Canadian Life
and Health Insurance
Association Inc.

Association canadienne
des compagnies d'assurances
de personnes inc.

October 15, 2002

Ms. Denise Brosseau
Secretary
Commission des valeurs mobilières du Québec
800 Victoria Square, Stock Exchange Tower
P.O. Box 246
22nd Floor
Montréal, Québec
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Dear Ms. Brosseau:

Re: Notice of Proposed Amendments to National Instrument 81-102 and Companion Policy 81-102CP Mutual Funds and Related Instruments (the Amendments)

The Canadian Life and Health Insurance Association (CLHIA), representing the vast majority of individual variable insurance contract issuers in Canada, is pleased to comment on the Amendments.

The Fund-of-Fund structure has been an integral component of the insurance industry's individual segregated fund market, and has added greater choice to consumers to meet their investment needs.

We strongly support the "Fundamental Principle of Proposed Approach" that a mutual fund is one of many potential investments a portfolio adviser may select to achieve its stated objective in managing a fund. This same principle obviously applies equally to segregated funds. In other words, a fund should be able to realize its objectives by either direct investments or, indirectly, through the purchase of fund units.

We are pleased to offer you our comments, in response to the Amendments, and some other related issues:

1. **Permitting a top fund to only invest in underlying funds subject to the National Instruments**.

Currently, the majority of fund-of-fund structures in the segregated fund market involve either mutual funds or other segregated funds as underlying funds. However, there are a number of pooled funds, which are managed mostly for the benefit of large pension funds, which are utilized as underlying funds. These funds have quantitative investment limitations under pension legislation to ensure prudence and diversification and should be treated as authorized underlying funds for mutual funds.

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We understand that one of the main principles of mutual fund regulation is the requirement that mutual funds provide redemption upon demand. Accordingly, we propose that underlying funds must provide redemption upon demand in order to qualify as underlying funds, and those underlying funds that cannot provide for redemption upon demand would qualify under the illiquid asset category and be subject to a quantitative limit.

Similarly, if your stated objective is to permit funds to realize their objectives by either directly purchasing securities or indirectly by the purchase of underlying mutual funds, we see no valid reason for excluding exchange-traded funds, which trade on the exchanges and provide redemption upon demand, but are not subject to the National Instruments.

2. **No sales charges, redemption fees or other fees are payable by the top fund in relation to its purchase/sale of securities of the underlying fund, and no fees or charges are paid to anyone in connection with purchase, holding or redemption of securities of underlying fund. No duplication of management fees between the top and underlying funds.**

If the top and underlying funds are related, we agree that there should be no duplication of management fees or sales charges. However, if the funds are unrelated, we suggest that market constraints and disclosure will ensure that the fees and expenses payable by consumers will be competitive, notwithstanding that there may be similar fees and expenses payable at both the top and underlying fund levels. Whatever economic relationship exists between the top and underlying funds should result in fees and expenses charged to the unitholder of the top fund that are transparent and reasonable. Market forces will ensure that those fees and expenses are competitive with investments in single funds.

3. **All fees and expenses rebated by underlying fund are made directly to top fund**.

With respect to segregated funds, all fees and expenses rebated by underlying funds go to the life company as the owner of the segregated fund assets, on the understanding that the fees and expenses of the top fund are clearly disclosed to contractholders.

4. **The top fund is exempt from the concentration and control restrictions for investment in underlying fund.**

Again, as stated above, if the underlying fund does not provide for redemption upon demand, then such an underlying fund should be subject to the quantitative limit for illiquid assets. Otherwise, if an underlying fund did provide for redemption upon demand, then the top fund should not be subject to the concentration and control restrictions with respect to its investment in such underlying fund.

In addition, we do not see the need for funds to declare themselves as either a top or underlying fund in their prospectus in order to gain that status. The primary goal of your rules should be to ensure that funds can achieve their stated objectives by investing either directly in securities or indirectly through units of underlying funds, and that goal should not preclude an individual fund from being both a top and underlying fund. If a top fund wishes to purchase units of underlying funds, then such intention should be clearly stated in its prospectus.

5. **Top fund must disclose in prospectus that**

    (a) it may purchase underlying mutual funds
    (b) percentage of net assets to purchase underlying funds
    (c) the selection criteria used.

If a fund's sole strategy is to invest in underlying funds, then this should be the fund's investment objective. Similarly, if a fund has a distinct investment objective, and wishes to employ the investment in underlying funds as a strategy to achieve that objective, then in the latter case this should be treated as an investment strategy and should not be subject to unitholder vote in order to change the strategy. If a fund is not changing its fundamental investment objective, it should not be required to treat a change to utilizing underlying funds in lieu of direct investments to achieve that objective as a fundamental change.

We do not understand why a fund should be required to state the exact percentage of net assets used to purchase underlying fund units, as long as they be permitted to disclose a range which would permit the fund manager to utilize such investments to achieve their stated objective.

We do not feel that the third requirement is a necessary or useful disclosure – the essential disclosure is the fundamental investment objective, and the policy or strategy should reveal how the fund will achieve that objective, whether by direct investment or underlying funds. If prospectuses do not need to disclose the selection criteria for individual securities, we so no reason why this should be required of the selection of underlying funds.

6. **Underlying funds must include disclosure of the effect of large scale redemptions if a top fund holds more than 10% of the underlying fund**.

We question whether this disclosure will provide useful information to a prospective purchaser to assist in making an informed decision regarding the purchase. We assume this is one of the risks that a fund manager must deal with and set up contingency plans for in the event it should occur.

7. **The top fund will not be able to vote its interest in the underlying fund if both funds are under common management.**

As was stated in the May 7, 1999 *A Comparative Study of Individual Variable Insurance Contracts (Segregated Funds) and Mutual Funds*, individual variable insurance contracts (under which segregated funds are investment options) do not provide contractholders with ownership or voting rights in the segregated funds. As such, it is the life company that has the voting rights on behalf of the segregated fund in any underlying fund. It was this fact that was the basis for the fundamental change rule for segregated fund contractholders, which provides certain transfer and exit rights in lieu of voting rights. If a life company were to vote for a fee increase in an underlying fund, it would either have to absorb that increase at the segregated fund level or else offer fundamental change rights to contractholders if it passes the increase on to such contractholders.

8. **Multi-layering, ie. more than one top fund and one underlying fund, will not be permitted, unless the underlying fund is an 'RSP clone fund'**.

We would suggest that the concerns re where investment decisions are made, what assets held by the top fund are direct holdings as opposed to underlying funds and full disclosure of fees and expenses paid by investors could easily be handled by disclosure, and should not be a basis for denying greater choice of investment options to consumers.

We believe that these proposals should be discussed in detail with representatives of both the insurance and mutual fund industries to ensure that consumers receive the maximum flexibility to achieve their investment goals, that fund companies and issuers have the utmost flexibility to deliver choice to consumers and that the rules governing these products provide harmonization of result, recognizing the different nature of both the investment products sold by each industry, as well as the legal structures for the entities delivering these products.

We would be pleased to discuss any of our responses with you in greater detail.

Yours truly,

Sheldon M. Meyers
Assistant General Counsel