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L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA
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British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

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Dear Sirs / Madames:

RE: Proposed Amendments to NI 81-102 Mutual Funds and NI 81-106 Investment Fund Continuous Disclosure

We are writing to provide comments of The Investment Funds Institute of Canada ("IFIC") with respect to the *Canadian Securities Administrators* ("*CSA") 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* (the "Amendments").

Our comments are divided into three distinct areas. The first part responds to those issues on which the CSA has specifically requested stakeholder feedback. The second part comments on the proposed Amendments, and the last section of our submission reiterates several key issues on the theme of modernization of mutual fund regulation from our March 2009 submission to the Ontario Securities Commission (Recommendations for Technical Amendments to National Instrument 81-102, *Mutual Funds*) which we believe merit reconsideration by the CSA.

Part I - Requested Feedback

Money Market Funds

We seek feedback on whether you agree or disagree with the 90 and 120-day dollar-weighted average term to maturity limits and whether there should be any limit on the exposure of a money market fund to floating rate notes.

As a general comment we believe the proposed amendments to the average term to maturity and the proposed liquidity requirements for money market funds are unnecessary and may actually cause negative, unintended consequences to money market funds. As we have detailed in Part II of this letter, we do not believe the CSA has identified any problems with the current rules governing money market funds that necessitate the changes that are proposed. As such, we would urge caution in proceeding with any proposals until their potential negative consequences have been studied and understood.

We disagree with the proposed combined 90- and 120-day dollar-weighted average term to maturity limits. Specifically we disagree with the notion of using a 120-day maximum that is calculated based on the actual term to maturity for all securities rather than the reset dates for floating rate notes. Given that this amendment appears to have been proposed to further the objective of improving investor protection, we believe the following comments and examples demonstrate that this objective will not be met by this proposal:

a) Regarding any exposure limit to floating rate notes (FRNs), it should be remembered that FRNs primarily carry two types of risk: (1) interest rate risk, which is low since the coupon is usually reset every 30 or 90 days and (2) credit risk, which is higher due to the longer ultimate maturity dates of FRNs. While we agree with the concept that securities with shorter maturity dates carry less risk generally, it is not fair to state that absolutely. For example, one of our manager members expressed the view that a government issued FRN (or a guaranteed FRN issued by a government agency) with a final maturity date of 5 years carries much less credit risk than many BBB- or A-rated corporate bonds with much shorter final maturity dates.

   Imposition of the new 120 day requirement may actually trigger a negative result, as this will likely further limit the ability of money market funds to invest in FRNs, as it is common for them to have resets of less than 90 days, which could further decrease the ability of these funds to serve as a critical source of funding for floating rate note issuers. This could also increase trading costs and the risk that funds may have to incur capital gains if they are required to sell FRNs before their maturity in order to meet the new requirement.

   If one wishes to liquidate an FRN prior to its maturing then a third type of risk, known as basis risk, becomes a factor. There may be no credit issues, and no interest rate issues, but an investor can still experience losses on FRNs, if sold in the secondary market, due to changes in the swap spreads on which FRNs are usually priced, related to term bonds with similar maturities. One can imagine a situation where a fund, having a significant exposure to FRNs, needs to liquidate and gets caught offside because the swaps move against its holdings, potentially causing losses for the fund.

Therefore, while we are opposed to the revised dollar weighted term to maturity limit with regard to non-government issued (or guaranteed) FRNs that are held within money market funds, we would be pleased to discuss further the CSA's concerns to ensure that the potential consequential risks of any limitations that the CSA may consider are well understood before they are imposed.

b) We believe the proposed change in term-to-maturity limits would do little to improve the liquidity position of money market funds. Given the other liquidity restrictions proposed, only a small percentage of the fund would be eligible to invest in floating rate note assets. Some manager members, for example, have utilized maximum portfolio weights as a means to control the risk. It must be understood that overly restrictive measures can exacerbate illiquidity in times of market turbulence as many (or all) fund managers may suddenly find themselves on the same side of the trade which could inadvertently drive prices down as everyone endeavours to sell the offending securities and return to compliance.

Furthermore, the proposed 120 day term to maturity limits would cause fund managers to seek investments in the same securities to a greater extent. With more fund managers investing in the same securities, the likelihood increases that the market will be more susceptible to volatile market swings and would likely result in unnecessary reductions in returns to investors. If too many portfolio managers all exit their FRN positions at once, it will almost certainly be to the detriment of the portfolio and the unitholders. This increases the "basis risk" associated with FRNs in a secondary trading environment mentioned earlier. Additionally, global bank regulators are requiring banks to issue longer-term paper, which constrains money market supply at the same time these proposed rules would increase demand from money market funds for more short-term paper.

To avoid this and other potential negative consequences, we again recommend that the CSA engage in a detailed discussion with the industry to provide a clearer demonstration of its concerns in order to determine if any changes would achieve the objectives of investor protection without potentially causing unknown, unintended negative consequences.

In any event, there is unanimity in opposition to the proposed 120 day notional average term to maturity as there is no real merit to this restriction.

We also seek feedback on whether the 90-day limit should be reduced to a shorter time frame as is the case in the money market fund rules approved by the United States Securities and Exchange Commission on January 27, 2010, which specify a 60-day limit.

We support maintaining the current 90-day limit on the dollar-weighted average term to maturity and are not in favor of a shorter limit. In the event a fund suffers a series of large redemptions and short-term cash equivalents are sold, the average term would rise inadvertently. It is to the benefit of all unitholders that there is some flexibility in meeting the proposed liquidity requirements; this can be facilitated by maintaining the 90-day dollar-weighted average term limit rather than reducing it.

The recent crisis proved that, in the face of liquidity pressures, the market operated to shorten the term to maturity of available securities. Accordingly, the portfolios of Canadian money market funds became shorter in the normal course of business (please refer to our further comments in this respect in Part II of this letter). We would prefer that the market be allowed to operate as it did, and that no artificial shorter term to maturity limits be imposed, as this could lead to unintended negative consequences given the context of the Canadian market, artificially and unnecessarily forcing the portfolio manager's hand.

An oft-cited reason for reducing average terms is to protect against interest rate risk - however, in times of crisis, treasury yields drop either as a result of a flight to quality, or central bank cuts to administered interest rates, or both. In fact the risks are more skewed towards liquidity and credit risk and unfortunately, reducing the dollar-weighted average term would do little to ultimately decrease those risks during a crisis. In times of market stress, it is the Treasury Bills, and in particular the longer-dated ones (i.e., 6-12 months), that appreciate the most in value as flight-to-quality trades are executed in the marketplace. This was indeed borne out in the credit crash during the fall of 2008. Thus, holding longer-dated Treasury Bills in a money market portfolio can provide an additional valuation cushion during times of stress. Being a forced seller of these securities due to a large withdrawal would be counterproductive to achieving superior investor protection.

If, despite our comments, the CSA chooses to proceed with any measures to shorten the term-to-maturity limit, it will be absolutely essential that the amendment come with a transition period of at least one year to allow for an orderly revision of money market fund portfolios without creating any market disruptions.

Mutual Fund Dealers – Commingling Restrictions

We request your feedback on the proposed exemption from the Commingling Restrictions

We support the exemption of members of the Mutual Fund Dealers Association (MFDA) from the commingling restrictions in NI 81-102. The policy rationale for the commingling restrictions is no longer valid in light of the fact that the MFDA and the Investor Protection Corporation (IPC) have established investor protection histories.

The use of frequently granted exemptive relief in the area also indicates that regulators have determined that it is appropriate that such parties not be subject to these restrictions. We see no reason why the exemption should not be extended to all members, thereby eliminating the costly process of applying for exemptive relief applications. As mutual funds are available through a variety of different distribution channels, it is appropriate that regulatory requirements remain equivalent regardless of the channel. We believe that regulations should treat members of the

MFDA in the same manner as members of the Investment Industry Regulatory Organization of Canada (IIROC) when dealing with similar issues, and we are encouraged to see that these proposed changes recognize this tenet.

Mutual Fund Dealers – Interest Determination and Allocation

We request feedback on the proposed amendments to exempt dealers from the interest requirement in Part 11 of NI 81-102.

We support the removal of the requirement for mutual fund dealers to pay interest to either the fund company or to investors. It appropriately falls within the mandates of the SROs to make rules on these issues. Regulators have had an opportunity to monitor the consequences of the rule and we are in agreement with their observations that the interest amounts are nominal and that the costs of compliance exceed the benefits of meeting the requirement. The removal of the restrictions provides appropriate flexibility regarding how mutual fund dealers conduct their business. In this regard, however, we note that although the commentary that accompanied the Amendment mentions that MFDA members will be exempt from such interest requirement, the proposed change in wording to section 11.4 exempts MFDA members only from sections 11.1 and 11.2, but not specifically from section 11.3(b) with respect to the requirement that a trust account maintained by a principal distributor or participating dealer bear interest at rates equivalent to comparable accounts of the financial institution. This is unlike the proposed amendments to the corresponding MFDA rules[1] that will specifically exempt MFDA members from the requirement that the trust account into which client moneys are deposited bear interest, and from the requirement that all interest earned on cash in such a trust account be paid either to securityholders or, alternatively pro-rata to the mutual fund (currently found in subsection 11.1(4) of NI 81-102).

Therefore, we suggest that the exemption in section 11.4 clearly indicate that MFDA (and IIROC) members are exempted from the interest bearing requirement in section 11.3, or that mention of same be made in the Companion Policy 81-102CP. We further seek confirmation that MFDA members may, at their option, place client moneys into an interest bearing trust account and that if they elect to do so any interest earned can be used to cover any charges imposed by the financial institution against the trust account, contrary to existing section 11.3(c).

We are supportive of the analysis that was used to propose the removal of this requirement and strongly encourage the continued use of meaningful cost benefit analyses on all regulatory initiatives.

[1] We note that the MFDA has proposed similar amendments to MFDA Rule 3.3.2 (*Segregation of Client Property – Cash*) to permit MFDA members to hold client cash for investment in mutual funds together with client cash for other investments. (See MFDA Bulletin #0438 – P issued June 28, 2010).

Part II – Other Comments on the Proposed Amendments

Money Market Funds

As a general matter, we have no concerns with the proposed move into new section 2.18 of the former definition of "money market fund".

However, we do have a concern with the CSA's use of the phrase "readily convertible into cash" in the proposed new liquidity requirement in subsections 2.18(1)(d)(i) and (ii). During the comment period we did verbally request, but have not yet received, clarification of this phrase. This phrase is used uniquely in this section, and is not explained elsewhere in the rule. Our members have advised that essentially every security in a money market fund is "readily convertible into cash". The issue is at what price. The language should have a qualifier that the conversion to cash must be at a fair and reasonable price. In contrast, we note that the similar new requirement adopted in the U.S. uses the concepts of "Daily Liquid Asset" and "Weekly Liquid Asset", essentially being cash, U.S. government securities and securities that will mature or are subject to a demand feature that is exercisable and payable within one business day (or five business days, as the case may be). Subject to our comments with respect to the unproven necessity for any of these additional restrictions, we would suggest that a similar "maturity or demand" test be adopted for any proposed liquidity requirement in section 2.18.

As stated earlier, the CSA's stated ultimate objectives of the proposed amendments and Phase 2 work are to improve i) market efficiency, ii) fairness, and iii) investor protection. Within the context of a **normal** credit environment, with clarified wording as noted above, the proposed mandated higher levels of liquidity would likely work to meet these goals. However, there could be some negative unintended consequences if a fund was mandated to maintain short term maturities and suffered a string of large withdrawals; the new policy would force it to sell longer-dated securities and reinvest the proceeds into shorter-dated securities instead of letting the longer ones roll down in term with the passage of time - in effect this could lock in paper losses that otherwise might not come to be. We are concerned that the CSA is proposing to make changes to the investment restrictions governing mutual funds without providing an explanation of the problems (if any) that the amendments are intended to remedy.

A committee of our members studied the various money market fund proposals that were released in the U.S., and the ultimate money market amending rules enacted by the SEC, and prepared a comparative analysis of the Canadian money market fund product and industry with that in the U.S. The primary purpose was to consider which, if any, of the U.S. proposals might be applicable, relevant or desirable to the Canadian product. Our analysis concluded that none of the U.S. proposals were appropriate for application in Canada.

The U.S. money market fund industry has a significant segment that is institutionally focused (money market funds with primarily institutional investors), and specific liquidity provisions may make more sense when the prospects of large and unexpected redemptions could occur more frequently. In the Canadian context, money market mutual funds are dominated by the retail sector, so that large, unexpected redemptions are much less likely, even at the worst of times. Consequently, requiring, for example, 15% of a portfolio's assets to have a one week maturity is excessive and would be contrary to the best interests of the unitholders as it would result in the fund unnecessarily generating lower returns. The portfolio manager of each fund is in the best position to determine the appropriate maturity and liquidity standards for each fund, based on the fund's (and unitholders') historical and anticipated behavior in the circumstances.

It is clear that Canadian money market funds functioned as designed and withstood the liquidity crisis of 2008-2009 without a single fund "breaking the buck" or otherwise collapsing. This was confirmed earlier this year with the release of OSC Staff Notice 33-733 *(Report on Focused Reviews of Investment Funds, September 2008 – September 2009*), in which the OSC observed that during the review period all Canadian money market funds were able to meet redemption requests, no investments held by the funds defaulted or were written down, and that virtually all funds were in compliance with the securities laws regulating money market funds. As regards liquidity redemption risk, the Report concluded (at page 16):

> "Fund managers did not have issues in meeting redemption requests by fund investors. In addition, they did not foresee issues in meeting future redemption requests given the high level of liquidity of their portfolios."

Accordingly, we are concerned that the CSA is proposing changes, including the new one day (5% of portfolio assets in cash or readily convertible into cash) and weekly (15% of portfolio assets in cash or readily convertible into cash) liquidity requirements, without demonstrating any need for these restrictions. As a result, we fear that these proposals could unintentionally and unnecessarily exacerbate harm to Canadian money market funds, if faced with another liquidity crisis.

For example, currently in Canada there is no market for overnight government deposit instruments. As such, in order for money market funds to meet the daily liquidity requirement they would be forced to maintain at least 5% of their assets continuously as cash on deposit (with minimal or no return and no deposit insurance protection), or invest in commercial paper, bankers' acceptances, and other commercial overnight instruments, or both. We submit that this would be counterproductive in extreme market circumstances and not to the benefit of investors who would suffer even further erosion in their returns (unless they elect to subject themselves to greater exposure to more volatile equity and fixed income markets to counteract the further drag on their portfolios caused by any exposure to money market funds), and could over time result in narrower money market fund selection for investors as managers re-examine the merits of absorbing fund fees and expenses.

Indeed, the overall impact of these proposals will likely direct the focus of money market funds toward shorter-term holdings which will decrease their ability to earn a reasonable return at a time when they can ill-afford to reduce the yield earned on their investments. This could, in turn, actually increase the risk that a fund might 'break the buck', which would negatively impact the CSA's stated objective of improving investor protection.

Accordingly, before the CSA proposes any changes to the investment restrictions applicable to money market funds, we recommend that the CSA establish a working group with industry participation so as to ensure that any proposed changes do not result in unintended harm, or result in Canadian money market funds, if faced with another liquidity crisis, being less able to withstand a similar financial crisis than they did most recently.

Again, should the CSA pursue implementation of any proposed amendments, despite such a dialogue and our written submissions, we would strongly recommend the grandfathering of current holdings or the provision of a transition period of at least one year, in order to allow managers time to revise their portfolios in the normal course of business, to minimize market disruptions and to protect investors from undue volatility in the market place (i.e. volatility due to changing regulatory requirements).

ETFs

Sections 9.1 and 10.2

The CSA has recognized that, in light of the different structures used by exchange-traded mutual funds, certain amendments should be made to reflect the standard relief that the CSA has granted to exchange-traded mutual funds. However, we question why the amendments have not been extended to reflect the standard relief that has been granted from sections 9.1 and 10.2 to permit the purchase and sale of securities of the exchange-traded mutual funds through the facilities of a stock exchange rather than through order receipt offices. We believe that this may have been an oversight, and request that consideration be given to extending the proposals to these two sections.

Subsection 15.3(4) Sales Communication Disclosure

We believe that the requirements under subsection 15.3(4) are too prescriptive in nature and recommend that the additional disclosure set out in the proposed provision be made on the website of the 'mutual fund rating entity' (a term that will now be defined under NI 81-102) instead of in the sales communication itself because this disclosure is very technical and unlikely to be read by the vast majority of investors and is not conducive for use in advertisements or other more time-sensitive sales communications. In practice the requirement to include this disclaimer within the body of advertisements will result in less information been made available to investors as it will be impossible to insert the disclaimer in many media (i.e., T.V. and radio) due to its length and complexity. Instead a reference to where this additional information can be placed is more appropriate should an investor be interested in such information.

The new disclosure requirements under proposed subsection 15.3(4) are very involved and include (among other requirements):

- disclosure of the mutual fund category,
- the number of funds rated in that category, and
- the name of the organization that maintains the category (which may differ from the rating entity).

Therefore, if a fund wishes to provide an overall rating/ranking (which entails providing ratings/rankings for the 1, 3, 5 and 10 (if available) year periods in addition to the overall rating/ranking as required by proposed section 15.3(4)(c)), and, given that fund categories and the number of funds being rated in a category change over time, it appears that the sales communication must disclose the category and number of funds separately for each of these time periods. We seek clarification whether this was the intention of the rule, or whether instead a fund need only disclose the current name and size of the category at the time that the sales communication is first used?

In reviewing the level of information prescribed, while certain requirements clearly make sense to include, such as (e)(i), (iii) and (v), we question whether the other items of information should instead be part of the website disclosure. For example, even though one can include a reference to the rating entity's website for greater detail on methodology, the sales communication must still disclose the key elements of the methodology used by the rating entity to establish the rating or ranking. In terms of a complexity / benefits ratio, we wonder how beneficial this information is to the investor, and whether all aspects of the methodology should instead be left to disclosure on the rating entity's website. Similarly, other required items seem fairly technical, and we believe of limited value to investors.

If the CSA proceeds in the proposed manner, it should consider providing guidance in the accompanying companion policy, such as an illustration of how a typical disclaimer should read. Alternatively, it may be appropriate to simply prescribe substantially the form of how the disclaimer should read in section 15.4 as has been done with other mandated disclaimers.

Part III – Modernization Proposals

Further to our submission on March 23, 2009, which highlighted a series of amendments that the industry requires to provide much needed flexibility, and which will be a step forward in modernizing the NI 81-102 framework of mutual fund regulation, we continue to press for the following critical changes.

ETFs

Section 2.5 of NI 81-102 permits mutual funds to invest in units of other mutual funds, subject to certain restrictions. In particular, clause 2.5(2)(a) requires that the other mutual fund must be subject to NI 81-101 *Mutual Fund Prospectus Disclosure* and NI 81-102 *Mutual Funds*. According to section 1.3 (application) of NI 81-101, mutual funds that are labour-sponsored funds, commodity pools or traded on an exchange are not subject to NI 81-101.

However, an exemption from clause 2.5(2)(a) exists in subsection 2.5(3) of NI 81-102 if the security is an index participation unit issued by a mutual fund. For the purposes of NI 81-102, an index participation unit (IPU) is defined as a security traded on a stock exchange in Canada or the United States and issued by an issuer the only purpose of which is to (a) hold the securities that are included in a specified widely quoted market index in substantially the same proportion as those securities are reflected in that index, or (b) invest in a manner that causes the issuer to replicate the performance of that index. (We acknowledge that the Amendment proposes to extend the definition of an IPU to include securities traded on an exchange in the United Kingdom.) Nevertheless, only ETFs that substantially replicate an index qualify for purchase.

In considering an ETF, the first issue is whether the ETF is a mutual fund (i.e., redeemable on demand based on NAV). In many cases, it is (so that subsection 2.5(2) applies), but sometimes it is not so that often the investment by a fund in an ETF is not subject to the fund-of-fund investment restrictions under section 2.5. This determination can be very time-consuming and is frustrating for both portfolio managers and investors who fail to understand why their funds can invest in some sector specific ETFs (as a means to provide better diversification and risk management through exposure to these sectors in a cost efficient manner), but not others, when the only difference between them is whether the ETF can be directly redeemed for NAV or not.

If the ETF is a mutual fund, however, then a conventional mutual fund cannot invest in it unless the ETF is an IPU. This is because Canadian ETFs fail the test in clause 2.5(2)(a) and non-Canadian ETFs fail the tests in clauses 2.5(2)(a) and 2.5(2)(c). However, if the ETF is an IPU, then there are exceptions to these two requirements (subsection 2.5(3) sets out the exception).

The main issue with an IPU is that it must invest in a manner that replicates the performance of a widely quoted market index. As long as the ETF is positively correlated 1:1 to the index, it will be an IPU. In other words, if the index goes up 2%, the ETF goes up 2%. The issue is that many are not so correlated. They may be "bull" funds, in which case they are positively correlated by more than 1:1 (e.g. if the index goes up 2%, the ETF goes up 4%, and vice versa), or "bear" funds, in which they are negatively correlated (e.g. if the index goes up 2%, the ETF goes down 2%). If an ETF is correlated to a commodity (e.g. a "gold" or "oil" fund), or provides exposure to a sector or geographic area (country or region) that is NOT correlated to an index, then it is not an IPU.

We believe that a result restricting funds from investing in an ETF having other than 1:1 positive correlation to a widely-quoted market index is far too restrictive, as is the case where the ETF provides exposure to a sector not represented by a widely quoted market index. We submit that the concerns about undue leverage risk can be adequately addressed by managers through application of the existing provisions in subsections 2.1(3) and (4) of NI 81-102, together with an extension of the cash cover requirements in section 2.8 and/or the short-sale conditions proposed by the Amendment, as applicable depending upon whether the ETF is a “bear” fund or not.

Additionally, we note that relief was granted allowing funds to invest up to 10% of net assets in exchange-traded commodity pools that correlate to a multiple (or inverse multiple) of the performance of an underlying index, and which are not subject to NI 81-101 (subject to certain restrictions)[2]. Since the CSA has consistently granted this relief with these conditions, we request that this relief for leveraged ETFs be codified.

With respect to investments generally by funds in ETFs, we recommend that the CSA eliminate the technical distinction relating to whether or not the ETF falls within the definition of a ‘mutual fund’, and instead allow funds to invest in them as they would any other exchange traded issuer. In this regard we note that concerns related to ‘cascading redemptions’ from bottom funds to top funds do not exist in the case where the bottom fund is an ETF, and that any concentration

[2] See for example the Passport System Relief obtained by AGF Funds Inc. issued by the OSC as Principal Regulator on June 11, 2010.

concerns can be dealt with through compliance with the current concentration restrictions imposed by section 2.1 of NI 81-102.

Section 2.1 – Concentration Restriction

We request that section 2.1 be amended in order to permit a fund to invest up to 35% of its assets in countries with "AAA" rated debt, and up to 20% in countries with "AA" rated debt. This is an area in which exemptive relief has previously been granted on numerous occasions for many global bond funds.

The current rule leads to anomalous results. As an example, consider that Japan currently has a "AA" rating. Under the current rule:

- any fund can place 100% of its assets in Canadian Government/Provincial debt which is rated lower than Japan;
- in 2006, Japanese debt comprised almost one-third of total world government debt. Global bond funds need increased flexibility to increase their holdings to better manage index weightings;
- should Japan default on its debt there is likely a much more significant problem with world capital markets. In this case, the concentration restriction is not an effective protection; and
- a fund may invest in 10 different countries with debt ratings well below "AA" without problem, including any of the 13 countries that make up the European Union, all of whose economies are subject to the same common market monetary policies (i.e., they are all governed by the European Central Bank and thus are not unlike a single country investment).

Fund-on-Fund-on-Fund Structures

The issue of fund-on-fund-on-fund structures is an important reform to the mutual fund framework that we believe would be beneficial to investors, reducing the need and administrative cost to have duplicative portfolios. We are pleased to see some recognition of this with respect to the proposal to extend the exemption for investments in RSP clone funds to other clone funds. As well, CSA members have already recognized a number of three-tiered fund structures by granting exemptive relief enabling such structures for foreign currency hedging, money market exposure and tax efficient investing. [3]

In 2003, amendments to NI 81-102 (the "Fund on Fund Amendments") were implemented to permit mutual funds to invest their assets in other mutual funds, subject to certain conditions and eliminating the requirement to obtain exemptive relief for such arrangements. While we recognize that the Fund on Fund Amendments have been a great benefit to the mutual fund

[3] See for example *Re NexGen Financial Limited Partnership*, March 6, 2008 (31 OSCB 3017), *Re Fidelity Investments Canada Ltd.*, March 20, 2007 (30 OSCB 3160), *Re Mackenzie Financial Corp.*, November 11, 2008 (31 OSCB 11741).

industry and to investors, we believe it is time for the Fund on Fund Amendments to be reviewed to determine whether they have provided the industry with an appropriate level of flexibility. Portfolio solutions make up a significant portion of the Canadian fund industry with 20% of mutual fund assets (as of August 2010) being held in fund on fund structures in Canada. This investment product type has been particularly popular with investors for some time with fund-of-fund sales over the last 12 months totaling $16.8 billion compared to $13.6 billion in net redemptions for traditional stand-alone fund products. Even in 2008, despite the downturn in equity markets worldwide, fund-of-funds attracted $3.2 billion in new sales. This was in stark contrast to other types of mutual funds which saw substantial outflows during the year.

In order to provide fund managers with greater flexibility in this fast-growing segment, and to provide investors with the most efficient and broadest range of investment options, our view is that the restrictions on fund on fund arrangements should be re-considered.

Three-Tiered Structures

Currently, provision 2.3(2)(b) of NI 81-102 prohibits a mutual fund from investing in another mutual fund (an "underlying fund") if the underlying fund holds more than 10% of its net assets in securities of other mutual funds. We would like to explore the removal of this restriction in its entirety as it limits structuring options and the types of portfolio funds that can be offered to investors, while offering investors no meaningful benefits or protections. There are circumstances where a three-tiered structure provides improved diversification for investors and provides managers with more flexibility and efficiencies in structuring portfolio solutions. Subsection 2.5(2) provides investors with protection from paying duplicative management fees, sales charges and redemption fees. An underlying fund that invests in other mutual funds would be subject to the requirements of section 2.5; adding a further fund above the underlying fund poses no harm or added risk to investors, would not create added organizational complexities and would not permit the layering of fees.

Sections 4.2 and 4.3 (Self-Dealing and Exception)

As noted in the September 2008 issue of *The Investment Funds Practitioner* published by the OSC[4], exemptive relief has been granted to facilitate a mortgage fund's purchase of mortgages from a related party that was pooling mortgages for the purpose of transferring them to the mutual fund. Relief was granted based on Independent Review Committee (IRC) approval and valuation of the mortgages in a manner satisfactory to Commission staff. Given that mortgage securities do not trade on the secondary market and therefore the price payable for securities are not reported on a public quotation system, we request that the rule codify the exemptive relief granted.

Also, we note that the relief available under subsection 4.3(1) requires that the bid and ask prices for the security be reported on a public quotation system in common use and, likewise, that the relief under subsection 4.3(2) refers to IRC approval pursuant to subsection 6.1(2) of NI 81-107 *Independent Review Committee for Investment Funds* which, in turn, references the bid and ask

[4] (2008) 31 OSCB 9119.

price (and fair market price) of the security. Often a mutual fund may wish to trade in a security for which bid and ask prices are not publicly available, but for which the current fair market valuation may be readily obtained (such as through an independent arm's length valuation or appraisal). Accordingly, we ask that the exemptions under section 4.3 be expanded to recognize that where a bid and ask price is not publicly quoted for a security, that the self dealing rules be exempted if the IRC recommends the transactions based on an independent 3rd party arm's length valuation.

For pooled funds, we recognize that they are not required to have an IRC under NI 81-107. However, where pooled funds do set up an IRC that is compliant with NI 81-107, it would be appropriate that the exception above also should be available to pooled funds under these provisions.

Sections 2.5(7) (Exemption from Mutual Fund Conflict of Interest Investment and Reporting Rules)

We note that in *The Investment Funds Practitioner* published in January 2010[5], the OSC indicated that it would seek to amend NI 81-102 'at the next available opportunity' to confirm that subsection 2.5(7) would apply so that funds would not need to seek additional relief from the mutual fund conflict of interest investment restrictions or the mutual fund conflict of interest reporting requirements in circumstances where a fund had obtained relief from any of the fund-of-fund investment requirements in section 2.5, but it does not appear that this has been followed-up in the Amendment.

Disclosure Reform

We would like to take this opportunity to highlight the CSA's undertaking to rationalize the continuous disclosure requirements, particularly in light of the proposed introduction of the Fund Facts document. In September 2009, IFIC presented to the CSA Investment Funds Committee detailed proposals for meaningful disclosure reform. At that time, members of the Committee expressed their initial views that the disclosure regime could be modernized in light of the expected introduction of a Fund Facts document. IFIC advised that a major structural change that should be considered would be to combine the Simplified Prospectus with the Annual Information Form into an Expanded Prospectus, and from there, review specific disclosure requirements with a view to rationalizing the disclosure regime.

It is our understanding that limited resources have prevented the CSA from undertaking this review. Nevertheless, we urge that this initiative be afforded higher priority in conjunction with the proposed changes to NI 81-102 (and consequential amendments to NI 81-106 and NI 81-101) so that materials prepared for investors, regulators and analysts are consistent, meaningful and have undergone a thorough cost / benefit analysis.

[5] (2010) 33 OSCB 8.

We would be pleased to provide further information or answer any questions you may have – please contact me directly or Ralf Hensel, General Counsel at 416-309-2314 or at rhensel@ific.ca.

Yours truly**,**

THE INVESTMENT FUNDS INSTITUTE OF CANADA

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