of NI 81-102. Mutual funds that gave prior written notice to their securityholders of their intention to short-sell in accordance with the terms of their exemptive relief are not required to again notify their securityholders. To the extent the Amendments require certain prospectus disclosure related to short-selling that may not have been required under the terms of a mutual fund's exemptive relief, we expect that the mutual fund will include the required disclosure in its current prospectus at the earlier of the next renewal or next amendment of that prospectus that is filed after the coming into force of the Amendments. A mutual fund intending to increase its current short-selling activities up to the prescribed limit in new section 2.6.1 should consider whether the increase would be a material change to the mutual fund triggering the requirement to amend its prospectus or fund facts document prior to implementing the new limit.

Materials Published

The following annexes are attached to this notice:

- Annex A – Summary of Changes to the 2010 Proposal
- Annex B – Summary of Public Comments Received by the CSA
- Annex C – Amendments to NI 81-102 and changes to 81-102CP
- Annex D – Amendments to NI 81-101

Annex E – Amendments to NI 41-101
Annex F – Amendments to NI 81-106
Annex G – Local material, where applicable

Questions

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