Fidelity Investments

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Dear Sirs/Mesdames:

Re: Notice of Proposed Amendments to National Instrument 81-102 and Companion Policy 81-102CP Mutual Funds and to National Instrument 81-101 Mutual Fund Prospectus Disclosure and Form 81-101F1 Contents of Simplified Prospectus and Form 81-101F2 Contents of Annual Information Form

This letter is in response to your request for comments on the proposed amendments to National Instruments 81-101 and 81-102 (the "Amendments"), which would establish a new framework for regulating fund-of-fund arrangements. The following are the comments of Fidelity Investments Canada Limited ("Fidelity Canada").

<u>Fidelity's Fund-of-Fund Experience</u>

Fidelity Canada is one of the largest managers of mutual funds in Canada, with more than $27 billion under management in Canada. We are part of a group of companies known as Fidelity Investments, the head office of which is located in Boston, Massachusetts.

Fidelity Investments specializes in investment management for individuals, and has operations in a number of different countries located around the world. The Fidelity Investments group manages a total of more than $925 billion in more than 275 mutual fund portfolios and other institutional accounts around the world. We have significant experience in actively managing fund-of-fund portfolios in the U.S. market, where the rules permit such arrangements.

General Comments

We applaud the initiative taken by the CSA in proposing a regulatory regime that will make actively managed fund-of-funds possible. This accommodation will provide significant benefits to investors as it has in other regulatory jurisdictions.

In our submission, however, there are several areas of concern that must be addressed before the Amendments will represent a solution that is in the best interests of investors. We agree that regulation in this area should be based on the fundamental principle set out by the CSA: "that a mutual fund is one of many possible investments that a portfolio advisor may make with the assets of a Top Fund" (the "Fundamental Principle"). We are concerned that many of the Amendments are inconsistent with the Fundamental Principle.

With the dual protection of rules designed to eliminate the potential conflicts or abuses inherent in fund-of-fund arrangements and a fund manager's fiduciary obligations, the combination of which is sufficient protection, investors would be better served if mutual fund managers have more discretion in selecting pooled investments. In other words, if pooled investments were treated like equity or fixed income investments, investors would benefit from increased access to diverse investment styles, diversification of securities, and lower execution costs. Similarly, provided that conflict of interest concerns are addressed, mutual fund managers should enjoy flexibility in structuring products for investors.

These submissions are reflected in our responses to the questions posed by the CSA and in our specific submissions about other provisions found in the Amendments.

Specific Responses

Question

1. Qualification of the bottom fund in the local jurisdiction

Proposed section 2.5(1)(c) of NI 81-102 requires that the bottom fund or the RSP clone fund in which the top fund invests be qualified for distribution under a simplified prospectus in the local jurisdictions in which the top fund is qualified for distribution. This requirement already exists in NI 81-102. The purpose of this requirement is to ensure that the local jurisdiction has control over both the top and the bottom fund, both funds being reporting issuers in the local jurisdiction.

The CSA invite comments on whether this practice should continue or whether a top fund should be able to invest in a bottom fund as long as the bottom fund is qualified in any of the local jurisdictions in Canada. If so, what parameters should be developed to ensure that local jurisdiction keeps its jurisdiction over the bottom fund in the event of wrongdoing by the bottom fund or the person that manages it?

Response

Limiting the jurisdiction of the Bottom Fund's qualification is inconsistent with the fundamental principal that the securities of the Bottom Fund are viewed as one of many potential investments. Funds are currently able to invest in securities that are qualified in other Canadian and in foreign jurisdictions. In our submission, investments in mutual funds need not be treated substantially differently than other investments. The fund's manager is under an obligation to ensure that the investments are prudent and in the best interests of fund investors. This obligation applies equally to investments in Bottom Funds. Canadian mutual funds are free to invest in securities of foreign issuers, such as Enron or Tyco, even though Canadian securities regulators have no jurisdiction over those issuers. We submit that there is no policy justification for treating investments in mutual funds differently.

Question

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

The definition of "bottom fund" in proposed section 1.1 of NI 81-102 requires that the bottom fund be a mutual fund to which both NI 81-102 and NI 81-101 apply, and that it not be a top fund. The purpose of this requirement is to ensure that a top fund's investments are appropriately diversified and that it is sufficiently liquid to meet redemption demands. This is similar to the requirement currently found in section 2.5 of NI 81-102.

The CSA invite comments on whether the investment options for a top fund should be expanded to include other types of mutual funds and investment funds such as pooled funds or commodity pools. If so, should there be any limit to the amount a top fund could invest in these other funds? Should they be treated as if they were illiquid assets to which section 2.4 of NI 81-102 applied?

Response

We submit that the Amendments should be based on the principle that a mutual fund is one of many potential investments that a portfolio adviser may make with the assets of a top fund. Consistent with that principle, Top Funds should be free to invest in other types of pools without limit.

In order to address concerns about diversification, the CSA should allow Top Funds to invest in pools that are managed in accordance with 81-102 investment restrictions. In order to enforce such a rule, the CSA might require that the pool must adopt 81-102 style investment restrictions. Such a pool could be deemed "eligible". The CSA enjoys jurisdiction over the advisors of eligible pools by virtue of the advisor's registration. Where a Bottom Fund advisor is not registered in a jurisdiction where the Top Fund is being offered, the CSA could require that Top Fund managers assumes responsibility for the breach by the Bottom Fund manager of the prescribed standard of care.

Any concerns related to the liquidity of an eligible pool are addressed by Part 2.4 of 81-102. If the securities of a pool cannot "… be readily disposed of …", then a Top Fund is subject to the 10% liquidity limit. If the CSA is concerned that managers may not apply the definition properly to certain types of pooled securities, it should include a discussion of the interpretation in the Companion Policy.

Given that concerns about diversification and liquidity can be adequately addressed, a limit for pools that are managed to comply with relevant 81-102 restrictions is not necessary or desirable. The only relevant distinguishing feature between these types of pools and an 81-101 fund should be that the former does not have a prospectus. There is no limit on mutual funds and no reason to impose one on eligible non-81-101 pools simply because the securities of such pools are not issued pursuant to a prospectus.

We also submit that the CSA should consider allowing Top Funds to invest in the securities of mutual funds offered in foreign jurisdictions pursuant to prospectuses – especially in the United States. The U.S. has what may be the most heavily regulated securities market in the world, SEC policies are largely consistent with CSA policies, and investors in Top Funds would be able to enjoy the investment exposure of U.S. based portfolios while retaining the protection of Canadian regulation. This type of investment exposure could be gained by way of direct investment in U.S. securities or by the use of derivatives, and we see no legitimate policy reason to preclude obtaining the same exposure through mutual funds.

Proposed New Regulatory Approach

In order to remain faithful to the Fundamental Principle and to address the policy concerns underpinning questions 1 and 2, we urge the CSA to consider the following regulatory approach.

If a pool is not a reporting issuer in a Canadian local jurisdiction, it should be deemed an "eligible pool", and thereby eligible as an investment by mutual funds, if the following two conditions are met:

1. The Bottom Fund manager is registered in either:

    (a) a Canadian local jurisdiction in which the Top Fund is qualified pursuant to NI 81-101; or

    (b) an "approved jurisdiction" and the Top Fund manager assumes responsibility for breach of the prescribed standard of care by Bottom Fund manager; and

2. The Bottom Fund is either

    (a) subject to regulation in an "approved jurisdiction" which impose diversification and liquidity requirements; or

    (b) voluntarily adopts the investment restrictions of NI 81-102.

Each Top Fund jurisdiction would designate jurisdictions recognized to have comprehensive regulatory regimes protecting investors, whether Canadian or foreign, to be "approved jurisdictions".

Under this proposed approach, the local regulator retains exclusive jurisdiction of the relationship between Top Fund manager and investor at the Top Fund level. Rules relating to disclosure, fund-of-fund protections, sales practices, and the conduct of the Top Fund manager protect the Top Fund investor and are administered by the local Canadian jurisdiction. The "approved jurisdiction" regulates the Bottom Fund in terms of disclosure, the sale of Bottom Fund securities, Bottom Fund investment restrictions and operations (as applicable), and the conduct of the Bottom Fund manager.

We submit that this approach is consistent with the Fundamental Principle and that it adequately addresses the underlying policy concern that investments in pools are sufficiently liquid and diversified. The investment flexibility that would result from permitting a Top Fund to invest in "eligible pools" would increase the number of ways a fund manager can seek to meet its objective and make available investment management expertise not currently available – a clear benefit to investors.

Question

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

The definition of "top fund" proposed in section 1.1 of NI 81-102 requires that the fund have a fundamental investment objective allowing it to invest in bottom funds or RSP clone funds (as defined in the proposed amendments). A fundamental investment objective is one that defines both the fundamental nature of the mutual fund and the fundamental investment features of the fund that distinguishes it from other mutual funds. A fund's investment strategies must be consistent with its fundamental investment objective, which can be changed only with unitholder approval.

The effect of this definition is that mutual funds that do not include investing in other mutual funds in their fundamental investment objectives will not be permitted to invest any amount into other mutual funds. One benefit of the existing regime is that mutual funds that occasionally determine it would be appropriate for the fund to achieve its investment objectives by investing a portion of its portfolio into other mutual funds, can do so, so long as they do not invest more than 10% of the fund's net assets (and they comply with the rest of section 2.5). Currently, this type of investing need not necessarily be disclosed as a fundamental investment objective or a strategy.

The CSA invite comments on this definition and specifically whether any mutual fund should be allowed to invest at least a portion of its assets in other mutual funds as a strategy to achieve its fundamental investment objective, whether or not investing in other funds is specifically identified as part of its fundamental objective.

The CSA also invite comment on whether mutual funds and investors would benefit if the existing 10% limit was retained? Would removing this provision cause any hardship to any existing funds of funds?

Response

The fact that a fund invests in other funds in order to meet its fundamental objective is an important strategy that must be disclosed, but it is not fundamental to the nature of a fund. The investment exposure of the fund – e.g. Far East equities – is fundamental, but the means of seeking that exposure – i.e. through another fund – is not. Rules that are intended to protect investors from any potential fund-of-fund abuses remove any distinction between the strategy of investing through a fund and investing in the underlying securities directly – consistent with the Fundamental Principle. Accordingly, investing in other mutual funds should be disclosed in the investment strategy section of a fund's prospectus, not in its investment objective.

Similarly, a fund should continue to be permitted to invest a reasonable proportion of its assets in other funds as a secondary strategy. Taking away the ability of a Top Fund to employ such a strategy without investment objective disclosure eliminates corresponding benefits to investors such as diversification and lower execution costs. For example, a fund should be permitted to use a secondary strategy in order to seek exposure to foreign securities in an efficient way or to employ more efficient cash management strategies. Managers should have the discretion to manage the fund within the bounds of the disclosure, without being subject to a prescribed limit. This type of discretion is currently exercised in many other contexts, such as a manager's interpretation of the percentage of a fund's assets that must be invested in the securities that are identified as primary securities in the fund's investment objective.

Requiring a fund to declare itself a Top Fund in its investment objective is problematic for other reasons. A fund that declares itself to be a Top Fund in order to take advantage of the type of secondary strategy contemplated above precludes it from becoming a Bottom Fund for other funds. The operation of the proposed rule would place a fund manager in the difficult position where it must determine whether the efficiencies that would accrue from potential Top Fund investments outweigh the benefits that would result from pursuing a fund-of-fund secondary investment strategy. The potential for benefits from each approach fluctuates over time. A fund manager that declares a fund a Top Fund in order to pursue the secondary strategy, would be forced to hold a vote in order to change the designation later, even though such a change would be in the best interest of investors. We do not believe that such a scenario would be an effective or efficient mechanism to protect the best interests of investors.

The Amendments are also problematic for existing funds. A fund that currently makes use of the 10% exemption in order to gain diversification or lower execution costs will be forced to go to the trouble and expense of an investor vote in order to change its objective. This added expense is likely to dissuade some managers from implementing the objective change -- a change that is not fundamental in nature and one that should accordingly not be put to an investor vote. Investors in those existing funds will be put in a worse position as a result of the Amendments.

We submit that the CSA should consider allowing a fund to include disclosure about whether it intends to use investing in other funds as a primary or as a secondary strategy. If a primary strategy is disclosed, other funds would be prohibited from investing in that fund. If a secondary strategy is disclosed, then the fund would still be eligible for investment by other funds. This approach keeps intact the CSA's goal to prohibit multi-tiered structures, but for RSP Clone Funds and funds with secondary strategies, and eliminates the concerns identified above.

<u>Question</u>

4. Control of the bottom fund by the top fund

i) Removal of the concentration and control restrictions

The proposed amendments permit the top fund to invest more than 10% (up to 100%) of its assets in a bottom fund. The proposed amendments also permit a top fund to purchase more than 10% of the voting, or equity, securities of a bottom fund.

The CSA invite comment on whether this approach is appropriate. Should there be a limit on the percentage of net assets invested in one bottom fund? Should a limit be placed on the percentage of voting, or equity, securities of a bottom fund that a top fund can acquire? The CSA is concerned with ensuring efficient capital markets while providing adequate protection for investors. Please provide an explanation why such limits should, or should not, be imposed and provide us with the recommended percentage limits.

<u>Response</u>

The approach is appropriate. A manager acting for both funds is under a duty to act in the best interests of all investors and, in such a situation, with sufficient disclosure, limits are not necessary.

The potential for a conflict of interest between a Top Fund as investor and other Bottom Fund investors is, however, a concern where the manager of the Top Fund is not the manager of the Bottom Fund. An unrelated manager is bound only to act in the best interests of Top Fund investors. Although remote, it is possible that those interests could be in conflict with the interests of other Bottom Fund investors. In order to address this possibility, specific disclosure about the possibility of this type of conflict should be provided.

ii) Massive redemption

The proposed amendments remove the limit on the percentage of securities that a top fund can hold in the bottom fund or RSP clone fund. It permits a mutual fund to hold more than 10% of the voting or equity securities and to actively manage those holdings. However, a bottom fund or a RSP clone fund must disclose in its simplified prospectus the risks associated with a possible massive redemption due to a top fund holding more than 10% of the securities of that fund. Because the proposed amendments eliminate the control and concentration restrictions for fund of funds, it is possible that a massive redemption by the top fund could impact the bottom fund and its securityholders.

The CSA invite comments on whether restrictions should be imposed on the top fund to ensure that the bottom fund has sufficient time to sell its assets and pay the top fund in an orderly manner.

Response

Restrictions should not be imposed. The risk of a large redemption is not unique to the fund-of-fund structure. Many funds currently have large institutional investors in connection with offering RSP Clone Funds or in creating other products such as segregated funds. The Bottom Fund manager is under a fiduciary duty to protect investors. If it permits a Top Fund to invest, it is under an obligation to ensure adequate protection in the negotiation of contractual arrangements relating to the purchase. If the investment is not made pursuant to a negotiated agreement, the manager should have in place contingency plans to mitigate any potential harm – such as the imposition of short-term trading fees.

Question

5. Prohibition against Sales and Redemption Charges

NI 81-102, securities legislation and the existing exemptive relief for funds of funds currently prohibit top funds from paying any sales charges in connection with a purchase of securities of a bottom fund, and similarly prohibits redemption fees being charged by the bottom fund for redemptions made by a top fund. This prohibition exists whether the top and bottom fund are related or unrelated.

Mutual fund managers have a duty to act in the best interests of the fund. As a result, the manager must ensure that its fund (top fund or bottom fund) is paying or receiving fees that are appropriate for any services being provided to the fund, or in connection with any investment the fund may make. In the fund of fund context (and absent the existing prohibitions we described), this requires that fund managers consider, as part of the decision to invest in other funds, what sales and redemption fees are charged by those other funds. In an arms length transaction, such as where the top and bottom fund are unrelated, both fund managers would be free to negotiate an appropriate arrangement for their funds in accordance with market demands.

Where the funds are related, the fund manager has competing interests that may make it difficult to comply with this requirement. For example, where the top and bottom fund manager are the same, it may be in the best interests of the fund complex overall to have fees paid by the top fund to the bottom fund. Because of the relationship, the manager may be unable to balance the competing interests of the securityholders in top fund against the interests of the fund complex as a whole.

Given the existing obligations on fund managers, the CSA invite comment about whether these prohibitions against the payment of sales charges or redemption fees are necessary. Is your view the same for both related and unrelated funds of funds?

Response

The prohibitions are necessary and desirable in the context of related managers. Where managers are unrelated, the parties should be free to negotiate sales and redemption charges. The fund manager is under an obligation to ensure each investment is prudent, taking into account the potential for return and the cost inherent in such an investment. Consistent with the Fundamental Principle, rules should not distinguish between direct investments, some of which are multi-tiered corporate structures with imbedded costs, and investment in mutual funds.

Short-term trading fees on the redemption of securities should be permitted. These fees protect a fund's investors from the potential for deterioration in performance that may result from rapid movements of cash into and out of a fund. The fees play a similar role in the context of fund-of-fund arrangements, especially where redemptions may be large.

Question

6. Voting rights of top fund securityholders in bottom fund matters

The proposed amendments no longer provide for a pass through of bottom fund voting rights which is currently mandated the Existing Decisions. The top fund's manager will now be responsible for voting those rights in accordance with its fiduciary obligations to its securityholders. However, when the manager of the top fund is related to the manager of the bottom fund, the voting rights held by the top fund cannot be exercised due to concerns relating to conflict of interests.

i) The CSA invite comment on whether the proposed approach is appropriate for the investors in the top fund or the bottom fund. Should the current requirement in the Existing Decisions, to pass the voting rights attached to the securities of the bottom fund to the securityholders of the top fund in order to vote on fundamental changes, be continued in the future?

Response

Yes, the proposed approach is appropriate and is consistent with the Fundamental Principle of the Amendments. Just as the case when a vote occurs in connection with direct investments, the Top Fund manager is in the best position to make a decision in the best interests of investors.

ii) Furthermore, the CSA invite comment on whether precluding a related manager of a top fund from voting securities of a bottom fund would be detrimental to its securityholders or the securityholders of the bottom fund since an important portion of the voting rights may not be exercised.

Response

Although precluding a related manager from voting securities of a Bottom Fund is potentially detrimental to Bottom Fund investors, especially where the Top Fund holds a large percentage of the securities of a Bottom Fund, the likelihood of a conflict outweighs the potential detriment. Accordingly, related managers should be precluded from voting Bottom Fund securities.

Question

7. Active management and prospectus disclosure

The proposed amendments provide greater flexibility to the portfolio manager of the top fund to modify its holdings in bottom funds by permitting "active" management of bottom funds. The Existing Decisions mandated a "passive" investment approach.

The proposed amendments also provide relief from the concentration and control restrictions in NI 81-102 for fund of funds investments.

Since the simplified prospectus of the top fund may not disclose each investment, and each modification on an ongoing basis, investors in a top fund will not be able to determine the top funds actual holding by reviewing the simplified prospectus. The CSA seek comment on whether this situation is problematic. Furthermore, if the top fund replaces its holdings in one "important" bottom fund, for another one, should the investors be notified of this change.

The CSA seek comment on this issue as well as suggestions on how, and whether, investors should have access to the updated holdings of the top fund. Should the simplified prospectus be amended, or a notice provided, every time an important bottom fund is changed?

Response

The proposed approach is consistent with the Fundamental Principle and is satisfactory. If Bottom Funds are viewed as simply another form of investment, then there is no reason to distinguish between the disclosure regime for direct investments and investments in pooled securities.

If an investor wishes to obtain an update of Top Fund holdings, he or she may contact the manager. If a manager determines that an investment or an intention to invest in a Bottom Fund is a "material fact", then it is under an obligation to provide prospectus disclosure. If the manager determines that its decision to divest in a Bottom Fund is a "significant change", it is under an obligation to provide timely disclosure to investors.

Specific Comments

Proposed Section 2.5(1)(d) of National Instrument 81-102

The proposed section 2.5(1)(d) prohibits the duplication of management fees between funds.

Submission

This prohibition is sensible in the context of passively managed fund-of-funds where the Top Fund manager is not engaged in investment management activity. Where the Top Fund is actively managed, however, the Top Fund manager is engaged in providing investment management advice. In light of a service being provided to the Top Fund, we submit that with full disclosure, managers should be permitted to charge management fees at the Top and Bottom Fund levels.

Proposed Section 2.5(1)(g) and (h) of National Instrument 81-102

Section 2.5(1)(g) and (h) provide that no fees may be paid in respect of the purchase, holding, or redemption of Bottom Fund securities by the Top Fund and that any rebates paid by the Bottom Fund must be paid to the Top Fund.

Submission

Institutional Series Holdings

Many Top Funds currently invest in institutional classes of Bottom Funds. The institutional class, often called O class, is a security where fees, either management fees or expenses, are negotiable and are charged outside the fund directly to an investor. Using these securities instead of the regular retail securities where fees and expenses are charged to the Bottom Fund is administratively less burdensome. In connection with these institutional class holdings, there is existing prospectus disclosure that managers may charge a Top Fund its proportionate share of the Bottom Fund's expenses. Custody expenses are an example of the type of expense that may be charged – clearly management fees are not contemplated. If the Top Fund held regular retail securities, it would have paid the expenses indirectly. There is no policy reason to distinguish between holdings in different classes and, consequently, this rule is overly broad.

Payment Arrangements Between Unrelated Managers

Agreements between fund managers that provide for lower management fees to be paid by a Top Fund in connection with investments in a Bottom Fund are common in the industry. The lower management fees are, in part, a reflection of the fact distribution costs represent a significant portion of a fund's management fees and that the Bottom Fund manager is not required to incur the costs in connection with fund-of-fund arrangements.

The Top Fund managers often use an ordinary retail class instead of an institutional class offering because the latter may place them in a disadvantaged tax position. The mechanisms for lowering management fees include the payment of trailer fees from the Bottom Fund manager to the Top Fund manager, the payment of management fee distributions from the Bottom Fund manager to the Top Fund, or direct payments from the Bottom Fund manager to the Top Fund manager. These mechanisms are designed not only to prevent the duplication of management fees, but also to ensure a lower fee is paid by the Top Fund.

As currently drafted, paragraphs 2.5(1)(g) and (h) would prohibit both arrangements described above with no corresponding benefit to investors. We submit that these paragraphs, along with paragraph 2.5(1)(d) be re-drafted in order to allow managers flexibility in designing fund-of-fund structures, provided that disclosure of all investing costs is made to investors.

Proposed Section 5.1 of National Instrument 81-102

If the changes to Section 5.1 are implemented, investor approval would be necessary in order to charge a new fee or expense, either to a fund directly or to an investor in connection with the holding of mutual fund securities.

Submission

This provision is overly broad and gives rise to the potential for unintended results. This potential is demonstrated in several ways. First, it is possible that the imposition of a new fee could be combined with a reduction in other fees so that the total fees charged to an investor decline. It should not be necessary to seek approval where securityholders are better off as the result of a change.

Second, fees charged directly to investors are outside the control of mutual fund managers. It is not fair to expect fund managers to know of all fees charged or, where it is aware of a new fee, to bear the burden of an investor vote resulting from a decision made by an unrelated third party.

Third, new fees may result from a change to NI 81-102 or other securities legislation. Take, for example, the relatively new requirement to hire a securities lending or repurchase agreement agent. A fund manager may be reluctant to establish a securities lending program, even though it would prove to be beneficial to investors, because the operation of the proposed new rule would impose the burden of an investor vote.

The fund manager or trustee should have the discretion to determine if a new fee that is in the control of the fund manager will have a material impact on the MER of a fund. Where a new fee would have such an impact, then the manager should follow the 81-102 significant change provisions. This response serves investors better than the process of holding a vote – an exercise often largely ignored by investors.

In the event that the CSA disagrees that proposed section 5.1 is not suitable, it should be redrafted to narrow its application in order to address the foregoing issues.

Conclusion

Although Fidelity Canada has a number of concerns with respect to the Amendments, we believe that the Amendments represent a significant step forward. We urge you to consider the concerns we have raised in this letter and our proposals for dealing with those concerns. We submit that the net effect of our proposals will be a closer adherence to the Fundamental Principle.

We appreciate the opportunity to comment on the Amendments, and look forward to a continuing dialogue regarding the implementation of a fund-of-fund regime that best serves the interests of investors.

Yours very truly,

[signed] "David S. Burbach"

David S. Burbach
Legal Counsel