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**NOTICE OF PROPOSED AMENDMENTS TO NATIONAL INSTRUMENT 81-102 MUTUAL FUNDS AND TO NATIONAL INSTRUMENT 81-106 INVESTMENT FUND CONTINUOUS DISCLOSURE AND RELATED CONSEQUENTIAL AMENDMENTS , June 25, 2010** http://www.osc.gov.on.ca/documents/en/Securities-Category8/rule_20100625_81-102_rfc-pro-amd.pdf

Kenmar Associates is pleased to respond to the CSA's request for comments. We add parenthetically that it was only by chance that we became aware of the NOTICE/Request for Comments. Kenmar believe that the CSA needs to improve its process for engaging retail investors. Otherwise, it risks hearing only from industry participants , the lawyers that represent them and industry lobbyists.

We question the assertion that *the proposed codification of exemptive relief that is frequently granted to investment funds will benefit investment funds and their investors by eliminating unnecessary regulatory burdens.* We have rarely found exemptive relief from established rules to benefit investors. For example , the infamous granting of an exemption on mutual fund DSC early redemption

penalty reimbursements so that investors could be sold expensive proprietary funds harmed investors. We have prepared a research paper on this topic and would be glad to share it with the CSA.

## Introduction

**Mutual funds are the investment of choice for Canadian small investors with about $600 billion invested.** The inability of investors to make wise investment decisions may have a significant negative impact on their quality of life in retirement and increase the likelihood of their dependence on government assistance programs. The changes proposed effectively change the core character and risks of mutual funds. The more significant proposals, if adopted, would :

- Facilitate public offerings of exchange-traded mutual funds by codifying exemptions that are, sadly, routinely granted by the CSA to these funds
- Impose additional constraints on money market funds
- Permit mutual funds to engage in limited short selling practices ( there is no mention of performance incentive fees but we assume they will not be permitted)
- Allow mutual funds to use investments in money market funds as "cash cover" for derivative transactions
- Provide additional "flexibility" for mutual funds wishing to invest in other mutual funds , a feature we see as adding more complexity , risk and costs for retail investors and
- Exempt mutual fund dealers from certain CSA compliance obligations despite MFDA reporting significant internal control deficiencies at some dealers.

Now , in addition to high fund fees, the CSA is proposing potentially adding to the risk profile of mutual fund investing . Recently , the OSC granted exemptive relief regarding the use of inverse and double leveraged return exchange traded funds ( ETF's) in certain retail mutual funds . We remain concerned that the rules we believe are in place are slowly watered down out of public view via exemptive relief decisions in which investors are excluded.

We focus here on money market funds and short selling practices but argue that these and other sweeping fundamental changes deserve much more public input than can be obtained by the regular CSA "Public" Comment Process.

## Recent Relevant Research

The 2007 "Tufano" report Mutual *Fund Fees Around the World* concluded that **Canada's mutual fund fees were among the highest in the world** suggesting that Canadians should be receiving truly superior performance for the outsized fees. Or, it could suggest an uninformed investor base paying an excessive price. Approximately 85 % of funds are purchased through an "advisory" (sales) channel . Source:, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=901023 ]

A 2006 U.S. Research paper by Cici, Gjergji , Gibson, Scott and Moussawi, Rabih, *For Better or Worse? Mutual Funds in Side-By-Side Management Relationships With Hedge Funds* available at SSRN: http://ssrn.com/abstract=905600 found that the reported returns of side-by-side mutual funds are significantly less than those of similar mutual funds run by firms that do not also manage hedge funds. This is because Fund managers receive higher compensation (relative to mutual fund managers) when hedge funds perform well. They also found that Side-by-side mutual funds generally received a significantly lower portion of low-priced shares of IPOs. According to the study, the 457 actively -managed mutual funds underperformed the comparable unaffiliated funds by 1.2% per year. **This favoritism occurred despite the fact that firms that engage in the simultaneous, or "side-by-side", management of mutual funds and hedge funds have a fiduciary duty to each fund's investors to make portfolio decisions and to execute trades in the most favorable way.** In the U.S. , mutual funds are governed by independent boards while in Canada , the only barrier to conflicts-of-interest are the relatively toothless Independent Review Committees operating per NI81-107. Read also *Side-By-Side Management May Favor Hedge Over Mutual Funds*
http://www.investopedia.com/articles/mutualfund/06/sidebysidemanage.asp

If we are not careful we could see a toxic mix of high fund fees occur when fund complexity is increasing, potential conflicts-of-interest accentuated and public disclosure via Fund Facts greatly abbreviated.

**Money Market (m/m) Funds**

These proposals cannot be read in isolation from the CSA's initiative for Fund Facts (FF). We have previously recommended that the FF's be delivered for all categories of funds including money market funds and recommend that today. Money market funds have had some of the biggest issues due to the credit crisis – the ABCP fiasco. Money market

funds also were used as the conduit for perpetrating financial assault in the mutual fund market timing scandal. We believe the delivery requirements that permit investors to waive their right to receive the document when buying money market funds or in cases in which they initiate the purchase is questionable. Note that in many cases a floating percentage in a investor's portfolio is always in m/m funds, perhaps 5%. The average hold period is about 10 months. Historically, up to $70 billion has been invested in m/m funds, many with MER's so high that investors earn nothing .Some Money Market funds are sold on a DSC basis which can be very costly for an uninformed investor. Thus , our interest in m/m funds and their disclosure.

In October 2008, the CSA published CSA Consultation Paper 11-405 *Securities Regulatory Proposals Stemming from the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada.* The CSA outlined specific issues relating to money market funds in the Consultation Paper, including those funds that had invested in non-bank ABCP, and signaled their intention to consider revisiting the rules for money market funds. Starting in September 2008, the OSC also reviewed selected money market funds focusing on portfolio holdings, valuation of portfolio securities, portfolio concentration, counter-party exposure and redemption levels. The results of that review were summarized in OSC Staff Notice 33-733 *Report on Focused Reviews of Investment Funds, September 2008- September 2009*, which was released in January 2010. Kenmar pressed for additional disclosure of findings during the period. During the non-bank ABCP fiasco some money market funds would have " broken the buck" had the fund sponsors not voluntarily bailed out the funds. With about $50 billion in assets currently, we believe m/m funds deserve the outmost in investor protection.

The proposed amendments to NI 81-102 in respect of money market funds resulted from comments received on the Consultation Paper and the results of the OSC's review of money market funds. [ The proposals are available at http://www.osc.gov.on.ca/documents/en/Securities-Category8/rule_20100625_81-102_rfc-pro-amd.pdf .] The proposed amendments would also codify routine exemptive relief granted to money market funds to permit investments in other money market funds. The new proposed requirements are as follows:

- **Liquidity requirement.** A money market fund would be required to have at least 5 % of its assets in cash or securities that are readily convertible to cash within one day and 15 % of its assets in cash or securities that are readily convertible to cash

within one week. New rules recently adopted by the United States Securities and Exchange Commission are more restrictive than the above noted CSA's proposals A U.S. taxable money market fund must have at least 10 % of its portfolio assets invested in cash, U.S. Treasury securities or securities that convert into cash within one day. A U.S. money market fund must have at least 30 % of its portfolio assets in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week.

- **Dollar-weighted average term to maturity limit.** A money market fund would be required, in addition to the current requirement of maintaining a portfolio with a dollar-weighted average term to maturity limit not exceeding 90 days (calculated on the basis that the term of a floating rate note is the period remaining to the date of the next rate setting of the note), to maintain a dollar-weighted average term to maturity limit not exceeding 120 days (calculated based on the actual term to maturity of all securities, including floating rate notes). Under SEC rules , the "weighted average maturity" of the portfolio of a U.S. money market fund is subject to a 60-day limit, with a 120-day "weighted average life" to maturity.
- **Investment restrictions.** A money market fund would be restricted from using specified derivatives or engaging in short selling. We agree with this restriction.

We see no good reason for Canadians to have to accept a lower level of protection. Money market funds are, in the minds of Canadians , considered as safe as GIC's and that is why we believe they should be regulated closely.

**RECOMMENDATION: Utilize the tighter U.S. Standards.**

We are unable to comment re money market funds' exposure level to floating rate Notes except to point out that any risks associated with these Notes should be clearly and prominently disclosed in the Prospectus and Fund Facts ( should FF come into effect) .

Finally, we see no advantage for investors in permitting a money market fund to be allowed to invest in another money market fund.

**RECOMMENDATION: Do not permit such a transaction** Making simple products complex has never worked to the benefit of Main Street.

**Short selling**

For years the mutual fund industry has told retail investors to Buy and Hold, think long-term, don't time the market and dollar cost average. Yet now we are told that selling short / timing the market may enable managers to better manage risk and earn incremental returns. [ In fact , regulators granted the first exemption to use short selling by retail mutual funds in 2003] This may in fact be correct but is there any research to support this for mutual funds?
**RECOMMENDATION: The CSA should make such research publicly available so informed commentary can be provided.**

The CSA have added section 2.6.1 Short Sales which would permit a mutual fund to sell securities short subject to compliance with certain conditions, including a cap on short selling of 20% of the mutual fund's net asset value ( It should be recognized that simple balance sheet measures of leverage are simplistic and may not be indicative of risk ) . The proposal to permit this practice is not inconsistent with the conditions to the exemptions granted virtually routinely by the OSC over the past few years. As is well known , short selling involves higher risks ; the 20 % restriction may offer limited protection in volatile markets or incidents like the still unexplained May 6th "Flash Crash". We are concerned that a fund could ask for and expect to receive an exemption beyond the 20 % limit.

At what point does a mutual fund shorting criteria make it a hedge fund.? 25 percent? 30 percent? More?
**RECOMMENDATION: We recommend a cap of 10 % rather than 20% including shorting by all subordinate funds. Additionally, the CSA should define an absolute upper limit as part of the proposed Amendments. If there is no upper limit on regulatory exemptions approval , we recommend one be set as an investor protection action.** We are also deeply concerned that no "look through" to the bottom fund(s) is contemplated – this could greatly increase the extent of permitted short selling exposure and expose small investors to a level of risks they may not be aware of.
**RECOMMENDATION: Do not encapsulate short selling into retail mutual funds without a comprehensive review by the OSC's Investor Advisory Panel and more direct consultation with buy-side stakeholders .**

We note also that the proposals would allow a mutual fund to use a dealer as a borrowing agent for short sale transactions made outside of Canada if that dealer is a member of a stock exchange and if that dealer has a net worth in excess of just $50 million.

**RECOMMENDATION: Reassess whether $50 million is a sufficiently high thresh hold. It has not changed since 2003.**

The amendment proposes to require a mutual fund engaging in short selling to disclose in its prospectus under "Investment Strategies" how short sale transactions are or will be entered into in conjunction with other strategies and investments of the mutual fund to achieve the mutual fund's investment objectives but Fund Facts does not include an entry for delineating a fund's Investment Objectives.
**RECOMMENDATION: Change the FF template to include the fund's Objectives .**

**RECOMMENDATION: We recommend that para 2.6.1 (b) (iii) be changed to read *An investment fund other than an Index Participation Unit* for greater clarity.**

Per the proposed amendments , total exposure to any one issuer that could be achieved through short selling would be limited to 5% of the net asset value of the mutual fund. Each of these limits would be determined as at the time the mutual fund sells a security short. The mutual fund would also be required to hold cash cover in an amount, including mutual fund assets deposited with the borrowing agent as security, that is at least 150% of the aggregate market value of all securities sold short by the mutual fund on a daily marked to market basis. We cannot ascertain whether these limits provide adequate investor protection .

We agree with the CSA that short selling cannot be used to create publicly offered "long-short funds", given the proposed restrictions on the use of the proceeds of a short sale.

As we understand it , the CSA is requiring the gains or losses from short selling to be separately disclosed so investors can track the results ; we agree with this. We also understand that any shorting of securities will be in full compliance with the rules governing such borrowing stipulated by the applicable exchange. Contrasted with the U.S. requirements imposing a duty to locate shares in order to initiate a short sale, section 2.2 of Canadian UMIR provides that a Participant (dealer) must only have a "reasonable expectation" of settling the trade. "Reasonable expectation" is not an objective standard and there are too many dishonest market participants who will take advantage of this proposed subjectivity to allow it, especially when the currently proposed penalties for non-compliance are so minimal. Does this increase the risk of a failed sale and the resulting consequences? The

term "arranged to borrow" [ para 2.6.1 ( c) (i) should be better defined so as to provide a basis for audit and compliance checking. ]

The numerous costs associated with short selling need to be accounted for. **RECOMMENDATION: We recommend that the CSA state that it expects the costs of shorting transactions to be included in the TER calculation in accordance with Canadian GAAP and soon IFRS . Similarly, the calculation of Turnover Ratio may need CSA guidance to ensure consistent application and reporting.**

Kenmar has been constructively critical of the routine waiving of regulations to permit short selling. We believe mutual fund risks are large enough without utilizing short sales in products marketed as key components of retirement planning / DC Pension Plans for small investors. Allowing short selling may have a benefit, but it will add to costs , and complicate disclosure , valuation, accounting and suitability determination. The impact on taxation could also be significant. We have always queried the exemptions and we certainly do not recommend that the base prohibitions be codified without more debate and dialogue. **RECOMMENDATION: Any fund that plans to short sell as an investment strategy should contain a prominent warning identifier or label in its name so that investors are cautioned without having to research the entire Simplified prospectus . This will also assist dealer representatives and investors in evaluating suitability.**

Per CSA Fund Facts (FF) proposals , the fund companies are allowed to rate the relative riskiness of its fund on a 5-point narrative scale that will leave investors in the dark about the fund's true risks. With such a scale the investor is not provided the information he/she needs to make an informed decision especially given the fundamental character changes mutual funds will undergo if the current NI81-102 proposed amendments are approved. Because it's likely that managers with similar Category mutual funds may adopt different methodologies (or metrics) to identify the mutual fund's risk level on the scale prescribed we believe this approach will lead to a confusing situation. We remain unconvinced that a 5-point narrative scale will provide the necessary sensitivity to risk that a worst case 12 month number would. This issue is further complicated by removal of short selling prohibitions from regulations now being considered for codification making it virtually impossible for FF to describe a mutual funds risks in one word. **RECOMMENDATION: We are now, more than ever, of the firm conviction that there should be a stronger bold type**

**message in FF that only the prospectus provides full and complete disclosure of investment risks and other important information.**

**Other Observation/ Comments**

**Unitholder rights:** Para 5.3 amendments will bypass unitholder voting if the fund discloses in its prospectus that, although the approval of securityholders will not be obtained before making the changes, securityholders will be sent a written notice at least 60 days before the effective date of the change that is to be made that could result in an increase in charges to the mutual fund or to its securityholders. We fail to understand why this requirement is being introduced . If a Unitholder has been sold a mutual fund on the basis of low fees , an increase in those fees is a material change . Furthermore, the 60 day notice is useless if the fund carries a early redemption charge .
**RECOMMENDATION: Let Unitholders retain the few rights they have or insist that early redemption penalties would be declared null and void in the event of a fee increase .**

**Use of mutual fund ratings in sales communications:** While **t**he use of performance ratings or rankings in sales communications is being clarified and additional disclosure would be required to ensure that such ratings and rankings are not misleading, we remain concerned that such marketing materials could undermine the hoped for benefits of FF as they have the Simplified Prospectus. As an aside , we have found little evidence that such ratings provide value to long-term investors. We also believe that the amendment that would permit mutual funds to provide an overall rating or ranking in addition to the ratings or rankings based on standard periods of performance will further confuse retail investors. We see this as adding unnecessary risk to the small investor and do not recommend it.

**RECOMMENDATION: Revisit the policy of utilizing such ratings** .

We found the advertising Guidelines of the HK Securities and Futures Commission to be particularly good
http://www.info.gov.hk/hkma/eng/guide/circu_date/attach/20090102e1a2.pdf

A definition of a "mutual fund rating entity" would be added to NI 81-102 but it is clear that such entities will not be regulated. We are all well aware of how unregulated bond rating agencies contributed to the 2007-2008 credit crisis. If a firm provides services to a mutual fund for

a fee, would that fall outside the definition given in 1. (j) of the proposed Amendment?

**RECOMMENDATION: We believe this should be monitored during compliance reviews.**

**Define Material Change :** The CSA proposal requires that a new or revised Fund Facts would have to be filed if there is a material change to the information in Fund Facts. The CSA should document if the following are considered as material changes:

- A change in investment mandate or style
- A change in fees, fee structure or expenses
- A major change in fund assets
- A change that would permit shorting of securities ( or purchase of leveraged ETF's)
- A change in manager
- A change in currency hedging strategy or securities lending practices
- Any significant change in the fund's risk profile e.g. initiating securities lending
- Any material change to the prospectus that would give rise to a change in FF's
- A change in fund Auditor or Custodian
- Any change that would affect the liquidity of the fund

**Define and Disclose Governance Risk: We recommend that the prospectus disclosure should include Fund Governance as a listed risk, given known NI81-107 IRC limitations/ constraints , a history of breakdowns including front running/market timing and the increased *flexibility* of mutual funds being contemplated by these amendments. We are not sure if funds can borrow from affiliated lending agents , but if they can , there should be regulatory safeguards regarding fairness ( revenue/interest sharing) , competitive bidding and of course public disclosure.**

**Define the term " Published Category"**: **This term is used in several parts of the Notice . We understand this to be the CIFSC list of fund Categories. This should be clarified.**

**Amend the definition of "index participation unit" by replacing "Canada or the United States*" with* "Canada, the United States or the United Kingdom*" :*** We have no recommendation since no

substantive rationale is provided for adding the UK . Again, in the absence of other information we see this as adding risk rather than reducing it. It is assumed that IPU's purchased for a fund would be congruent with its stated objectives and name. We note that the UK regulatory regime is undergoing tremendous change as a result of numerous and significant financial meltdowns.

**Co-mingling of accounts:** We have not analyzed the risks or benefits .

**Payment of interest:** While the CSA states that it " understands " that because the cash sits in the trust account for a very brief period of time before being disbursed, the amount of interest earned on the trust account and remitted by a dealer is most often nominal. The CSA further "understands" that costs to implement the internal controls and procedures necessary to comply with the interest determination, allocation and distribution requirements are significant relative to the amount of interest paid out. The CSA then argues that in recognition of the administrative burden, unnecessary complexity and increased costs associated with this interest requirement, that such interest should no longer be paid to investors. There appear to be a lot of assumptions here when what is needed is facts. It is investors income that is being compromised. Should interest rates rise, these amounts could run into the millions of dollars. Given today's low cost of computing, we challenge the statement that the trivial task of paying interest to clients is too much of a regulatory burden. If adopted, the end result would be a net gain for fund dealers and a net loss for investors. Perhaps it is IIROC which should amend its dealer rules to permit interest payment?
**RECOMMENDATION: As a very minimum, interest should be paid on the minimum monthly cash balance in the account unless the interest payable is less than say, $1.00 .**

An immediate consequence of these proposed amendments is increased transaction complexity, different types of transactions and perhaps more transactions.
**RECOMMENDATION: We therefore strongly recommend that the CSA reintroduce the requirement that mutual funds make available, upon request, the *Statement of Portfolio Transactions.*** This would allow financial journalists, advisers, academia, fund analysts, fund rating entities and investors to assess the fund , determine suitability and rate the fund and its management processes.

**Questions/ Points to ponder:**

1. Are regulations in place that mandate how any revenue from securities lending is to be allocated or can it be assumed that all lending revenue, less expenses ,will be credited to the donor fund ( believe some ETF's split lending income with the fund sponsor) ?
2. Is it accepted that any fund that fits the criteria of an Alternative Strategies fund per CIFSC standards must place itself into the Alternative Strategy Category? If it is in this Category , will FF's be an adequate disclosure and how will suitability constraints be handled by dealers/ registered reps?
3. Are there any governance issues that need to be dealt with ? For example, if the fund sponsor also manages hedge funds, there could be performance shifting.
4. Is the requirement that each short position must carry a stop-loss order requiring the position to be closed once the price of the stock exceeds 108% of the price of the short still applicable and if not, why not?
5. Should securities lending rules be more congruent with short selling rules ? [ to avoid cost friction]

**Bottom line**

Retail Mutual fund investors are regarded as among the most vulnerable. Regulators have concluded that Grade 6 language is required to deal with literacy inadequacies. Further, it's generally accepted that financial literacy is also seriously wanting among this investor group. We find it inconsistent that the CSA is allowing more flex to marketing materials and investment strategies while not requiring benchmark performance, total costs and key risks/ risk metrics to be disclosed to retail investors via FF. An important shortcoming of the proposed Fund Facts is that it fails to set rational expectations for the investment returns by utilizing a inadequate/misleading risk scale and now , with short selling , even more disclosable risks exist for fund investors. Furthermore, the assumption that dealer representatives ( previously referred to as "salespersons" ) have the skill set to advise on these turbo-charged mutual funds merits regulator validation.

To the extent that the codification of opaquely disclosed and controversially granted exemptive relief to established , published rules permits the use of new riskier investment strategies for investment funds, the flexibility to use these investment strategies may cause investment funds to increase risk and also reduce

incremental returns without any reduction of fees as a result of lowered costs for regulatory exemption applications .

This Instrument will only be effective if there is robust regulatory monitoring and determined enforcement. Mechanisms need to be in place to ensure that the fund companies can be measured and are compliant .

We would also like to take this opportunity to request that, given the critical importance of these Amendments to retail mutual fund investors especially seniors , pensioners and retirees, that the CSA not depend solely on written submissions from the "public". It should be clear that retail investors are at a substantial disadvantage relative to fund industry participants with dedicated professional staff to make such submissions. Historically, the submissions from industry participants overwhelm the few retail investor inputs if indeed there actually are any. This unbalanced situation can lead to seriously flawed rule-making.

**RECOMMENDATION: We recommend that the OSC expose the Amendments to a complete review by its newly established Investor Advisory Panel and correspondingly extend the due date beyond Sept. 24 to accommodate their deliberations . We also recommend that each member of the CSA undertake to pro-actively host a forum, inviting retail investors, investor advocates, software suppliers, academia, consumer associations and seniors and pension groups to dialogue the proposed changes face- to- face before encapsulating such fundamental changes into mutual fund regulations. Compensation should be provided for participants.** This represents a wonderful opportunity for Commissions to reassess the manner in which they exercise their public interest jurisdiction. For the OSC in particular, it would be a positive response to the Standing Committee on Government Agencies recent observations and recommendations.

We would be pleased to discuss our comments with you in more detail at any time.

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