

**CSA Notice and Request for Comment
Proposed Amendments to
National Instrument 81-102 *Mutual Funds*
Companion Policy 81-102CP *Mutual Funds* and
Related Consequential Amendments
-and-
Other Matters Concerning
National Instrument 81-104 *Commodity Pools* and
Securities Lending, Repurchases and Reverse Repurchases
by Investment Funds**

March 27, 2013

Introduction

The Canadian Securities Administrators (the CSA or we) are publishing for a 90-day comment period proposed amendments to National Instrument 81-102 *Mutual Funds* (NI 81-102) (the Proposed 81-102 Amendments, as set out in Annex E) to introduce core operational requirements for publicly offered non-redeemable investment funds, other than scholarship plans.¹ As described below, some of the Proposed 81-102 Amendments relate to mutual funds. We are also publishing for comment proposed changes to Companion Policy 81-102CP to National Instrument 81-102 *Mutual Funds* (81-102CP) (the Proposed 81-102CP Changes).

Related consequential amendments set out in Annexes F to K are also being published for comment:

- to reflect the proposed change in the name of NI 81-102; and
- to update National Instrument 41-101 *General Prospectus Requirements* (NI 41-101) and Form 41-101F2 *Information Required in an Investment Fund Prospectus* (Form 41-101F2).

The proposed rule amendments described above are collectively referred to in this Notice as the Proposed Amendments. The Proposed Amendments, together with the Proposed 81-102CP Changes, are referred to as the “Proposed Provisions”. The Proposed Provisions, together with the proposals relating to National Instrument 81-104 *Commodity Pools* (NI 81-104) and securities lending, repurchases and reverse repurchases described below, represent the first stage

¹ Scholarship plans are being considered by the CSA in a separate initiative. References to “non-redeemable investment funds” in this Notice do not include scholarship plans. In British Columbia, labour sponsored venture capital corporations registered under the *Employee Investment Act* (British Columbia) and venture capital corporations registered under the *Small Business Venture Capital Act* (British Columbia) would need to comply with NI 81-102 if the Proposed 81-102 Amendments are adopted. Annex L, published in British Columbia, describes how the changes would impact these funds.

in Phase 2 of the CSA's implementation of the Modernization of Investment Fund Product Regulation Project (the Modernization Project).

In addition to the Proposed 81-102 Amendments, the Modernization Project also involves the creation of a more comprehensive alternative fund framework, to be effected through amendments to NI 81-104, that would operate in conjunction with the Proposed 81-102 Amendments. The framework would govern investment funds that invest in assets, or use investment strategies, that would not be permitted by the Proposed 81-102 Amendments. The framework is intended to create a more consistent, fair and functional regulatory regime across the spectrum of publicly offered investment fund products. We are seeking feedback on the appropriate parameters for the alternative fund framework.

The Modernization Project also includes the enhancement of the disclosure requirements relating to securities lending, repurchases and reverse repurchases by investment funds. We are also seeking feedback on how disclosure pertaining to these activities should be enhanced.

Background

The mandate of the Modernization Project 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. The types of investment funds covered by the Modernization Project are publicly offered mutual funds (including exchange-traded mutual funds) and non-redeemable investment funds. The Project is being carried out in phases.

(i) Phase 1

In Phase 1, the CSA focused primarily on publicly offered mutual funds in amending NI 81-102, National Instrument 81-106 *Investment Fund Continuous Disclosure* (NI 81-106) and other investment fund rules to codify exemptive relief that had been frequently granted in recognition of market and product developments. As well, we made amendments to keep pace with developing global standards in mutual fund product regulation, notably, introducing maturity restrictions and liquidity requirements for money market mutual funds. The Phase 1 amendments came into force on April 30, 2012, except for the provisions relating to money market funds, which came into force on October 30, 2012.

(ii) Phase 2

The CSA's objective in Phase 2 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. In May 2011, we published 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* (Staff Notice 81-322) to set out a two-staged approach to Phase 2 and to seek comment on our proposed approach.

First Stage of Phase 2

In the first stage of Phase 2, now underway, we are focusing on implementing an operational rule for non-redeemable investment funds. Historically, operational requirements have not been applied to non-redeemable investment funds although, like mutual funds, they are subject to the continuous disclosure and fund governance requirements set out in NI 81-106 and National Instrument 81-107 *Independent Review Committee for Investment Funds* (NI 81-107), respectively.

While non-redeemable investment funds are not new to the investment fund product landscape, their structure and characteristics have evolved along with the investment fund industry. Non-redeemable investment funds now use diverse investment strategies and provide investors with exposure to a variety of assets. In a time of increasing product innovation, we indicated in Staff Notice 81-322 that a staged approach will allow us to focus first on strengthening investor protection and addressing fairness issues arising out of the lack of an operational rule for non-redeemable investment funds. As well, introducing an operational rule for non-redeemable investment funds will level the playing field among non-redeemable investment funds, conventional mutual funds and exchange-traded mutual funds, providing a more consistent framework within which these funds can compete with each other.

In Staff Notice 81-322, we indicated that we were considering the adoption of core restrictions and other operational requirements, analogous to those in NI 81-102, for non-redeemable investment funds. These requirements could include, for example, certain conflicts of interest provisions and securityholder and regulatory approvals for fundamental changes to a non-redeemable investment fund and its management. In addition, we sought feedback on whether there were other restrictions and operational requirements that would be appropriate for non-redeemable investment funds and whether investment restrictions similar to those in Part 2 of NI 81-102 should apply to non-redeemable investment funds. We also sought feedback on a stand-alone operational rule for non-redeemable investment funds and the advantages and disadvantages of this approach.

Key Feedback Received on Staff Notice 81-322

In the feedback we received on Staff Notice 81-322, many commenters expressed the view that investment restrictions similar to those contained in Part 2 of NI 81-102 should not be adopted for non-redeemable investment funds because the primary distinction between mutual funds and non-redeemable investment funds is the flexibility to use alternative investment strategies to provide investors with exposure to different asset classes and innovative techniques. We were told this distinction is beneficial to investors and should not be eliminated. We have observed, however, that non-redeemable investment funds use a range of investment strategies that involve different levels and types of risks. Many non-redeemable investment funds invest using more conventional investment strategies similar to those used by mutual funds governed by NI 81-102. Others invest beyond the limits set out in NI 81-102.

While the CSA recognize that non-redeemable investment funds differ from mutual funds in certain key aspects, we do not agree that the differences provide a sufficient policy basis to support the absence of any investment restrictions for publicly offered non-redeemable

investment funds. Accordingly, we are proposing to include non-redeemable investment funds in the restrictions and practices in NI 81-102 that, in our view, represent fundamental requirements for all publicly offered investment funds.

We think that many of the investment restrictions in Part 2 of NI 81-102 represent fundamental requirements, as the restrictions:

- establish parameters for investment funds to meet the expectations of retail investors who invest in pooled investment products;²
- prohibit activities that are inconsistent with the fundamental characteristics of investment funds as passive investment vehicles;³ or
- reflect prudent fund management practices.⁴

We recognize, however, that certain investment restrictions in Part 2 of NI 81-102 may need to be modified for non-redeemable investment funds because of the differences discussed below.

Taking into account the feedback on Staff Notice 81-322, we accept that investors may benefit from a wider array of investment choices. The CSA wish to preserve the flexibility for non-redeemable investment funds to provide investors with access to alternative investment strategies. Accordingly, concurrently with the Proposed 81-102 Amendments, we are considering how to redesign NI 81-104 to expand the instrument to include both mutual funds and non-redeemable investment funds that wish to use alternative investment strategies that would go beyond the parameters of NI 81-102 (these investment funds are referred to as “alternative funds”). See “Modernization Project – Alternative Funds Framework” below.

We anticipate finalizing certain aspects of the Proposed 81-102 Amendments in advance of others. These include the proposed conflicts of interest provisions, securityholder and regulatory approval requirements, and custodianship requirements. Other aspects, particularly certain proposed investment restrictions that are interrelated with NI 81-104, will require more time to consider and evaluate. We expect these components to be considered in conjunction with any related amendments to NI 81-104 and to come into force contemporaneously at a later date.

More detailed responses to the comments on Staff Notice 81-322 are in Annex D of this Notice.

Second Stage of Phase 2

In the final stage of this initiative, the CSA will review the investment restrictions applicable to mutual funds in Part 2 of NI 81-102 to assess if any changes should be made in light of market and product developments.

² For example, diversification requirements for retail investors to benefit from greater diversification through investing in a fund as compared to investing on an individual account basis.

³ For example, prohibitions on investing in real property or in issuers for the purpose of controlling them.

⁴ For example, restrictions relating to securities lending, repurchases and reverse repurchases.

Substance and Purpose of the Proposed Provisions

The Proposed 81-102 Amendments introduce core operational requirements for non-redeemable investment funds, analogous to those applicable to mutual funds in NI 81-102. They will provide baseline protections for investors, regardless of whether they purchase an investment fund product structured as a mutual fund or a non-redeemable investment fund. They will also mitigate the potential for regulatory arbitrage within the current investment fund regulatory regime by levelling the playing field among non-redeemable investment funds, conventional mutual funds and exchange-traded mutual funds and providing a more consistent regulatory framework for comparable investment products.

The Proposed 81-102 Amendments, together with amendments to NI 81-104 required in the design of an alternative funds framework, are expected to provide sufficient flexibility for mutual funds and non-redeemable investment funds to give investors access to alternative investment strategies, and to help investors differentiate amongst the various types of publicly offered investment fund products. These amendments are expected to contribute to more efficient capital markets by providing greater certainty and consistency for investment funds and their managers regarding the regulatory framework that they must follow.

The CSA, in the context of the Modernization Project, also seek to keep pace with developing global standards by enhancing the disclosure requirements relating to securities lending, repurchase and reverse repurchase transactions by investment funds.⁵

The other components of the Proposed Amendments, as well as the Proposed 81-102CP Changes, are consequential to the Proposed 81-102 Amendments.

Summary of Proposed Amendments

The proposed operational requirements for non-redeemable investment funds in the Proposed 81-102 Amendments parallel many requirements applicable to mutual funds in NI 81-102. The CSA are of the view that many of the requirements in NI 81-102 provide core protections for investors that invest in investment funds and should not be limited only to mutual fund investors. Accordingly, we propose that similar provisions apply to non-redeemable investment funds. In some instances, we have proposed alternative requirements that recognize the differences between non-redeemable investment funds and mutual funds.

(i) Similarities and Differences between Mutual Funds and Non-Redeemable Investment Funds

⁵ See, for example: Financial Stability Board, Strengthening Oversight and Regulation of Shadow Banking – A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos (18 November 2012) online: <http://www.financialstabilityboard.org/publications/r_121118b.pdf>; European Securities and Markets Authority, Guidelines on ETFs and other UCITS issues – Consultation on Recallability of Repo and Reverse Repo Arrangements (25 July 2012) online: <<http://www.esma.europa.eu/system/files/2012-474.pdf>>; International Organization of Securities Commissions, Principles for the Regulation of Exchange Traded Funds (March 2012) online: <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD376.pdf>>.

Non-redeemable investment funds are similar to mutual funds in many ways. Under securities legislation, the primary purpose of both types of investment funds is to invest money provided by their securityholders. Both types of investment funds offer the benefits of pooled investment and portfolio management services to the public.

However, the CSA recognize that non-redeemable investment funds differ from mutual funds and, in particular, conventional mutual funds, in certain key aspects. Unlike conventional mutual funds, non-redeemable investment funds do not offer unlimited securities on a continuous basis and they do not redeem their securities at net asset value (NAV) on a regular basis. Instead, non-redeemable investment funds typically issue a fixed number of securities in an initial public offering,⁶ following which the securities are generally listed and trade on an exchange at market prices which may be at a premium or discount to NAV. Many non-redeemable investment funds also give investors the right to redeem their securities annually at a price based on the NAV of the securities,⁷ while others have a fixed life. Finally, while conventional mutual funds are primarily distributed by mutual fund dealers, non-redeemable investment funds are generally only distributed by investment dealers in the underwriting syndicate for the funds' public offering.

The key elements of the Proposed Amendments are outlined below. A consolidated list of the specific issues in the Proposed 81-102 Amendments on which we seek comment is set out in Annex A.

(ii) Investment Restrictions

As noted above, we think that many of the investment restrictions in Part 2 of NI 81-102 represent fundamental requirements that should apply to non-redeemable investment funds. In our review of the investment restrictions adopted by existing non-redeemable investment funds, we have observed that many non-redeemable investment funds have adopted several of the restrictions in Part 2 in their constating documents. We think that certain of the investment restrictions in Part 2 of NI 81-102 that impose constraints designed to limit risks for retail investors also represent prevailing industry best practices for investment funds that invest using conventional investment strategies.⁸ Accordingly, we propose that those restrictions in Part 2 also apply to non-redeemable investment funds that invest using conventional investment strategies. Extending Part 2 to include these non-redeemable investment funds will result in the same regulatory protections for investors of all investment funds using conventional strategies, regardless of whether the fund is structured as a mutual fund or a non-redeemable investment fund.

⁶ Non-redeemable investment funds are commonly referred to as “closed-end funds” because they issue a fixed number of securities rather than an unlimited number of securities on a continuous basis.

⁷ The CSA generally take the view that where an investment fund redeems its securities based on NAV less frequently than once a year, the fund does not provide an “on demand” redemption feature and is therefore not a mutual fund subject to the requirements of NI 81-102. Please also see “Redemptions” below.

⁸ For example, limits on short selling and cover requirements for derivative positions.

We propose not to apply certain provisions in Part 2 of NI 81-102 to non-redeemable investment funds where differences between mutual funds and non-redeemable investment funds provide a basis for different requirements. Instead, we propose alternative provisions that recognize the differences and we propose limits that act as prudent safeguards.

Concentration Restriction

Many existing non-redeemable investment funds have adopted a concentration restriction that requires them to limit their investment in an issuer to an amount equal to 10% of NAV at the time of purchase, similar to the concentration restriction in section 2.1 of NI 81-102. Based on this prevailing practice, it appears that a 10% concentration limit is considered an industry best practice in providing a minimum level of diversification.

Therefore, we are proposing that a concentration restriction be adopted for non-redeemable investment funds, based on section 2.1 of NI 81-102. We also propose that the definition of “fixed portfolio ETF” in NI 81-102 be amended to permit a non-redeemable investment fund that has a fundamental investment objective of holding and maintaining a fixed portfolio of publicly traded equity securities of issuers named in their prospectus to exceed the 10% concentration restriction in section 2.1 of NI 81-102. We seek comment on whether a 10% concentration restriction is appropriate for non-redeemable investment funds and, if not, why a higher issuer concentration restriction would be appropriate for non-redeemable investment funds. We are also considering whether “alternative funds” governed by NI 81-104 should be permitted to have a more generous concentration restriction than in section 2.1 of NI 81-102. See “Modernization Project – Alternative Funds Framework” below.

Investments in Physical Commodities

We are proposing to limit investments by a non-redeemable investment fund in physical commodities and specified derivatives the underlying interests of which are physical commodities to, in the aggregate, an amount equal to 10% of NAV at the time of purchase. This limit is similar to the limit imposed in recent orders that granted exemptive relief to mutual funds to permit them to make these types of investments. Non-redeemable investment funds that wish to focus on physical commodities or derivatives that provide exposure to physical commodities may choose to be “alternative funds” regulated under NI 81-104. See “Modernization Project – Alternative Funds Framework” below.

Investments in Illiquid Assets

We are proposing that non-redeemable investment funds be permitted to invest a larger portion of their assets in illiquid assets than mutual funds. We note that, unlike mutual funds, non-redeemable investment funds generally do not offer regular redemptions based on NAV. Rather, most of them primarily offer liquidity through listing their securities on an exchange. We seek comment on the limit on illiquid asset investments that would be appropriate for non-redeemable investment funds.

Borrowing

We are proposing that non-redeemable investment funds be permitted to borrow cash up to an amount equal to 30% of NAV. The 30% borrowing limit generally reflects the current practice of

the majority of existing non-redeemable investment funds, which limit their cash borrowings to an amount that is between 10% to 33% of NAV.

We also think that requiring borrowing from a lender that is licensed to carry on a lending business could provide additional monitoring and controls over a non-redeemable investment fund's cash borrowings that are based on the investment strategies and financial condition of the specific fund. We are proposing that non-redeemable investment funds borrow from a "Canadian financial institution" (as defined in National Instrument 14-101 *Definitions*), as we have observed that existing non-redeemable investment funds generally borrow from Schedule I or II banks. We seek comment on whether this requirement for non-redeemable investment fund borrowings is appropriate. We are also considering whether non-redeemable investment funds that are "alternative funds" regulated under NI 81-104 should be permitted to borrow more than 30% of NAV. See "Modernization Project – Alternative Funds Framework" below.

We also note that under the Proposed 81-102 Amendments, non-redeemable investment funds would be able to create leverage only through cash borrowings. Non-redeemable investment funds that wish to create leverage through the use of specified derivatives (as defined in NI 81-102) or short selling may choose to be "alternative funds" regulated under NI 81-104. See "Modernization Project – Alternative Funds Framework" below.

Investments in Mortgages

We are proposing that there be no limit on a publicly offered non-redeemable investment fund's investments in guaranteed mortgages (as defined in NI 81-102). We are also proposing that mortgage investments by these types of funds be restricted to guaranteed mortgages. The CSA are of the view that mortgages that are not fully and unconditionally guaranteed by a government or government agency ("non-guaranteed mortgages") may not be appropriate investments for publicly offered investment funds.⁹

We have observed that there is currently a limited number of existing publicly offered non-redeemable investment funds that have investment objectives of investing in non-guaranteed mortgages. We therefore are proposing a 24 month transition period for the application of the restriction in proposed paragraph 2.3(2)(b), to give these types of funds time either to divest their holdings of non-guaranteed mortgages (which would trigger a change in investment objective if the fund's investment objectives state that the fund will be investing in non-guaranteed mortgages) or to transition into the regulatory regime for issuers that are not investment funds. We are seeking comment on the impact of the proposed restriction on non-guaranteed mortgage investments and the appropriate length of the transition period. We are also seeking comment on alternatives to a transition period, such as a grandfathering provision, and the impact of this alternative.

Fund-of-Fund Structures

We are proposing that non-redeemable investment funds be required to follow the requirements in subsection 2.5(2) of NI 81-102 when investing in mutual funds. We also propose that non-

⁹ For a discussion about the investments of mortgage investment entities, see CSA Staff Notice 31-323 *Guidance Related to the Registration Obligations of Mortgage Investment Entities*.

redeemable investment funds not be permitted to invest in other non-redeemable investment funds. Otherwise, a non-redeemable investment fund could have portfolio exposure that is greater than 130% of its NAV if it invests in an underlying non-redeemable investment fund that leverages its portfolio through cash borrowings. The CSA have also observed that non-redeemable investment funds generally do not seek to invest in other non-redeemable investment funds. Non-redeemable investment funds that wish to use greater leverage may choose to be “alternative funds” regulated under NI 81-104. See “Modernization Project – Alternative Funds Framework” below.

We also seek feedback on the application of proposed paragraphs 2.5(2)(a) and (c) of NI 81-102 to certain non-redeemable investment funds that use a fund-of-fund structure involving an underlying mutual fund.

Securities Lending, Repurchases and Reverse Repurchases

We think that non-redeemable investment funds should engage in securities lending, repurchases and reverse repurchases on the same basis as mutual funds. Therefore, we are generally proposing that the framework applicable to securities lending, repurchases and reverse repurchases by mutual funds apply to non-redeemable investment funds. We also propose to amend paragraphs 2.12(1)12 and 2.13(1)11 of NI 81-102 such that the aggregate market value of securities loaned under securities lending transactions or sold in repurchase transactions by an investment fund may not exceed an amount equal to 50% of the fund’s NAV.

Paragraphs 2.12(1)12 and 2.13(1)11 currently state that the aggregate market value of the securities loaned under securities lending transactions or sold in repurchase transactions may not exceed 50% of the fund’s total assets, not including the collateral held by the fund for the loaned securities and the cash held by the fund for the sold securities. The proposed amendments to paragraph 2.12(1)12 and 2.13(1)11 would mean that non-redeemable investment funds, which are proposed to be permitted to borrow cash up to an amount equal to 30% of their NAV, may not include any borrowed cash (or portfolio assets purchased with borrowed cash) in calculating the maximum market value of their securities that may be loaned under securities lending transactions or sold in repurchase transactions. For mutual funds, the CSA consider that the impact of this proposed amendment would be minimal as mutual funds are generally not permitted to be leveraged and their liabilities are generally not significant relative to their total assets.

(iii) New Non-Redeemable Investment Funds

Seed Capital

As noted above, non-redeemable investment funds typically raise sufficient funds for investment purposes by issuing a fixed number of securities in their initial public offering, instead of engaging in a continuous distribution of securities. Because of the differences in capital raising models of mutual funds and non-redeemable investment funds, the CSA do not think that the seed capital and minimum subscription requirements in sections 3.1 and 3.2 of NI 81-102 should apply to non-redeemable investment funds.

Organizational Costs

Proposed subsection 3.3(3) of NI 81-102 prohibits the costs of organizing a new non-redeemable investment fund from being borne by the fund. Currently, managers that launch non-redeemable investment funds do not pay any of the organizational costs; instead, the costs are paid out of the proceeds of the initial public offering of the non-redeemable investment fund. On the other hand, managers that launch mutual funds must pay the costs of establishing new mutual funds and then recoup the costs through the ongoing management fee charged to the fund. The CSA recognize that non-redeemable investment funds undertake an initial public offering that raises a fixed amount of money in a limited amount of time, rather than offering securities on a continuous basis. While this has historically accounted for the difference in organizational cost payment models between non-redeemable investment funds and mutual funds, the CSA think it is important to examine the application of proposed subsection 3.3(3) of NI 81-102 to non-redeemable investment funds.

Both investors and managers benefit from managers establishing investment funds that are sustainable in the long term. However, the financial risk of launching a non-redeemable investment fund that may not be sustainable appears to be borne only by investors if all of the organizational costs are paid out of the proceeds of the initial public offering. Therefore, requiring managers to pay the organizational costs of a new non-redeemable investment fund could be perceived to further align the interests of managers with those of investors.

Another potential benefit of the proposed provision is that it may increase the efficiency of non-redeemable investment fund launches. The proposed provision could further strengthen the manager's interest in minimizing organizational costs to reduce its initial outlay, resulting in cost efficiencies when launching new funds. Also, as certain organizational costs are fixed, it appears to the CSA that launching a larger fund may be more cost efficient than launching multiple smaller funds, which may have the potential disadvantages of higher per unit operational costs and lower secondary market liquidity.

Finally, the introduction of a requirement for the manager to pay the organizational costs of launching a new non-redeemable investment fund will level the playing field between mutual fund managers and non-redeemable investment fund managers and may discourage arbitrage opportunities. The CSA have observed several instances where managers launch mutual funds without paying any organizational costs by creating a non-redeemable investment fund and then converting it into a mutual fund after a short period of time.

We recognize that if managers are required to pay organizational costs, managers that cannot finance the organizational costs would not be able to launch new non-redeemable investment funds. As well, smaller non-redeemable investment funds may not be launched. We seek comment on the potential impact and the benefits and costs of proposed subsection 3.3(3) for non-redeemable investment funds. In addition, we seek comment on whether the different capital raising model followed by non-redeemable investment funds may support the fund continuing to pay some of the organizational costs out of the proceeds of the initial public offering of the fund and whether there are specific components of organizational costs that are more appropriately borne by the non-redeemable investment fund and components that are more appropriately borne by the manager.

(iv) Conflicts of Interest

We are proposing to apply the conflicts of interest provisions in Part 4 of NI 81-102 to non-redeemable investment funds. The introduction of these provisions will extend key protections to non-redeemable investment fund investors. This proposal received broad support from commenters that provided feedback to Staff Notice 81-322.

(v) Fundamental Changes

We think that non-redeemable investment fund investors should have similar protections and rights as mutual fund investors relating to fundamental changes to their funds. Therefore, we are proposing to apply the provisions in Part 5 of NI 81-102 to non-redeemable investment funds.

Securityholder and Regulatory Approval Requirements

The CSA have observed that the constating documents of many non-redeemable investment funds incorporate investor voting rights that are similar to those in Part 5 of NI 81-102. However, these rights are not consistently provided by each non-redeemable investment fund offered to the public. Codifying these requirements will give all investors consistent and guaranteed voting rights on important changes that impact the fund or its management.

We propose to re-draft the requirement to obtain regulatory approval for a change in control of the manager for greater clarity and move it from subsection 5.5(2) to proposed paragraph 5.5(1)(a.1) of NI 81-102. While this will be a new requirement for non-redeemable investment funds, there are no substantive changes for mutual funds from the re-draft.

Proposed New Securityholder Approval Requirements

In addition to the existing requirements in Part 5, the CSA also propose that prior securityholder approval be obtained to implement a change to the nature of an investment fund. Specifically, prior securityholder approval is proposed to be required to implement any change that would convert a mutual fund into a non-redeemable investment fund, convert a non-redeemable investment fund into a mutual fund, or convert an investment fund into an issuer that is not an investment fund. In addition, the costs and expenses to implement the change (which include the costs of obtaining securityholder approval and, if applicable, the costs of filing a simplified prospectus to commence a continuous distribution) may not be borne by the investment fund.

We are proposing a limited exemption from the proposed securityholder approval requirement for a non-redeemable investment fund that is structured from inception to convert to a mutual fund upon the occurrence of a specified event. Conditions for this proposed exemption include prospectus and sales communication disclosure of the conversion and securityholder notice prior to the conversion.

The CSA also propose an exemption to the securityholder and regulatory approval requirements for fund mergers involving specialized non-redeemable investment funds that have a limited life and that do not list or trade their securities on a secondary market. These non-redeemable investment funds are typically organized as limited partnerships and have the investment

objective of providing returns through tax-assisted investments in “flow-through” shares issued by resource companies. Investors must remain invested in the funds to realize the tax benefits of their investment, with liquidity provided at the termination of the fund through a distribution of the net proceeds or a reorganization with a mutual fund under which assets are transferred on a tax-deferred basis to the mutual fund in exchange for securities issued by the mutual fund. Given the unique structure and purpose of these non-redeemable investment funds, the CSA propose that these funds be exempted from securityholder and regulatory approval requirements if they are effecting a rollover into a mutual fund, provided that certain requirements, including prospectus disclosure requirements, are met.

Proposed New Conditions for Pre-Approved Fund Mergers

In addition to the current conditions in subsection 5.6(1) of NI 81-102, the CSA propose that, as a condition to effect a merger of a non-redeemable investment fund with another investment fund without securityholder or regulatory approval, the non-redeemable investment fund offer to redeem its securities at their NAV at a date that is before the effective date of the merger. In our view, the ability to exit the fund at NAV helps to mitigate the need for securityholder approval.

The CSA also propose that a merger be effected at NAV as a condition for the merger to proceed without securityholder or regulatory approval. This condition helps to mitigate conflicts of interest where funds under common management are merged. The TSX Company Manual contains a similar condition for fund mergers to be implemented without securityholder approval.

Termination of Non-Redeemable Investment Funds

Proposed section 5.8.1 of NI 81-102 requires that non-redeemable investment funds terminate no earlier than 15 days and no later than 30 days after filing a press release to disclose the intended termination. This provision is intended to give investors sufficient time to consider the consequences of the termination and also require that money be repaid promptly to investors if a fund is terminating, as any secondary market liquidity can be expected to decline significantly after the termination of the fund is disclosed.

(vi) Custodianship Requirements

Custodianship requirements for non-redeemable investment funds that parallel the requirements for mutual funds in Part 6 of NI 81-102 currently exist in Part 14 of NI 41-101. We propose to update the drafting in Part 6 of NI 81-102 based on the drafting in NI 41-101, and apply the updated NI 81-102 requirements to non-redeemable investment funds. There are no substantive changes to the custodian requirements for any investment funds, other than requiring all non-redeemable investment funds, rather than only those that file a prospectus under NI 41-101, to comply with the custodianship requirements. Part 14 of NI 41-101 will remain in order to maintain the custodianship requirements for scholarship plans.

(vii) Incentive Fees

We propose that restrictions on non-redeemable investment funds paying incentive fees apply in a similar manner as for mutual funds. Part 7 of NI 81-102 sets parameters for incentive fees to be charged appropriately with reference to a relevant benchmark, which we think should apply to all investment funds that use similar investment strategies. A non-redeemable investment fund that invests using alternative investment strategies permitted under NI 81-104 may choose to be an “alternative fund” regulated under NI 81-104 and pay incentive fees in accordance with that instrument. See “Modernization Project – Alternative Funds Framework” below.

(viii) Sales of Securities

The CSA do not propose to apply the provisions in Part 9 of NI 81-102 to non-redeemable investment funds because of the differences in the distribution models between non-redeemable investment funds and mutual funds. However, we are proposing to introduce subsections 9.3(2) and (3) to require that issuances of non-redeemable investment fund securities not cause dilution to existing securityholders. These subsections parallel the requirement that mutual fund securities be issued at NAV. We seek comment on whether proposed subsections 9.3(2) and (3) achieve the purpose of preventing dilutive issuances while taking into account how new securities are distributed.

(ix) Warrant Offerings

Proposed new Part 9.1 of NI 81-102 prohibits an investment fund from issuing warrants, rights or other specified derivatives the underlying interest of which is a security of the investment fund. In recent years, the CSA have observed non-redeemable investment funds issuing warrants that could potentially dilute the value of the securities held by investors who do not exercise the warrants. Steps to mitigate dilution, such as selling the warrants on the secondary market, may be ineffective or not sufficient to compensate investors who do not exercise their warrants for the loss of the value of their securities. As warrants are automatically issued to securityholders, warrants may also appear to be coercive, with securityholders obligated to make an additional investment or face the risk of dilution.

We think that investors in a non-redeemable investment fund may not expect the costs of warrant issuances to be part of their investment bargain; specifically, investors do not generally expect that the fund they invest in will seek additional capital from them after they have made the initial investment, or that they will have to incur costs for the fund to raise additional capital. The CSA are of the view that a restriction on warrant issuances will not unduly limit the ability of an investment fund to raise additional money. A manager that wishes to raise additional money for its fund may file a prospectus to issue new securities, provided that the issuance is not dilutive to existing securityholders.

(x) Redemptions

The CSA do not propose to apply many of the provisions in Part 10 of NI 81-102 to non-redeemable investment funds because of the differences in redemption models between these funds and mutual funds. However, we propose similar requirements for non-redeemable

investment funds that offer annual redemptions based on NAV or more regular redemptions at market value. We are proposing that:

- like mutual funds, non-redeemable investment funds that offer redemptions send investors an annual reminder of the procedures for exercising redemptions;
- non-redeemable investment funds pay redemption proceeds promptly; specifically, no more than 15 business days after the redemption is effected;
- non-redeemable investment funds not redeem securities at an amount that is greater than the NAV of the security on the redemption date, to avoid dilution to remaining securityholders; and
- non-redeemable investment funds that offer redemptions be permitted to suspend redemptions if the requirements in section 10.6 of NI 81-102 are met.

Many existing non-redeemable investment funds offer redemptions of their securities based on NAV once a year. The CSA have taken the view that investment funds that offer redemptions based on NAV no more than once a year are non-redeemable investment funds. We seek comment on whether to reconsider this position.

(xi) Commingling of Cash

The CSA are proposing to amend Part 11 of NI 81-102 so that the provisions relating to the holding of monies from sales and redemptions in a trust account will apply to non-redeemable investment funds. The Proposed 81-102 Amendments would also permit cash received in respect of sales and redemptions of all investment fund securities to be held in one account.

(xii) Sales Communications

We are proposing to apply the provisions in Part 15 of NI 81-102 to sales communications of non-redeemable investment funds, with modifications that recognize differences between mutual funds and non-redeemable investment funds. The proposed requirements in Part 15 do not impact the restrictions applicable during the waiting period and the period between the issuance of the receipt for the final prospectus and the closing of the prospectus offering.

We are proposing to amend section 15.6 of NI 81-102 such that a mutual fund that was converted from a non-redeemable investment fund must, if it wishes to present performance data, present past performance data for the period when it existed as a non-redeemable investment fund. This is consistent with the continuous disclosure requirements in NI 81-106, as well as exemptive relief that has been granted to such funds.

(xiii) Naming Convention for Investment Funds

We are considering whether “alternative funds” regulated under NI 81-104 should be required to include the words “Alternative Fund” in their name to clearly differentiate “alternative funds”

from investment funds subject only to NI 81-102. See “Modernization Project – Alternative Funds Framework” below. We seek comment on whether investment funds that are subject only to NI 81-102 should also be required to include specific identifiers in their name that would identify them as investment funds that use the conventional investment strategies permitted in NI 81-102.

(xiv) Other Provisions relating to Non-Redeemable Investment Funds

We are proposing that non-redeemable investment funds set record dates in accordance with Part 14 of NI 81-102, except that if a non-redeemable investment fund lists its securities on an exchange, it may follow the rules of the applicable exchange regarding record dates.

We also propose that non-redeemable investment funds maintain and make available securityholder records in accordance with Part 18 of NI 81-102.

(xv) Transition Period for Certain Proposed Provisions relating to Non-Redeemable Investment Funds

As noted above, we anticipate that some aspects of the Proposed 81-102 Amendments, specifically, the proposed core operational requirements for non-redeemable investment funds other than certain provisions in Part 2 of NI 81-102, will come into force in advance of other aspects. We expect that the introduction of certain investment restrictions in Part 2 of NI 81-102 and their interrelation with NI 81-104 will take more time to consider and evaluate. Given their interconnectedness, we expect that these components will be considered together and come into effect contemporaneously at a later date.

Currently, the CSA propose an 18 month transition period for existing non-redeemable investment funds to comply with the investment restrictions in proposed amended sections 2.2, 2.3,¹⁰ 2.4 and 2.5 of NI 81-102 to give existing funds sufficient time to align their portfolios with the new requirements. Any new non-redeemable investment funds established after the coming-into-force date of the Proposed 81-102 Amendments pertaining to these sections would be required to comply with the investment restrictions in Part 2 of the amended NI 81-102 immediately. We seek comment on the transition period and alternatives to a transition period.

We are also proposing an 18 month transition period for compliance with Part 7 of NI 81-102, and a 6 month transition period for existing non-redeemable investment funds to continue to use sales communications (other than advertisements) that were prepared prior to the coming-into-force date of the Proposed 81-102 Amendments pertaining to Part 15 of NI 81-102.

(xvi) Related Consequential Amendments

Amendments to NI 41-101 and Form 41-101F2

Where a non-redeemable investment fund is structured to convert into a mutual fund upon the occurrence of a specified event, we propose to amend Form 41-101F2 to require specific prospectus disclosure of the conversion.

¹⁰ Other than proposed paragraph 2.3(2)(b), for which a 24 month transition period is proposed.

We also propose to require specific prospectus disclosure of investments in physical commodities. If an investment fund invests in physical commodities, proposed Item 6.1(7) of Form 41-101F2 will require certain disclosure under the “Investment Strategies” heading, including the types of commodities the fund may purchase, whether the commodity exposure is in the form of investments in physical commodities or investments through specified derivatives the underlying interest of which are physical commodities, and how the fund will use its investment in physical commodities to achieve its investment objectives.

Many non-redeemable investment funds redeem their securities by reference to NAV annually, with the redemption proceeds being equal to the NAV per security less certain costs that may be deducted from the NAV per security. In response to the feedback received on Staff Notice 81-322, we propose to amend Item 15 of Form 41-101F2 to require disclosure of any costs or other fees that may be deducted from the NAV per security to clarify what amount will be received upon redemption.

We propose to repeal Item 21.2 of Form 41-101F2 to reflect the proposed restrictions on borrowing by non-redeemable investment funds. As proposed subparagraph 2.6(a)(i.1) of NI 81-102 would restrict cash borrowings to loans from a Canadian financial institution (as defined in National Instrument 14-101 *Definitions*), non-redeemable investment funds would not be permitted to issue debt securities to the public.

We also propose to repeal Items 21.3 and 27 of Form 41-101F2 to reflect the proposed prohibition on investment funds offering warrants or specified derivatives the underlying interest of which are securities of the investment fund.

Finally, we propose to delete references to “subsidiaries” of investment funds in Form 41-101F2 as these references would not be consistent with proposed amended section 2.2 of NI 81-102.

Other Consequential Amendments

We propose minor consequential amendments to NI 81-106, NI 81-107 and its commentary, and the national instruments and policies in Annexes I to K to reflect proposed changes in certain definitions in NI 81-102 to encompass non-redeemable investment funds and to reflect the change in the name of NI 81-102 from “National Instrument 81-102 *Mutual Funds*” to “National Instrument 81-102 *Investment Funds*”.

(xvii) Proposed 81-102 Amendments that Impact Mutual Funds

While Phase 2 focuses on introducing operational requirements for non-redeemable investment funds, there are provisions in the Proposed 81-102 Amendments that would impact mutual funds, in addition to our consideration of additional requirements relating to securities lending, repurchases and reverse repurchases by investment funds in Annex C and our proposals to redesign NI 81-104 described below. These provisions are:

- proposed amended sections 2.11 and 2.17 will require an exchange-traded mutual fund that is not in continuous distribution to issue a news release if the fund intends to begin

using specified derivatives, short selling and entering into securities lending, repurchases and reverse repurchases transactions;

- proposed amended paragraphs 2.12(1)12 and 2.13(1)11 will limit the amount of securities loaned or sold in repurchase transactions by a mutual fund to 50% of NAV, rather than 50% of total assets, excluding the collateral delivered to the fund (see “(ii) Investment Restrictions – Securities Lending, Repurchases and Reverse Repurchases” above);
- subsection 3.3(2) is proposed to be repealed, as the rationale for introducing proposed subsection 3.3(3) for non-redeemable investment funds also applies to exchange-traded mutual funds that are not in continuous distribution (see “(iii) New Non-Redeemable Investment Funds – Organizational Costs” above);
- proposed amended paragraph 5.1(1)(g) will broaden the securityholder approval requirements to require securityholder approval for a merger of a mutual fund with any issuer, rather than a merger with another mutual fund;
- proposed new paragraph 5.1(1)(h) will require that a mutual fund that wishes to implement a change that restructures the fund into a non-redeemable investment fund or an issuer that is not an investment fund to obtain prior securityholder approval, with the fund prohibited from bearing the costs of the restructuring;
- proposed new paragraph 5.6(1)(k) will include a new condition that the consideration offered to securityholders of an investment fund for a merger have a value that is equal to the NAV of the fund if the merger is to be effected without prior securityholder or regulatory approval;
- subsection 5.6(2) is proposed to be repealed, as NI 81-106 requires that the auditor’s report that accompanies financial statements of an investment fund not contain a reservation;
- proposed section 9.1 will prohibit the issuance of warrants and similar instruments by all investment funds;
- proposed subsections 9.3(2) and (3) will apply to an exchange-traded mutual fund that is not in continuous distribution to prevent dilutive issuances of securities;
- proposed subsections 10.4(1.3) and 10.6(2) will require an exchange-traded mutual fund that is not in continuous distribution to pay redemption proceeds no more than 15 business days after the redemption is effected, unless the redemptions of the fund have been suspended in accordance with the requirements in section 10.6; and
- proposed amendments to Part 11 will permit cash received in respect of sales and redemptions of all investment fund securities (and not only mutual fund securities) to be held in one trust account.

We are also considering requirements for investment funds governed only by NI 81-102 to include specific identifiers in their name (see “(xiii) Naming Convention for Investment Funds” above).

Adoption Procedures

We expect the Proposed Amendments to be incorporated as part of rules in each of British Columbia, Alberta, Manitoba, Ontario, Nova Scotia, Prince Edward Island, New Brunswick, Newfoundland and Labrador, Northwest Territories, Yukon and Nunavut, and incorporated as part of commission regulations in Saskatchewan and regulations in Québec. The Proposed 81-102CP Changes are expected to be adopted as part of policies in each of the CSA jurisdictions.

Alternatives Considered to the Proposed Amendments

The alternative to the Proposed Amendments would be not to cover non-redeemable investment funds in NI 81-102 and thus maintain the status quo.

Not proceeding with the Proposed Amendments would continue to permit non-redeemable investment funds to operate without a set of core operational requirements, such as certain conflicts of interest prohibitions, securityholder and regulatory approval requirements for fundamental changes and custodianship requirements. We think this alternative would not be appropriate in view of the investor protection and fairness concerns arising from the lack of baseline protections for investors of non-redeemable investment funds. Without the Proposed Amendments, there would also be less certainty and consistency for non-redeemable investment funds and their managers regarding the operational requirements that they must follow.

Anticipated Costs and Benefits of the Proposed Amendments

We think the Proposed Amendments strike the right balance between protecting investors and fostering fair and efficient capital markets. The Proposed Amendments will benefit investors and the capital markets by creating a more consistent, fair and functional regulatory regime across the spectrum of investment fund products.

Core operational requirements for non-redeemable investment funds and a more comprehensive regulatory framework for alternative funds will increase the efficiency for the investment fund industry by enabling them to offer products in a more timely fashion, as the requirements applicable to all publicly offered investment funds will be more clearly delineated for managers, investors and the market generally. We also think that the Proposed Amendments will level the playing field for all investment funds.

The CSA are of the view that the Proposed Amendments will not create substantial costs for investment funds, their managers or securityholders. Many of the Proposed Amendments codify prevailing investment parameters and limits within the non-redeemable investment fund industry. Our review of existing non-redeemable investment funds indicates that a majority of non-redeemable investment funds already follow investment restrictions that are comparable to the proposed investment restrictions in NI 81-102. Further, many managers either manage

various types of investment fund products (including mutual funds subject to NI 81-102) or have already established the necessary infrastructure to monitor compliance with the investment restrictions included in the constating documents of their funds. Therefore, these managers are already equipped to monitor compliance with any additional investment restrictions.

Introducing fundamental investor rights and protections may involve additional costs for non-redeemable investment funds, their managers or their securityholders. We think that the costs associated with providing investors with fundamental rights and protections are proportionate and do not outweigh the benefits. Areas where there may be a cost burden include:

- the proposal to prohibit a non-redeemable investment fund or its securityholders from paying the organizational costs of a new non-redeemable investment fund may require managers to finance the organizational costs of new funds. Managers could reconsider how they charge fees to their funds or securityholders if they pay the costs of launching a new fund;
- the proposed application of the securityholder voting requirements in Part 5 of NI 81-102 to non-redeemable investment funds may result in additional costs. Similar to our view on the importance of providing mutual fund investors with the right to vote on fundamental changes, we think that Part 5 provides important protection for investors of non-redeemable investment funds that would outweigh the associated costs. We also do not expect managers to implement fundamental changes on a frequent basis; and
- the proposed prohibition on warrant issuances to protect existing investors of an investment fund from dilutive offerings may result in increased costs if managers have to look for other ways of increasing their assets under management. We expect that managers will raise additional money through offerings of new securities of the fund, rather than through warrant offerings. As managers may still raise additional money through new offerings, we think that this prohibition does not represent an undue restriction on managers and that the investor protection benefits from this proposed prohibition outweigh the costs.

Overall, we think the potential benefits of the Proposed Amendments are proportionate to their costs. We seek feedback on whether you agree or disagree with our perspective on the cost burden of the Proposed Amendments, as well as your views on the cost burden of implementing other elements of the Modernization Project, including the proposed reform of NI 81-104 described below. Specific quantitative data in support of your views in this context would be particularly helpful.

Modernization Project – Alternative Funds Framework

Together with the CSA's introduction of core operational requirements for publicly offered non-redeemable investment funds, we are considering amendments to NI 81-104 to include both mutual funds and non-redeemable investment funds that focus on alternative asset classes or use alternative investment strategies not permitted by proposed amended NI 81-102.

Currently, NI 81-104 sets forth a regulatory framework that applies only to specialized mutual funds that are commodity pools by exempting them from certain restrictions in NI 81-102. A redesign of NI 81-104 to include both mutual funds and non-redeemable investment funds is intended to preserve the flexibility for non-redeemable investment funds to use alternative investment strategies that may not be permissible under the Proposed 81-102 Amendments, and at the same time, create a more comprehensive regulatory framework in NI 81-104 for alternative funds (both mutual funds and non-redeemable investment funds). Any amendments to NI 81-104 will also seek to help investors more effectively differentiate between investment funds that use alternative investment strategies from investment funds that use more conventional investment strategies.

As part of our review of NI 81-104, we are examining the current exemptions from NI 81-102 that are contained in NI 81-104 to determine whether each exemption should remain and what, if any, new exemptions should be added. We are also considering new disclosure requirements in the prospectus, continuous disclosure and sales communications for investment funds that wish to use the alternative investment strategies in NI 81-104 and whether there is a need for additional proficiency requirements for the sale of alternative fund securities.

We have set out below the key elements of a proposed regulatory framework in NI 81-104 on which we seek feedback. This will inform the rule-making relating to NI 81-104 and the proposed investment restrictions in NI 81-102, as the two frameworks are intended to work in conjunction with each other to allow a wide variety of investment funds to be offered to the public. After reviewing your feedback, we will publish proposed amendments to NI 81-104 for comment. Based on the feedback received, we may also publish for comment modifications to certain of the Proposed 81-102 Amendments that interact with proposed amendments to NI 81-104.

Feedback is welcome on all aspects of the proposed regulatory framework in NI 81-104 being considered by the CSA. A consolidated list of the specific issues on which we seek feedback is set out in Annex B.

(i) Definition of “Alternative Fund”

The CSA contemplate that NI 81-104 would apply to

- an “alternative fund” to which NI 81-102 applies, and
- a person or company in respect of an alternative fund to which NI 81-104 applies.

The CSA are considering replacing the term “commodity pool” in NI 81-104 with “alternative fund”, a term that we think will better describe the types of investment objectives or strategies that characterize the investment funds that would be subject to the amended NI 81-104. Alternative funds will be permitted to invest in certain asset classes and use certain strategies not permitted by NI 81-102 by virtue of exemptions from NI 81-102 that will be contained in NI 81-104. We seek feedback on the use of the term “alternative fund” and whether it accurately describes the types of funds that would be expected to be captured by NI 81-104.

The current definition of “commodity pool” in NI 81-104 refers to a mutual fund that has adopted fundamental investment objectives that permit it to use or invest in specified derivatives or physical commodities in a manner not permitted by NI 81-102. The CSA are considering defining an “alternative fund” as an investment fund that, in its initial prospectus, states that it is an alternative fund in response to Item 1.3(1) of Form 41-101F2. Both mutual funds and non-redeemable investment funds could be alternative funds if they satisfy the definition.

(ii) Investment Restrictions

Concentration Restriction

To allow investment funds greater flexibility to engage in alternative investment strategies, we are considering permitting alternative funds to invest a larger percentage of their NAV in securities of a single issuer than the proposed 10% restriction in NI 81-102. Depending on the comments received on the Proposed 81-102 Amendments, non-redeemable investment funds may become subject to a higher concentration restriction than 10% under NI 81-102, and this may impact the concentration restriction under NI 81-104. See “Summary of Proposed Amendments” above. We seek feedback on the types of investment strategies an alternative fund may engage in that would require a fund’s investment in an issuer to exceed the current 10% concentration restriction in NI 81-102.

Also, given that we anticipate alternative funds having more leveraged exposure than investment funds that invest within the limits in NI 81-102, we are considering whether the concentration measurement in section 2.1 of NI 81-102 based on the net asset value is a sufficient measurement to provide information about the concentration of an alternative fund’s portfolio. We seek feedback on whether there are other ways that would better describe the level of concentration of an alternative fund portfolio.

Investments in Physical Commodities

The CSA are considering maintaining the current exemptions from paragraphs 2.3(d), (e), (f), (g) and (h) of NI 81-102 in NI 81-104. We think that NI 81-104 should similarly permit alternative funds structured as non-redeemable investment funds to invest in physical commodities and specified derivatives linked to physical commodities in the same way as commodity pools currently do today. The CSA expect that investment funds that primarily focus on investing in physical commodities through direct holdings or through specified derivatives would be alternative funds subject to NI 81-104.

Currently, there are mutual funds that have received exemptive relief from NI 81-102 to be “precious metals funds” because their fundamental investment objectives provide that they invest primarily in gold, silver or platinum. We do not expect these funds to be impacted by our consideration of proposed amendments to NI 81-104.

Fund-of-Fund Structures

Generally, we are considering permitting an alternative fund to invest in underlying investment funds (including underlying alternative funds) subject to similar conditions applicable to fund-of-fund investments in section 2.5 of NI 81-102.

The application of paragraphs 2.5(2)(a) and (c) of NI 81-102 to alternative funds would mean that an alternative fund that wishes to use a fund-of-fund structure may invest only in underlying mutual funds that are reporting issuers in the same jurisdictions as the alternative fund. The CSA are not at this time contemplating the inclusion of an exemption from paragraphs 2.5(2)(a) and (c) in NI 81-104 to permit alternative funds to invest in underlying funds that are not reporting issuers. We are of the view that fund-of-fund structures that involve investing in underlying investment funds that are not reporting issuers in the same jurisdictions as the alternative fund (e.g., underlying funds that are foreign investment funds or Canadian-based investment funds that are offered under prospectus exemptions) are more appropriately addressed through discretionary exemptive relief for each specific structure proposed to be offered.

Borrowing

The CSA are considering whether alternative funds should be permitted to borrow cash beyond the proposed 30% limit for non-redeemable investment funds in NI 81-102. If alternative funds are permitted to borrow a greater amount of cash, we are considering a limit that would not exceed 50% of NAV at the time of borrowing. We seek feedback on whether alternative funds that are structured as mutual funds and those that are structured as non-redeemable investment funds should have different borrowing restrictions in NI 81-104, in light of a mutual fund's need to fund regular redemptions.

Short Selling

The CSA are considering permitting alternative funds to sell securities short beyond the limits in NI 81-102 to provide these funds with more flexibility to use long/short strategies. We are considering limiting the aggregate market value of all securities of an issuer that may be sold short by an alternative fund to 10% of the NAV of the fund, calculated at the time of the short sale. As well, we are considering restricting the aggregate market value of all securities that may be sold short by an alternative fund to 40% of the NAV of the fund, calculated at the time of a short sale. These limits would be similar to those imposed in orders that granted exemptive relief to commodity pools to permit them to short sell. We are also considering including an exemption in NI 81-104 from the short selling conditions in subsections 2.6.1(2) and (3) of NI 81-102, which require funds to hold cash cover and prohibit the use of short sale proceeds to purchase securities other than securities that qualify as cash cover. We seek feedback on whether alternative funds should be permitted to short sell on this basis.

Use of Derivatives

We contemplate maintaining the current exemption from sections 2.8 and 2.11 of NI 81-102 in NI 81-104 to permit alternative funds to create leverage through using specified derivatives. This exemption would apply to both mutual funds and non-redeemable investment funds that are alternative funds.

Leveraged Daily Tracking Alternative Funds

In recent years, the CSA have observed offerings of investment funds (Leveraged Daily Tracking Alternative Funds) that seek to provide daily investment returns that are up to two times the daily positive or inverse return of an underlying interest (e.g., an index, commodity price, interest rate or exchange rate) that they track. When held for periods longer than one day, the return of these

funds may differ from the multiple or inverse multiple of the return of the relevant underlying interest over the longer period. These differences may be inconsistent with investor expectations.

The CSA are considering introducing a restriction on alternative funds from providing returns of more than two times the existing daily positive or inverse return of an underlying interest. We also seek feedback on issues relating to the marketing of Leveraged Daily Tracking Alternative Funds, as well as issues relating to the proficiency of individual dealing representatives who sell securities of Leveraged Daily Tracking Alternative Funds and dealer supervision of trades in securities of these funds.

Counterparty Credit Exposure

We are considering whether the exemption from subsections 2.7(4) and (5) of NI 81-102 (the Counterparty Exposure Exemption) in NI 81-104 should be repealed. The repeal of the Counterparty Exposure Exemption will restrict an alternative fund from having a mark-to-market exposure under its specified derivatives positions with any one counterparty other than an acceptable clearing corporation or a clearing corporation that settles transactions made on a futures exchange listed in Appendix A to NI 81-102 (the Clearing Corporation Exception), which exceeds, for a period of 30 days or more, 10% of the NAV of the alternative fund. The existing Clearing Corporation Exception in subsection 2.7(4) of NI 81-102 would permit alternative funds to continue to use investment strategies based on standardized futures.

Repealing the Counterparty Exposure Exemption would be intended to reduce the risk of exposure to a single counterparty, particularly in connection with illiquid over-the-counter (OTC) derivatives. Where an alternative fund's exposure to a counterparty constitutes a significant amount of the fund's NAV, we think that the risks associated with such exposure, particularly the credit risk of the counterparty, may materially alter the nature and risk profile of the fund.

We also note that large counterparty exposures through OTC derivatives may be inconsistent with the restrictions on investments in illiquid assets, as NI 81-104 does not exempt commodity pools from the restriction in section 2.4 of NI 81-102.

We seek feedback on the impact of this approach to existing commodity pools that may be relying on the Counterparty Exposure Exemption and whether the repeal of this exemption would appropriately mitigate the risks of counterparty exposure, or whether there are other ways to achieve the desired outcome.

Total Leverage Limit

Limit

The CSA are considering introducing a total leverage limit for alternative funds in NI 81-104. Alternative funds may employ leverage through a number of ways including borrowing, short selling and derivatives transactions; also, they may obtain leveraged exposure through investing in underlying funds that employ leverage. Although the provisions relating to each investment strategy may specify limits for each strategy, we are considering creating a single cap on the total

amount of leverage an alternative fund may create through leveraged investment strategies. The cap would include the leverage obtained through investing in underlying funds that employ leverage.

We are considering a total leverage limit for alternative funds of 3:1, based on the leverage calculation method currently specified in Form 41-101F2. The proposed 3:1 limit would be required to be respected by an alternative fund at all times, and not only at the time of entering into a transaction that creates leverage. We seek feedback on this proposed limit and whether the total leverage limit should be the same for mutual funds and non-redeemable investment funds, having regard to a mutual fund's need to fund regular redemptions.

Leverage Measurement Methods

Form 41-101F2 currently requires the maximum leverage an investment fund may use to be disclosed as a ratio of total long positions (including leveraged positions) plus total short positions divided by the net assets of the investment fund. This calculation has the benefit of presenting a single number that may be readily understood by retail investors. The drawback to this measure is that it may not fully express the nature of the leverage applicable to an alternative fund, as leverage created through different means may have different impact. For example, a leveraged position created through using standardized futures may be closed quickly by entering into an offsetting position, while leverage created through borrowing may be more difficult to reduce. Leverage through purchasing a call option differs from leverage through a long position in a forward contract since the former does not create future payment obligations. Other aspects of particular investment strategies may also complicate the calculation of leverage.

We are considering whether there are other methods of measuring leverage and invite feedback on this.

Other Investment Restrictions for Alternative Funds

Other than the investment restrictions discussed above, the CSA seek feedback on whether there are additional investment strategies that NI 81-104 should permit or restrict for alternative funds.

(iii) New Alternative Funds

Seed Capital and Organizational Costs

The CSA are considering the requirements applicable to the launch of new alternative funds. We are considering adopting a model for alternative funds that is substantially similar to Part 3 of NI 81-102. We are considering a model under which sections 3.1 to 3.3 of NI 81-102 would apply to the launch of a new alternative fund that is a mutual fund, except that:

- the minimum amount specified in subsection 3.1(2) of NI 81-102 that must be received by the fund before redemptions may be processed would be raised from \$500,000 to \$5,000,000 for an alternative fund; and
- the manager of the alternative fund (or the persons or companies specified in subsection 3.1(1) of NI 81-102, who, together with the manager of the alternative fund, are referred

to as “sponsors”) would be required to provide seed capital of \$150,000, instead of the \$50,000 in seed capital currently required for commodity pools under section 3.2 of NI 81-104.

Under the proposed model, sponsors that launch new alternative funds that are non-redeemable investment funds would only have to comply with proposed amended section 3.3 of NI 81-102 (see “Summary of Proposed Amendments – (iii) New Non-Redeemable Investment Funds”).

On-going Investment by Sponsors

Subsection 3.2(2) of NI 81-104 restricts a commodity pool from redeeming securities unless the securities issued to sponsors remain outstanding and the sponsors maintain a \$50,000 investment in the commodity pool.

In recent years, exemptive relief has been granted to permit sponsors of a commodity pool to withdraw their seed capital investment in the commodity pool, provided that:

- the commodity pool has received \$5,000,000 in subscriptions from investors other than the sponsors; and
- if the value of the commodity pool units subscribed to by investors other than the sponsors drops below \$5,000,000 for more than 30 consecutive days, the sponsors reinvest the seed capital amount and maintain that investment until the value of the commodity pool units subscribed to by investors other than the sponsors exceeds \$5,000,000.

We are considering whether to eliminate the restriction in subsection 3.2(2) of NI 81-104 and permit sponsors to withdraw their seed capital investment in alternative funds, subject to the same conditions for the exemptive relief described above. We are also seeking feedback on whether sponsors should be required to maintain an on-going investment in alternative funds.

(iv) Proficiency

Currently, Part 4 of NI 81-104 requires mutual fund restricted individuals (as defined in NI 81-104) who sell commodity pool securities to have qualifications in addition to those for selling mutual fund securities. In particular, a mutual fund restricted individual may only trade in a security of a commodity pool if that individual meets the additional proficiency standards set out in subsection 4.1(1) of NI 81-104. Part 4 also imposes proficiency requirements for dealer supervision of trades in commodity pool securities.

Given the unique features that will characterize alternative funds such as the increased flexibility to create leverage and engage in potentially more complex strategies, the CSA are considering whether further proficiency requirements should apply to all individual dealing representatives who sell alternative fund securities. For example, these individuals could be required to have additional experience or to have passed additional courses. We seek feedback on whether and what additional proficiency requirements could apply.

(v) Enhanced Disclosure and Transparency

A key element of the CSA's proposal for a more robust framework for alternative funds is to provide clarity for investors and the market by more effectively differentiating between alternative funds and investment funds subject only to NI 81-102. To achieve this, we are considering the introduction of specific requirements relating to the naming, prospectus disclosure, sales communications, and continuous disclosure of alternative funds, as set out below.

Naming Convention

We are considering requiring all alternative funds to have the words "Alternative Fund" in their name. This requirement would apply to existing commodity pools and other investment funds that wish to gain access to the NI 81-104 framework, subject to a transition period. We seek feedback on whether there are identifiers other than including "Alternative Fund" in the name of the alternative fund that would achieve the same purpose. In addition, we are considering whether alternative funds that list and trade their securities on an exchange should be required to use trading symbols or a suffix to the symbol that would more readily identify the fund as an alternative fund.

Prospectus Disclosure

The CSA anticipate that alternative funds would file a prospectus using Form 41-101F2. To further differentiate alternative funds from conventional investment funds, the CSA are considering introducing a disclosure item in Form 41-101F2 that would require the inclusion of a prescribed text box in bold text in a specified font size on the cover page of the prospectus of an alternative fund, as follows:

This fund is an alternative fund. This fund may use investment strategies or invest in assets in a different manner than other investment funds. The risks of investing in this fund may differ significantly from the risks associated with other investment funds.

These brief statements do not disclose all the risks and other significant aspects of investing in this fund. You should carefully read this prospectus, including the description of the principal risk factors before you decide to invest.

In addition, we are considering requiring an alternative fund to disclose in its prospectus under the "Investment Strategies" heading how its investment strategies differ from those of a conventional investment fund under NI 81-102.

Finally, we are also considering prohibiting an alternative fund from being offered in the same prospectus document with investment funds that are not alternative funds.

Sales Communications

The CSA are considering introducing specific sales communication disclosure requirements to NI 81-104 to assist investors and market participants in distinguishing alternative funds from other types of investment funds. Similar to the text box disclosure on the cover page of the

prospectus, we are considering a requirement for all sales communications for alternative funds to include a text box at the top of the first page of any sales communication or at the beginning of a sales communication that is not in printed form, with the following content:

This fund is an alternative fund. This fund may use investment strategies or invest in assets in a different manner than other investment funds. The risks of investing in this fund may differ significantly from the risks associated with other investment funds.

We are also considering prohibiting alternative funds from comparing themselves to other types of investment funds in their sales communications. The CSA have observed comparisons between commodity pools and mutual funds, for example, that do not present a fair and balanced picture of the respective benefits and risks associated with each type of fund.

Continuous Disclosure

As alternative funds will have more flexibility to generate leverage and engage in more complex strategies, the CSA are considering whether investors may benefit from more frequent financial reporting and tailored disclosure of how specific investment strategies have affected the returns of an alternative fund. Increased transparency could also help investors and their advisers monitor the risks of the funds they have chosen.

Monthly Website Disclosure

To supplement the existing quarterly information required under NI 81-106, we are considering requiring an alternative fund to disclose publicly on its or its fund manager's website, on a monthly basis (with an appropriate time lag for the manager to prepare the information), the largest monthly and annual NAV drawdowns of the alternative fund in the past five years, or since inception if the alternative fund has been in existence for less than five years.

We are also considering whether to require an alternative fund to disclose its maximum and average daily leverage amounts during the most recent 12 month period. These reports would be updated on a monthly basis (also with an appropriate time lag for the manager to update the information) and be posted on the fund's or its manager's website.

We seek feedback on whether the proposed monthly disclosure of NAV drawdown and leverage information for alternative funds will be useful to investors or the market generally. We also seek feedback on whether there is other information that could be provided regularly on an alternative fund's or its manager's website that would be meaningful for investors.

Semi-Annual and Annual Disclosure

In addition to the disclosure regarding borrowing under subsection 3.6(2) of NI 81-106, we are also considering amending the semi-annual and annual disclosure requirements in NI 81-106 to require tailored disclosure relating to an alternative fund's use of investment strategies that create leverage. For example, alternative funds could be required to disclose the maximum amount of leverage and the average amount of leverage used during the reporting period. The additional

disclosure could also contain a qualitative explanation of how leverage was employed during the reporting period.

(vi) Transition

The CSA recognize that existing commodity pools, as well as non-redeemable investment funds that currently use investment strategies that may not be permitted under the Proposed 81-102 Amendments, may seek to become alternative funds under the new definition. We think that existing investment funds should disclose to their investors and the market their intent to become alternative funds under NI 81-104. We seek feedback on the steps that existing investment funds should take for transitioning into the alternative funds framework provided in the revised NI 81-104.

We anticipate that existing investment funds that wish to transition into the alternative funds framework will be given sufficient time to take the necessary steps to make the transition. We anticipate that there would be a transition period proposed for comment, the design of which will depend on feedback received on the requirements for transition.

Securities Lending, Repurchases and Reverse Repurchases by Investment Funds

In connection with our proposal to apply the framework for securities lending, repurchases and reverse repurchases in NI 81-102 to non-redeemable investment funds, we also reviewed the existing requirements in NI 81-102 and NI 81-106 relating to securities lending, repurchases and reverse repurchases in light of the recent international focus on these activities to examine whether the existing requirements continue to keep pace with international standards.¹¹ While we think that the current operational requirements are generally comparable to existing standards in other international jurisdictions, as a result of this review, we are considering additional rules to enhance the transparency of the returns, costs and risks of securities lending, repurchases and reverse repurchases by investment funds, particularly where conflicts of interest may arise in connection with these activities.

Please refer to Annex C for specific questions for which we seek feedback to inform our consideration of amendments to the requirements relating to securities lending, repurchases and reverse repurchases by investment funds.

We will also continue to monitor global regulatory developments relating to securities lending, repurchases and reverse repurchases by investment funds.

Local Matters

Annex L is being published in any local jurisdiction that is making related changes to local securities laws, including local notices or other policy instruments in that jurisdiction. It also includes any additional information that is relevant to that jurisdiction only.

Unpublished Materials

¹¹ See note 5 above.

In developing the Proposed Provisions, we have not relied on any significant unpublished study, report or other written materials.

Request for Comments and Feedback

We are soliciting comment on the Proposed Amendments. As well, we are seeking feedback on the proposals being considered for an alternative fund regime under NI 81-104 and the proposals being considered in relation to securities lending, repurchases and reverse repurchases by investment funds. We have identified specific issues in Annexes A to C to this Notice.

We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period. All comments will be posted on the OSC website at www.osc.gov.on.ca.

Please submit your comments in writing on or before June 25, 2013. If you are not sending your comments by email, please send a CD containing the submissions (in Microsoft Word format).

Where to Send Your Comments

Address your submission to all of the CSA as follows:

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

Please send your comments only to the addresses below. Your comments will be forwarded to the other CSA members.

The Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8
Fax: 416-593-2318
Email: comments@osc.gov.on.ca

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
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C.P. 246, tour de la Bourse
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Questions

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Contents of Annexes

The text of the Proposed Provisions is contained in the following annexes to this Notice and is available on the websites of members of the CSA:

- Annex A: Specific Questions of the CSA relating to the Proposed 81-102 Amendments
- Annex B: Specific Questions of the CSA relating to the Alternative Funds Framework in NI 81-104
- Annex C: Specific Questions of the CSA relating to Securities Lending, Repurchases and Reverse Repurchases by Investment Funds
- Annex D: Summary of Public Comments on Phase 2 Proposals for the Modernization Project
- Annex E: Proposed Amendments to National Instrument 81-102 *Mutual Funds* and Companion Policy 81-102CP *Mutual Funds*
 - Schedule E-1: Proposed Amendments to National Instrument 81-102 *Mutual Funds*
 - Schedule E-2: Blackline Showing Proposed Amendments to National Instrument 81-102 *Mutual Funds*
 - Schedule E-3: Blackline Showing Proposed Changes to Companion Policy 81-102CP to National Instrument 81-102 *Mutual Funds*
- Annex F: Proposed Amendments to National Instrument 41-101 *General Prospectus Requirements*
- Annex G: Proposed Amendments to National Instrument 81-106 *Investment Fund Continuous Disclosure*
- Annex H: Proposed Amendments to National Instrument 81-107 *Independent Review Committee for Investment Funds* and Commentary in National Instrument 81-107 *Independent Review Committee for Investment Funds*
 - Schedule H-1: Proposed Amendments to National Instrument 81-107 *Independent Review Committee for Investment Funds*
 - Schedule H-2: Proposed Changes to Commentary in National Instrument 81-107

Independent Review Committee for Investment Funds

- Annex I: Proposed Amendments to Specified Instruments (Change in Name of National Instrument 81-102 *Mutual Funds*)
- Annex J: Proposed Changes to Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations*
- Annex K: Proposed Changes to National Policy 11-203 *Process For Exemptive Relief Applications In Multiple Jurisdictions*
- Annex L: Local Matters