phase 2 of the modernization of investment fund product regulation project – mutual funds

CSA proposes further amendments to the regulation of open-end mutual funds

This is the second in a series of McMillan bulletins relating to the Canadian Securities Administrators project to modernize the regulation of publicly offered investment funds. The bulletins will separately address how the modernization project affects different types of investment fund products. This bulletin will focus on the proposed changes affecting open-end mutual funds as well as highlight the principal changes implemented in Phase 1 of the Modernization Project. Future bulletins will focus on non-redeemable investment funds (or closed-end funds) and commodity pools and other non-traditional investment funds (or alternative funds, as they are proposed to be renamed).

On March 27, 2013, the Canadian Securities Administrators (CSA) published for comment proposed changes to the regulatory regime governing investment funds pursuant to Phase 2 of its Modernization of Investment Fund Product Regulation Project (the Modernization Project). The Modernization Project is a two-phase project the mandate of which is to review the regulation of publicly offered investment funds. The overall objective of Phase 2 of the Modernization Project is to address market efficiency, investor protection and fairness issues that arise out of the regulatory requirements applicable to different types of investment funds.

In the first stage of Phase 2, the CSA have proposed certain amendments to National Instrument 81-102 *Mutual Funds* (NI 81-102) aimed at bringing certain non-redeemable investment funds into the regulatory framework that governs open-end mutual funds. The proposed amendments to NI 81-102 introduce core operational requirements and investment restrictions that did not previously exist for closed-end funds. The CSA also seek feedback on an "alternative fund framework" that would see changes in National Instrument 81-104 *Commodity Pools* (NI 81-104), which currently governs commodity pools, to broaden the scope of NI 81-104 to a wide variety of alternative investment funds. The proposed Phase 2 amendments also impact open-end mutual funds as more particularly set out in this bulletin.

In the final stage of Phase 2, the CSA intend to specifically review the investment restrictions applicable to open-end mutual funds under NI 81-102 to assess if any additional changes should be made.

proposed phase 2 amendments that impact mutual funds

securities lending, repurchases and reverse repurchases – what are they exactly?

The CSA have proposed amendments to NI 81-102 that would limit the amount of securities loaned or sold in securities lending, repurchase and reverse repurchase transactions by a mutual fund to 50% of the net asset value of the fund, rather than the current 50% of the total assets of the fund (excluding collateral). As a result of the proposed amendments, investment funds subject to NI 81-102 would be unable to include any borrowed funds or portfolio assets purchased with borrowed funds in determining the maximum value of securities that may be loaned or sold in connection with such transactions. The impact of these proposed amendments may be considerable for open-end mutual funds, even though they are generally not permitted to borrow cash except for specified purposes. Such funds will have liabilities, such as accrued fees for service providers, resulting in a much lower limit for these transactions when net asset value is utilized in the calculation instead of total assets. The impact would be even greater, however, for investment funds that are permitted to borrow cash (such as closed-end funds[1]), as the changes will reduce the amount of securities available to be loaned or sold by the liabilities of the investment fund and by the amount of leverage they employ.

As a general matter, the CSA expressed concern about the lack of transparency of the benefits, costs and risks of securities lending, repurchase and reverse repurchase transactions, given that in some cases the investment fund's financial statements do not disclose the amount of revenue paid to the lending agent and the costs of conducting these activities. The CSA feel that investors require this information to properly understand and assess the returns from transactions such as securities lending, and how the revenue has contributed to the overall performance of the fund.

For this reason, the CSA are seeking feedback on recommended approaches to ensure that financial statements of an investment fund provide adequate disclosure about the revenue and costs of securities lending transactions, including the share of revenue paid to the lending agent. Specifically, the CSA have requested comments on various measures that they propose to require as additional disclosure in an investment fund's management reports of fund performance, as well as the usefulness of adding the lending agent to the list of service providers detailed in an investment fund's prospectus or annual information form and information on indemnities obtained by an investment fund from the lending agent. The CSA also seek feedback on whether the

[1] Under the Phase 2 amendments it is proposed that closed-end funds will become subject to NI 81-102 and be permitted to borrow cash to a maximum of 30% of their net asset value.

agreements entered into between an investment fund and a lending agent should be required to be filed on SEDAR.

potential restructuring obstacles – extra securityholder approval and costs

The CSA have proposed an amendment to NI 81-102 that would broaden securityholder approval requirements for a merger of a mutual fund with any other issuer, rather than only requiring such approval for a merger with another mutual fund.

The CSA have also proposed a new requirement that a mutual fund obtain prior securityholder approval for a change in the nature of the fund from a mutual fund to a closed-end fund (and *vice versa*) and from an investment fund to an issuer that is not an investment fund. The proposed provision would also prohibit the fund from bearing the costs of such a restructuring transaction, including the cost of obtaining securityholder approval and, if applicable, the cost of filing a prospectus to commence continuous distribution. The CSA take the position that since reorganizations and restructurings permit managers to retain the fund's assets under management, these transactions are beneficial to managers and, accordingly, the managers should bear the costs of such transactions.[2]

The CSA have proposed an exemption from the securityholder approval requirements for closed-end funds that are structured from inception to convert to open-end mutual funds, provided certain disclosure requirements in the fund's prospectus and sales communications are satisfied and securityholders are sent a notice at least 60 days prior to the conversion.

The CSA have also proposed an exemption from securityholder approval requirements for closed-end funds structured as flow-

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[2] Previous exemption orders have provided as a condition to relief that all costs of effecting a merger had to be borne by the manager and not the funds, suggesting that the CSA proposal is a codification of current practice.

through limited partnerships that effect rollovers to open-end mutual funds, provided that, among other things, the fund does not bear any costs of the transaction and the consideration offered to securityholders is equal to the net asset value of the fund.

Another new requirement proposed by the CSA is that the consideration offered to securityholders of an investment fund in connection with a merger of the fund that is effected without prior securities regulatory approval must have a value that is equal to the net asset value of the fund. Managers should keep this new requirement in mind if mergers are intended to be effected in reliance on the exemption from prior securities regulatory approval contained in section 5.6 of NI 81-102.

no new warrant offerings

The proposed amendments would also contain a new prohibition on the issuance of warrants and similar securities by investment funds. While this is primarily directed toward closed-end funds since they are not in continuous distribution, there are some investor protection concerns that the CSA have expressed with respect to warrant offerings generally, including with respect to mutual funds. Among other things, concerns have been expressed that: (i) warrants may be dilutive if not exercised, resulting in a loss of value on the units; (ii) warrants are automatically issued, and thus may be coercive to securityholders who are forced to participate or face dilution; and (iii) a possible conflict of interest exists between the manager and the securityholders, because the manager gets paid based on assets under management (and as a result, the warrant issue only benefits the manager without a corresponding benefit to unitholders). The CSA have stated that a restriction on warrant offerings would not unduly limit the ability of managers to raise additional money, as they will still be able to file a prospectus to reopen a fund or provide for distribution of additional securities.

what we can learn from phase 1 of the modernization project

It is useful to examine the context of the proposed amendments (and the willingness of the regulators to accept comments on certain amendments) as a follow-on to changes already considered and made to NI 81-102 (as well as consequential amendments[3]). These prior changes were introduced in Phase 1 of the Modernization Project, the majority of which came into force on April 30, 2012. In Phase 1, the CSA focused on codifying exemptive relief that had been frequently granted to open-end mutual funds under NI 81-102 in recognition of market and product developments and to keep pace with developing global standards.[4] The following is a summary of some of the key changes affecting open-end mutual funds already in place resulting from the Phase 1 amendments.

short-selling securities

Notably, the Phase 1 amendments permitted mutual funds to short sell securities subject to a cap of 20% of their net asset value, provided that the securities are sold for cash and are not illiquid assets or securities issued by an investment fund (other than index participation units, which are permitted). The market value of securities of any one issuer sold short by a mutual fund cannot exceed 5% of its net asset value. A mutual fund must also maintain cash cover of at least 150% of the market value of all securities sold short. The range of permitted cash cover was expanded by revising the definition of NI 81-102 to include securities of money market funds and certain floating rate notes.

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[3] Phase 1 of the Modernization Project included amendments to NI 81-102, National Instrument NI 81-106 *Investment Fund Continuous Disclosure* (NI 81-106), National Instrument NI 81-101 *Mutual Fund Prospectus Disclosure* (NI 81-101) and National Instrument NI 41-101 *General Prospectus Requirements* (NI 41-101).

[4] The Phase 1 amendments included significant changes to the regulation of exchange traded funds (ETFs) and money market funds that are not covered in this bulletin as it is focused on conventional open-end mutual funds.

The CSA indicated that the cash cover requirement is intended to be consistent with IIROC dealer-member rules and similar U.S. requirements.

In response to a comment that the cap on short selling does not include a look-through provision, the CSA stated that a mutual fund is not required to look through to short sale exposure in an underlying fund, which is consistent with the fund of fund requirements in NI 81-102 that do not look-through to investments of an underlying fund. The CSA stated that the fund-of-fund provisions are based on the view that the top fund is holding securities of an underlying fund just as it would hold any other investment and gave the example of not looking through to the business assets of corporate issuers in which a fund may invest.

Phase 1 also introduced custodial requirements relating to short sales that restrict the market value of the portfolio assets deposited by a mutual fund with a borrowing agent (other than the fund's custodian) to 10% of its net asset value. In addition, a mutual fund cannot deposit portfolio assets with a dealer in Canada unless such dealer is registered and a member of IIROC. Outside Canada, the dealer must be a member of a stock exchange and have a net worth of at least $50 million.

objective disclosure

New requirements were introduced to ensure that mutual fund ratings and rankings used in sales communications are objective and to minimize the risk that the public may be misled. The amendments require a mutual fund to disclose the category and number of funds separately for each period of standard performance data and the CSA encouraged fund managers to consider presenting the disclosure in tabular or other format that displays the required information clearly and concisely. The CSA stated that these new disclosure requirements are consistent with those mandated under similar U.S. rules governing the use of mutual fund ratings in retail communications.

Amendments in Phase 1 also introduced a requirement that an investment fund make its net asset value and net asset value per security readily available to the public at no cost, in order to make it easier for current and prospective investors to access that information. The amendments further required that an investment fund that sells securities short calculate its net asset value on a daily basis. In response to a commenter's concern that there would be significant costs of system changes to post net asset value information on a website daily, the CSA stated that the amendments do not necessarily equate to an obligation to disseminate information on a website and that the manager may select the means through which it intends to make the required information available to the public at no cost.

Such a stance on disclosure might signal that the regulators will not be receptive to arguments to the effect that increased disclosure, particularly proposed disclosure with respect to securities lending and similar transactions, would be too costly for managers to implement.

fund-of-fund investments

Phase 1 resulted in amendments that provided managers with greater flexibility in structuring so-called "three-tiered" fund-of-fund structures. The change provided an exemption from the general prohibition on investing in a mutual fund that holds more than 10% of its net assets in other mutual funds, provided that the other mutual fund is a "clone fund". A "clone fund" is defined as a mutual fund whose investment objective is to track the performance of another mutual fund. The CSA expressed the view that tracking the performance of another mutual fund did not necessarily equate to replicating it, as it allows for minor variances in performance of the clone fund and the fund being tracked, such as on account of the use of derivatives or other investment strategies for a specified purpose. The CSA indicated that the exemption is sufficiently broad to permit the use of derivatives to maintain a currency hedge.

Phase 1 also resulted in changes that allow a clone fund to suspend redemptions when the underlying fund whose performance it is tracking has suspended redemptions.

Although some structuring flexibility was provided as described above, the CSA explicitly stated that they did not intend to make any similar changes that would permit mutual funds to invest in privately offered pooled funds managed by the same portfolio manager.

conflicts of interest

The CSA added guidance in the Companion Policy to NI 81-102 to confirm that a mutual fund that obtains exemptive relief from the fund-of-fund restrictions can also rely on the exemption contained in NI 81-102 from the conflict of interest investment restrictions and reporting requirements for funds that comply with such restrictions.

index participation units

It may be of interest that in the initial Phase 1 proposal, the CSA considered expanding the definition of "index participation units" under NI 81-102 to include those traded on a stock exchange in the United Kingdom (in addition to those in Canada and the U.S.). However, the CSA decided not to proceed with this amendment, citing regulatory concerns regarding European ETFs and the inability to easily expand the list of markets from time to time. The CSA stated they would continue to deal with investments in foreign ETFs on an exemptive relief basis.

next steps

The deadline for submitting comments to the CSA on the proposed amendments in Phase 2 is **June 25, 2013**. Please contact one of the authors of this bulletin listed below or another member of our Investment Funds & Asset Management Group if you have any questions or seek assistance with the preparation of a comment letter relating to these proposals.

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a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.