Commission des valeurs mobilières du Québec October 15, 2002
800 Victoria Square
Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montréal, Québec
H4Z 1G3

Attention: Denise Brousseau, Secretary

Dear Sirs & Mesdames:

Re: Request for comments on Proposed Amendments of the Canadian Securities Administrators ("CSA") to:

- **National Instrument 81-102 ("NI 81-102") and Companion Policy 81-102CP Mutual Funds**
- **National Instrument 81-101 ("NI 81-101") Mutual Fund Prospectus Disclosure**
- **Form 81-101F1 - Contents of Simplified Prospectus ("81-101F1")**
- **Form 81-101F2 - Contents of Annual Information Form**

(collectively referred to as the "Proposals")

We have reviewed the CSA's Proposals and appreciate the opportunity to provide you with our comments. The Proposals indicate in general, a positive enhancement to the existing Fund of Funds regulations and we agree with the fundamental principle of the proposed approach. The Proposals represent changes that TD Asset Management Inc. ("TDAM") has been working toward and we sincerely commend the outcome of the significant effort to update the regulatory framework for fund of funds structures. There are however, certain elements of the Proposals that give rise to significant concerns:

1. The condition that a bottom fund, as defined in the Proposals ("Bottom Fund") must be qualified in all the same jurisdictions as the top fund, as defined in the Proposals ("Top Fund").

2. The requirement that a Bottom Fund be qualified under NI 81-101 and NI 81-102 and the resulting prohibition against Top Funds investing in Exchange-Traded Funds ("ETFs").

3. The removal of a fund's ability to invest up to 10% of its assets in other funds unless it falls under the definition of a Top Fund.

4. The prohibition against the charging of trailer fees in arm's length arrangements.

5. The prohibition against multiple layering, except with regard to RSP clone funds.

By way of background, TDAM is one of Canada's largest managers, advisers and distributors of investment products with approximately $117 billion in assets under management. TDAM provides mutual funds, pooled funds, segregated account management, and investment advisory services to retail individuals, pension funds, corporations, endowments, foundations and high net worth individuals. The TD Mutual Funds division of TDAM is the fifth largest mutual fund manager in Canada managing approximately $28 billion in retail mutual fund assets on behalf of more than 1.4 million investors. The TD Quantitative Capital division manages approximately $33 billion in mutual and pooled fund assets, primarily in index and quantitative portfolios on behalf of institutional investors.

Specific questions were raised by the CSA on the Proposals and we are happy to outline our comments below:

Response to Specific Questions of the CSA

1. ***Qualification of the Bottom Fund in the local jurisdiction***.

We do not agree that a Bottom Fund should be qualified for distribution in all the same jurisdictions as the Top Fund (the "Qualification Requirement").

A mutual fund is but one of many potential investments that a portfolio adviser may make with the assets of a Top Fund. As the Qualification Requirement does not apply to other types of investment products in the same way, we believe it should not apply to mutual funds. For example, a mutual fund is permitted to hold securities of an issuer, that is not a "reporting issuer" or equivalent in the jurisdiction in which the fund is available for distribution. These securities are nonetheless subject to regulation primarily in their home jurisdiction. Failing a national regulator, we believe reliance on the individual members of the CSA for regulating funds available for sale in their respective jurisdictions is reasonable and therefore believe the restriction of limiting a Top Fund's investments in other mutual funds to those meeting the Qualification Requirement, is unnecessary.

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

NI 81-101 governs the prospectus disclosure requirements for mutual funds, other than labour-sponsored venture capital corporation funds, commodity pools, funds listed and posted for trading on a stock exchange or funds quoted on an over-the-counter market. TDAM believes that the prospectus disclosure requirements of Bottom Funds should not dictate the type of investment a Top Fund is permitted to make. We believe that the underlying investment and how it is managed should be the determining factor on whether an investment is permitted. As such, we are of the view that the requirement that a Bottom Fund be subject to NI 81-101 is unnecessary.

While mutual funds to which NI 81-101 and 81-102 apply should be an option, in our view a Top Fund should not be prohibited from investing in other types of securities or funds, such as non-prospectus pooled funds, without a limit. For example, using non-prospectus pooled funds as Bottom Funds is an attractive investment option for a Top Fund, as such investments tend to have management expense ratios lower than comparable funds to which NI 81-101 apply, which may lead to reduced overall management fees to the investor. TDAM also believes that commodity pools would be welcomed products to many investors including those less sophisticated investors who may not have otherwise had access to such investment vehicles.

TDAM's view is that a Top Fund should be permitted to invest in funds that conform to the principles of NI-81-102 with regard to investment restrictions and practices, including redemption qualities. Such a requirement is adequate to ensure the required liquidity and security of the investment. The end result of this is the protection of the investor, which is a goal shared by TDAM, the CSA and the Proposals.

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

TDAM strongly disagrees with removing the ability of a fund to invest up to 10% of its assets into other funds unless the fund falls under the definition of a Top Fund. We find this requirement to be a significant deterrent to allowing the portfolio adviser the flexibility that is needed to effectively manage a portfolio.

We see no clear justification for considering an investment of up to 10% of a fund's assets in other mutual funds to be different from any other provision for other securities and investment products. This strategy is often used to gain the benefits of lower execution costs and greater diversification.

As elaborated upon below under the heading "General Comments – Index Participation Units ("IPUs") and Exchange-Traded Funds ("ETFs")", we also see the proposal, removing the 10% provision, to be a barrier to mutual funds investing in IPUs and ETFs, which we consider an essential investment vehicle for most funds. Even if an investment in an IPU or an ETF were meant to represent a temporary position in the fund, the fund would only be able to proceed with the investment if it is a Top Fund. In addition, to be a Top Fund, that same fund would have to preclude itself from being a Bottom Fund. This may not always be desirable.

Being a Top Fund may not necessarily fall within the broader strategy of the portfolio manager. TDAM is of the firm view that a fund manager should always have the flexibility to manage his / her portfolios in any manner which is consistent with applicable regulatory requirements and the fundamental investment objectives of the fund. This flexibility should include the ability to make investments in other mutual funds up to a pre-disclosed stipulated limit without the requirement to disclose a fund of funds structure as a primary investment strategy in the investment objectives of the fund. Also, we are of the view that under such circumstances this type of disclosure could

confuse the investor into believing that the fund is *primarily* a fund of funds, when actually it may just be taking a position as a short-term strategy. Rather than prohibit the investment, disclosure explaining that these types of positions are contemplated, should be sufficient to inform the investor.

We agree that in cases where a fund holds or intends to hold more than 10% of its assets in another fund, it is reasonable that the fund be required to disclose a fund of funds structure in its investment objective and in effect declare itself a Top Fund. Also, as a safeguard against the abuse of the fund of fund rules ultimately adopted, we suggest that in cases where a fund's portfolio primarily consists of other funds (even where the holdings in each respective fund represent less than 10% of the fund portfolio's assets) that such a fund should be required to declare itself to be a Top Fund.

We would like to draw your attention to subsection (3) of the instructions of Item 6 of 81-101F1 Part B. It outlines a requirement to include an investment strategy, which is an essential aspect of the mutual fund, in the objectives of the fund. The Proposals require a fund to include a fund of funds structure in its investment objective if such a fund intends to invest any amount in another mutual fund. If such an investment was not an essential aspect of the mutual fund, i.e. a minor strategy, the Proposals in effect require the mutual fund to include a minor investment strategy in the investment objectives of a fund. We see an investment of less that 10% in a mutual fund as a minor strategy and definitely not an essential aspect of a fund and as such, there should be no requirement to have it included in the investment objective of the fund. This proposal appears inconsistent with the subsection stated above and we recommend that the CSA review this contradiction.

4. ***Control of the Bottom Fund by the Top Fund.***

TDAM supports the removal of the concentration and control restrictions and would like to recommend that no limit be set on the percentage of net assets that may be invested in one Bottom Fund. Likewise, we believe there should be no limit placed on the percentage of voting or equity securities of a Bottom Fund that a Top Fund can hold. We believe that this flexibility may produce better returns that ultimately will benefit the unitholder.

With regard to the risk of massive redemption, we are of the view that this has always been a potential risk where an individual or institutional investor has held a large investment in a fund and is therefore not unique to a fund of funds structure. We do not see that there is any greater risk in a fund of funds structure as compared to any other mutual fund. Actually, our experience indicates less transactional volatility in our Managed Assets Program Portfolios.

TDAM believes that a Top Fund that invests in a Bottom Fund is no different from any other large investor investing in that Bottom Fund and this obviates the need for imposing a requirement to make 'large redemption risk' disclosure. Furthermore, the proposed disclosure would have to be stated in almost every simplified prospectus so as not to preclude funds from being a Bottom Fund. Typically the result of this is that the

disclosure would become overused and as such, would lose its intended value. Further, the annual information form requires disclosure identifying investors that hold more than 10% of the assets of the fund and this document should be adequate to ensure investors are properly informed of such large investors.

5. ***Prohibition against Sales and Redemption charges.***

TDAM agrees that it is appropriate to prohibit Top Funds from paying sales charges in connection with a purchase of securities of a Bottom Fund and likewise, redemption charges from being made for withdrawals by a Top Fund where the respective funds are related. An obvious conflict of interest may arise from such arrangements, which may not be viewed as a decision to invest in another mutual fund solely because it is in the interest of the unitholders. However, we do not believe that there is a conflict of interest in permitting a manager to receive a trailer fee from allocating a portion of a Top Fund's assets to an arm's length manager's fund for the following reasons:

- Trailer fees are tied to assets as are management fees (i.e., they are maximized by growing the size of the fund). In both instances the manager only receives such payment if the fund attracts assets. If there are no assets, there will be no trailer fees.
- In the context of unrelated funds the trailer fees represent an efficient way to earn revenue to pay for distribution costs. If managers are unable to earn revenue to pay for distribution costs, it is unlikely that unrelated funds will be used in their program, thereby reducing investor choice.

The end result is the total management expense ratio on a look through basis. Managers would in the end obtain either the trailer fee or the management fee, both of which are based on assets under management.

6. ***Voting rights of Top Fund securityholders in Bottom Fund matters.***

TDAM supports the proposal to remove the requirement of passing through Bottom Fund voting rights to Top Fund unitholders. The passing through of voting rights is both cumbersome and ineffective. It has been our experience that unitholders are not active in exercising their voting rights and the participation of unitholders at meetings is extremely low. This process also has a huge cost burden that adds little value.

7. ***Active Management and Prospectus Disclosure***

We do not consider it problematic if each underlying investment in a Bottom Fund is not shown in the simplified prospectus of the Top Fund, other than in the "Top Ten Holdings" section. It is of our view that in most cases the "Top Ten" would represent 90% or more of the holdings for a fund of funds structure. However, where investing in a particular fund (such as a RSP clone fund) is required to meet the investment objective of a Top Fund, it is reasonable to require a disclosure in that regard.

The CSA have asked whether unitholders should be notified when a Top Fund replaces its holdings in one "important" Bottom Fund, with another one. It is our position that such a change should be left to the discretion of the manager to determine whether a change in a Bottom Fund meets the test of a "significant change" as outlined in NI 81-102. If it were determined to meet this test, it would then be necessary for the manager to meet the requirements under section 5.10 of NI 81-102 to file a material change report, press release and prospectus amendment with the CSA. We are of the view that this existing process is adequate and that there is no need for further regulation in this regard.

General Comments:

a. **Index Participation Units ("IPUs) and Exchange-Traded Funds ("ETFs")** – We have a number of comments on this item which are set out as follows:

I. The Proposals differentiate between IPUs and ETFs. It is not clear why the CSA have differentiated between these two names, as an IPU is a form of ETF and the Canadian marketplace does not seem to differentiate between the two. In Canada, all ETFs track a widely quoted index, with the exception of 2 Bond ETFs sponsored by BGI, which track a specific Government of Canada Bond. The regulatory relief and manner in which these products trade in the market are essentially the same. If the CSA view an ETF differently than an IPU, we would encourage the CSA to define the term ETF in the National Instrument.

II. As a sponsor of 4 ETFs/IPUs and of mutual funds that make extensive use of ETFs/IPUs for investment of excess cash balances, we are concerned that the proposal:

(i) will impose unwarranted restrictions on the ability of a mutual fund to manage its assets by making use of ETFs/IPUs which are valuable investment tools to portfolio managers;

(ii) will create unfair barriers to the use of ETFs/IPUs compared to other competing products such as exchange-traded index futures and other "specified derivatives", in circumstances where they would otherwise be alternative investment tools; and

(iii) will result in an unlevel playing field between ETFs/IPUs and index and other mutual funds, which is not justified by differences in applicable regulatory treatment, product-related risks or disclosure requirements.

III. Proposed Section 2.5(1)(a) would require a mutual fund that wishes to purchase ETFs/IPUs, for any reason, to declare itself a Top Fund and adopt investment objectives, which includes such an investment. We believe this requirement is unnecessarily onerous for the following reasons:

i. Most typically, a mutual fund will use ETFs/IPUs due to the relatively low cost, and ease of trading for purposes such as:

- cash management or "equitization" for new funds as a temporary exposure to a sector or to an index, to avoid market impact costs when trying to acquire a large position in a particular security, or in lieu of cash for managing large redemptions;
- the temporary exposure to a particular sector;
- the reposition of portfolios by using them as investments for short-term cash; and
- trading baskets of securities instead of multiple trades.

In these instances, ETFs/IPUs are held for a short period and represent a small portion of a fund's overall portfolio that benefits investors by either reducing portfolio costs or increasing portfolio returns. In this way their use is not the objective of the fund, but rather a cost-effective strategy to accomplish the fund's true investment objective. TDAM is unclear why a strategy to accomplish a fund's objective in this way must be "incorporated into" the funds objective.

TDAM does agree however, that where the fund's objective is to invest in other ETFs/IPUs for longer periods and these investments represent a substantial portion of a fund's overall portfolio, the requirements of Proposed Section 2.5(1)(a) may be appropriate.

ii. By forcing a fund, which otherwise may wish to use ETFs/IPUs for the purposes noted above, to declare itself a Top Fund, the CSA are forcing a fund to chose between benefiting from portfolio management techniques available to other funds, and being a Bottom Fund. It is unclear to TDAM why a fund must make such a choice. Participating as a Bottom Fund in a fund on funds program should not be to the detriment of unitholder returns. However, this is a by-product of the current proposal.

iii. The proposed rules will effectively act as a prohibition of funds using ETFs/IPUs, resulting in an "unlevel" playing field, as there are index and other products, such as exchange-traded index futures and other "specified derivatives" that will not be affected equally by these proposals. The result serves to limit the growth of the ETF/IPU market in Canada, ultimately limiting investor choice. Further, with mutual funds effectively unable to use ETFs/IPUs, the market liquidity for such products will be negatively impacted, possibly affecting bid-ask spreads and producing higher costs to investors who are able to use ETFs/IPUs

TDAM strongly believes that mutual funds should be permitted to invest in ETFs/IPUs subject to the current control and concentration restrictions and further, that a fund should not have to declare itself a Top Fund in order to invest a small percentage of its assets in ETFs/IPUs. We are not aware of any problems with the status quo. Several funds, not otherwise permitted to invest in ETF/IPUs as a result

of self-dealing restrictions in the *Securities Act* (Ontario), have received exemptions permitting them to purchase various ETF products. This strongly suggests that investments in ETFs/IPUs are not against the public interest and are otherwise consistent with securities regulation generally.

We urge the CSA to reconsider the proposed amendment, as it relates to ETFs/IPUs. We have demonstrated it will only serve to discourage Canadian mutual funds from engaging in the numerous beneficial portfolio management opportunities that ETFs/IPUs offer and negatively impact the growth of these investment products in Canada.

b. **Introducing New Fees and Fees paid Directly – Securityholder approval** – TDAM is of the view that this proposal needs further consideration as it is not clear what types of fees are intended to be caught under proposed subsection 5.1(a) NI 81-102.

We believe there is a difference between account fees that the manager may not even be aware of and fees charged by the fund or the manager directly. The proposal does not appear to make this distinction and recommends that securityholder approval be required prior to introducing or increasing all fees charged directly to a fund's securityholders in connection with holding of securities of the mutual fund. It is our view that this broad wording would include fees charged by distributors beyond the control of the manager, for such things as RSP Accounts and the like.

As you may be aware, a manager may disclose in the prospectus that the management fee may be "up to" a particular limit, but may currently charge a fee that is under that limit. If the manager chooses to increase the fee up to the stated limit, this would cause a change in the fee that results in an increase in charges to the unitholder. The proposed amendment appears to indicate that under such circumstances approval would be required. We believe that further approval for such an increase should not be required, as the maximum fee would have already been disclosed in the prospectus to the unitholders. We recommend that the Proposals be adjusted to make clear such changes would not require unitholder approval, as is the case under the current regulations.

There are numerous other potential instances where, under the proposed amendment, a unitholder vote for increased fees would prove unnecessary, a nuisance to unitholders, inappropriate and an unwarranted use of money. TDAM believes there needs to be specific direction with regard to what type of fees and expenses the CSA contemplate will be subject to unitholder approval. We therefore recommend that this proposal be revisited and revised to encompass the intention of the CSA, which we believe is to protect the unitholders from the arbitrary increase of management fees.

c. **Multiple Layering** - TDAM does not agree with the proposal to limit multiple layering and feels that a manager should be permitted to proceed with multiple layering and not just for investments in an RSP clone fund.

We see multiple layering comparable to an investment in a conglomerate that holds underlying assets. Such underlying assets also hold further underlying assets. We do not feel that investors are concerned at which level the investment decisions are being made. It is our position that the real investor concern, if any, relates to the maintenance of the portfolio balance in the Top Fund and the relevant disclosures in the simplified prospectus of the Top Fund which outlines how the Bottom Funds will be managed.

Prohibition on multiple layering should not be necessary as long as the interests of investors are being protected. We are of the view that investors benefit from these multi-tiered investments, and as long as the existing safeguards in NI 81-102 apply, there should be no need to exclude such structures from a manager's portfolio. We understand that the Ontario Securities Commission has granted relief for such structures in the past, which provides a clear basis for arguing that these structures are not against the public interest. We see no basis for a complete eradication of multi-tiered structures at this time (with the exception of RSP clone funds) for Top Funds.

d. **Fee Rebates and Trailer Fees** – The proposal that all fees and expenses rebated by the Bottom Fund be paid to the Top Fund does not appear to address the issue. As discussed under the heading "Prohibition against Sales and Redemption Charges" above the objective is to ensure that the decision to invest in another mutual fund is made solely because it is in the interest of the security holders of the Top Fund.

It is expected that Mutual Fund Managers will invest in products that, not only perform well, but also those that are well priced. This strategy is considered to be in the interest of investors. There will always be a competitive market on the pricing of a fund and as such, this proposal will not accomplish its intended result.

All mutual funds, including both Top and Bottom Funds have distribution costs to be supported. By passing the trailer fee from the Bottom Fund to the level of the Top Fund, the Bottom Fund will essentially be required to increase its fee to support distribution costs already structured. There will be less clarity of the duplication of fees and the proposed amendments will be ineffective.

Further, from our experience and understanding, these rebates and fees are currently permitted and disclosed to investors in the prospectus without objection or complaint to date. If there is an issue with the level of disclosure provided, then perhaps revision to the disclosure should be considered rather than the abolition of the practice.

As a result of the foregoing, TDAM is of the view that fee rebates and trailer fees rebated by the Bottom Fund should not be passed to the Top Fund.

e. **Availability of securityholder list – Notice requirement for Change of Control Manager-**

TDAM agrees that where a mutual fund manager is the target of a hostile takeover, the security holder list should be provided to the offeror to enable the offeror to send the 60 day notice required by clause 5.8 (1) (a) of NI 81-102. However, we believe that the making available of the security list should only occur where there has been a **successful** offer. By this we mean the takeover must be approved, by shareholders of the manager subject to the hostile takeover, before the security list is turned over. To emphasize, the takeover must be one that **will** materialize and not one that **may** materialize. Otherwise it would be an unwarranted compromise of the unitholders' privacy.

We therefore recommend that the proposal be amended by deleting the words "an offer" and substituting the words " a successful offer".

Conclusion

In conclusion, TDAM is very supportive of many of the Proposals and feel that the changes will offer significant advancement for mutual funds, mutual fund managers and investors.

While we are of the opinion that certain proposals require further consideration, we are very pleased with the general principle of the proposals and would be happy to provide any further explanations or submissions regarding the matters raised above. We would also be very willing to make ourselves available for any further dialogue relating to the proposal.

Yours truly,

Robert F. MacLellan