NOTICE OF RULES AND POLICIES MADE UNDER THE SECURITIES ACT

AMENDMENTS TO
NATIONAL INSTRUMENT 81-102
AND COMPANION POLICY 81-102CP
MUTUAL FUNDS

AND TO
NATIONAL INSTRUMENT 81-101
AND COMPANION POLICY 81-101CP
MUTUAL FUND PROSPECTUS DISCLOSURE

AND TO
FORM 81-101F1
CONTENTS OF SIMPLIFIED PROSPECTUS

AND TO
FORM 81-101F2
CONTENTS OF ANNUAL INFORMATION FORM

Notice of Rules and Policy

The Commission has, under section 196.1 of the *Securities Act* (Alberta) (the "Act"), made rules (collectively, the "Rule Amendments") that amend the following instruments (the "Existing Rules"):

1. National Instrument 81-101 Mutual Fund Prospectus Disclosure (NI 81-101),

2. Form 81-101F1 Contents of Simplified Prospectus (Form 81-101FI),

3. Form 81-101F2 Contents of Annual Information Form (Form 81-101F2), and

4. National Instrument 81-102 Mutual Funds (NI 81-102).

The Commission has also adopted policies (collectively, the "Policy Amendments") that amend the following policies of the Commission (the "Existing Policies"):

1. Companion Policy 81-101CP to National Instrument 81-101 Mutual Fund Prospectus Disclosure (CP81-101); and

2. Companion Policy 81-102CP to National Instrument 81-102 Mutual Funds (CP81-102).

The Rule Amendments will come into force on May 2, 2001. The date that the Rule Amendments come

into force is referred to in this Notice as the effective date of the Rule Amendments. The Policy Amendments will come into force on the effective date of the Rule Amendments.

In this Notice, the Rule Amendments and the Policy Amendments will be referred to collectively, as the Amendments.

The Amendments are initiatives of the Canadian Securities Administrators ("CSA"). The Rule Amendments have been, or are expected to be, adopted as rules in each of British Columbia, Alberta, Manitoba, Ontario and Nova Scotia, a Commission regulation in Saskatchewan, and policies in all other jurisdictions represented by the CSA. The Policy Amendments have been, or are expected to be, implemented as policies in all of the jurisdictions represented by the CSA.

Background

The CSA published drafts of the Amendments for comment in two separate Notices of Proposed Amendments, published in Alberta on:

- January 28, 2000[1] (the "January Draft Amendments"); and
- June 16, 2000[2] (the "June Draft Amendments").

The January Draft Amendments dealt primarily with the CSA's proposal to permit mutual funds to enter into securities lending, repurchase and reverse repurchase transactions. The June Draft Amendments proposed changes to permit index mutual funds to better meet their investment objectives, but also proposed changes to the calculation of the management expense ratio of mutual funds, amongst other housekeeping changes.

The Notices of Proposed Amendments published with the January Draft Amendments and the June Draft Amendments provide background for the Amendments and describe the changes proposed to be made to the Existing Rules and the Existing Policies and the reasons for such changes.

The comment periods for the January Draft Amendments and the June Draft Amendments ended on April 30, 2000 and September 14, 2000, respectively. The CSA received a number of submissions on each of the January Draft Amendments and the June Draft Amendments. The CSA have considered the comments provided in these submissions and their decisions regarding these comments are reflected in the Amendments. Changes have been made from the January Draft Amendments and the June Draft Amendments in response to comments received.

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1 (2000) 9 ASCS 317.

2 (2000)9 ASCS 2190.

The CSA are of the view that none of the changes made from the January Draft Amendments and the June Draft Amendments are material within the meaning of securities legislation. Accordingly the Amendments are not subject to a further comment period.

Since the CSA are not making any material changes from the January Draft Amendments or the June Draft Amendments, these two rule and policy amendments have been combined into the Amendments. The Amendments should be read with the Existing Rules and the Existing Policies, as amended.

Appendix A to this Notice lists the commentators on each of the January Draft Amendments and the June Draft Amendments. Appendix B provides a summary of the comments received on the January Draft Amendments and the response of the CSA to those comments. Appendix C provides this information for the June Draft Amendments.

This Notice summarizes the changes to the January Draft Amendments and the June Draft Amendments made in response to comments received and as a result of further consideration of the applicable proposed rules and policies by the CSA.

Substance and Purpose of the Amendments

The purpose of the Amendments is to:

- allow mutual funds to enter into securities lending, repurchase and reverse repurchase transactions on a basis that the CSA believe is appropriate to both ensure investor protection and permit mutual funds to realize the potential benefits of these transactions for their securityholders;

- permit index mutual funds to better achieve their investment objectives by allowing them to track their target indices without concentration limits, provided certain disclosure requirements are adhered to; and

- make various housekeeping amendments to the Existing Rules and the Existing Policies to address issues that were brought to the attention of the CSA when they were finalizing the Existing Rules and the Existing Policies in late 1999 and since those rules and policies came into force on February 1, 2000.

The Notices of Proposed Amendments published with the January Draft Amendments and the June Draft Amendments contain a complete description of the substance and purpose of the Amendments.

Transitional Matters

The Investment Funds Institute of Canada has asked the CSA, on behalf of its members, whether the CSA would object if mutual funds gave the notices required by the Amendments to permit those mutual funds

to engage in securities lending transactions, repurchase agreements and reverse repurchase agreements, after the date the CSA have made the Amendments, but before they become effective. Similar questions have been asked on behalf of index mutual funds wishing to take advantage of the concentration restriction exemptions provided in the Amendments once the Amendments come into force.

The CSA note that the Amendments do not prescribe that the required notices be given only once the Amendments become effective. If this were the result, the CSA note that mutual funds would be obliged to wait 60 days before engaging in these transactions following the coming into force of the Amendments.

Provided the content of the notices conform with the requirements set out in the Amendments and investors are informed that a mutual fund will engage in these transactions only if and when the Amendments come into force, the CSA will consider the notices properly given if given before the coming into force of the Amendments. Since the coming into force of the Amendments is dependent, in Ontario and British Columbia, on government approval, the CSA recommend that the notices clarify this point.

The CSA also will not object to mutual funds wishing to amend their prospectuses to provide the required disclosure, provided clear disclosure is given of the status of (i) the funds' ability to engage in these transactions and (ii) the coming into force of the Amendments.

Summary of Changes to the Amendments from the January Draft Amendments and June Draft Amendments

This section describes changes made in the Amendments from the January Draft Amendments and the June Draft Amendments except that changes of a minor nature, or those made only for purposes of clarification or drafting reasons, are generally not discussed. For a detailed summary of the contents of the January Draft Amendments and the June Draft Amendments, reference should be made to the Notices published with those proposed amendments.

Rule Amendment to NI 81-102

Section 1.1 - Definitions

"permitted index"

The June Draft Amendments proposed a new definition of "permitted index" in connection with the proposed rules relating to index mutual funds. The CSA have amended this definition from the June Draft Amendments by deleting the requirement that a permitted index be one that is "widely quoted". Instead, the definition now provides that a permitted index must be one that is either (a) both administered by an organization that is not affiliated with any of the mutual fund, its manager, its portfolio adviser or its principal distributor and available to persons or companies other than the mutual fund, or (b) one that is widely

recognized and used. This change was made in response to concerns surrounding the potential ambiguity of the words "widely quoted". The CSA are of the view that an index which is widely recognized and used, but which may not be widely quoted by the media, should not be prevented from qualifying as a "permitted index".

"qualified security"

The January Draft Amendments proposed a new definition of "qualified security" in connection with the securities lending, repurchase and reverse repurchase transaction rule amendments. The CSA have amended this definition from the January Draft Amendments. The CSA agree with commentators that commercial paper and debt of Canadian financial institutions where the issuer or guarantor of such securities has an approved credit rating can constitute acceptable collateral for securities lending. Firstly, this change will permit mutual funds to accept collateral that is currently permitted as eligible collateral in the guidelines for securities lending for pension plans and life insurance companies (the "OSFI Guidelines") developed by the Office of the Superintendent of Financial Institutions ("OSFI")[3]. The CSA are of the view that the collateral for these transactions remain limited to securities which are sufficiently liquid and secure while being consistent with current practices for institutional lenders in Canada. Secondly, the change will also allow mutual funds more flexibility in how the cash collateral, or sale proceeds from a repurchase transaction, can be reinvested, since such reinvestment can only be in qualified securities. Thirdly, the change will allow more flexibility in the securities which may be purchased by a mutual fund under a reverse repurchase transaction.

Section 2.1 - Concentration Restriction

The June Draft Amendments proposed new subsections (5), (6) and (7) of section 2.1 to provide an exemption from the concentration restrictions for index mutual funds, as defined by the June Draft Amendments.

Subsection (6) has been amended from the June Draft Amendments in two ways. Firstly, to clarify that an index mutual fund can only rely on the relief provided by subsection (5) if it includes the disclosure required by subsection (5) of Item 6, as well as the disclosure required by subsection (5) of Item 9, both of Part B to Form 81-101F1. Subsection (6) of section 2.1 as drafted in the June Draft Amendments did not specifically refer to subsection (5) of Item 6. This was an oversight since the June Draft Amendments clearly proposed that this disclosure be included in the simplified prospectus of an index mutual fund.

Section 2.12 - Securities Loans

The January Draft Amendments proposed a new section 2.12 which contained the conditions to be satisfied

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[3] OSFI Guidelines Pensions B-4 Securities Lending - Pension Plans (February 1992) and OSFI Guidelines Life Insurance Companies B-4 Securities Lending (February 1997).

by a mutual fund in order for it to enter into a securities lending transaction as lender.

Three changes have been made to section 2.12 from the January Draft Amendments.

Firstly, paragraph 6 of subsection 2.12(1) has been amended to permit specified irrevocable letters of credit as acceptable collateral for a securities lending transaction. Letters of credit must be issued by a Canadian financial institution with an approved credit rating as defined in NI 81-102. Letters of credit issued by the counterparty, or an affiliate of the counterparty, of the mutual fund in the transaction will not be acceptable collateral. The CSA understand that letters of credit are eligible collateral under the OSFI Guidelines and for mutual funds in the United States for securities lending transactions. The CSA's views on the prudent use of letters of credit as collateral have been added in subsection 3.6(4) of the Policy Amendments relating to CP81-102.

Secondly, paragraph 12 of subsection 2.12(1) has been amended to clarify the aggregate lending/repurchase transaction limit. The CSA have simplified this limit to be 50 percent of the total assets of a mutual fund (*without* including the collateral) in response to some apparent confusion on the calculation methodology contained in the January Draft Amendments. The January Draft Amendments followed the model for U.S. mutual funds whereby mutual funds are permitted to lend up to 33 - 1/3 percent of total assets *including* the collateral received from the borrower. The new limit of 50 percent without counting the collateral received is substantively similar to the 33 - 1/3 percent restriction in the U.S. model, but the CSA consider that the revised limit is easier to understand.

Thirdly, clause 2.12(2)(a) has been amended to permit a mutual fund to reinvest any cash collateral received in qualified securities with a term to maturity no longer than 90 days. The January Draft Amendments essentially limited reinvestment of cash collateral to overnight investments. After reviewing the comments received on this issue, the CSA are of the view that this restriction was not commercially practicable. The Amendments allow lending agents to invest any cash collateral on a portfolio basis within the term to maturity restriction. The CSA believe that this change will allow for investment diversification while continuing to restrict investments to secure, liquid and short-term instruments.

Similarly, clause 2.12(2)(b) has been amended to allow a mutual fund to invest cash collateral received from securities lending transactions, in reverse repurchase transactions as permitted by section 2.14. Under clause 2.12(2)(b) of the January Draft Amendments, a mutual fund was limited to reinvesting its cash collateral in overnight reverse repurchase transactions. This result was not intended by the CSA.

Section 2.13 - Repurchase Transactions

The January Draft Amendments proposed a new section 2.13 which contained the conditions to be satisfied by a mutual fund in order for it to enter into a repurchase transaction as lender.

Three changes have been made to section 2.13 from the January Draft Amendments.

Firstly, paragraph 10 of subsection 2.13(1) has been amended to permit repurchase transactions with a maximum term of 30 days. After reviewing the comments, the CSA are of the view that the maximum term of five business days proposed in the January Draft Amendments was overly restrictive and the amendment is more reflective of commercial realities for these transactions. This change will allow mutual funds to reduce the administrative costs of entering into new repurchase transactions on a weekly basis.

Secondly, paragraph 11 of subsection 2.13(1) has been amended to clarify the aggregate lending/repurchase limit in a manner identical to that described above in respect of section 2.12.

Thirdly, clause 2.13(2)(a) has been amended to permit a mutual fund to reinvest cash sale proceeds in qualified securities with a maximum term to maturity of 30 days. This change mirrors the change to paragraph 10 of subsection 2.13(1) which permits a mutual fund to enter into a repurchase transaction with a term of up to 30 days. A mutual fund will have the added flexibility to invest the cash sales proceeds from a repurchase transaction in 30 day debt instruments which may be more liquid, provide better returns to the fund and provide for additional diversification.

Similarly, clause 2.13(2)(b) has been amended to remove the requirement that reverse repurchase transactions entered into with sales proceeds must have "a term to maturity no longer than the term of the repurchase transaction". As with the change to clause 2.12(2)(b), a lending agent is permitted to manage the reinvested cash, subject to the restrictions that any reverse repurchase transaction must be permitted by section 2.14.

Section 2.14 - Reverse Repurchase Transactions

The January Draft Amendments proposed a new section 2.14 which contained the conditions to be satisfied by a mutual fund in order for it to enter into a reverse repurchase transaction.

Section 2.14 has been changed in two ways from the January Draft Amendments.

Paragraph 3 of subsection 2.14(1) has been amended to delete the restriction on the term to maturity of the qualified securities purchased by the mutual fund under a reverse repurchase transaction. The CSA are of the view that the current restrictions, including: (i) the maximum term of the reverse repurchase transaction; (ii) the over-collateralization requirement; (iii) the daily marking to market of collateral and (iv) the definition of qualified securities adequately address the risks that this restriction was intended to deal with.

Paragraph 9 of subsection 2.14(1) has been amended to increase the maximum term of a permitted reverse repurchase transaction to 30 days (from five business days). As discussed above in the context of repurchase agreements, the CSA are of the view that the maximum term of five business days in the January Draft Amendments was overly restrictive.

Section 2.15 - Agent for Securities Lending, Repurchase and Reverse Repurchase Transactions

The January Draft Amendments proposed a new section 2.15 which contained the requirements relating to the use of an agent by a mutual fund to administer its securities lending, repurchase and reverse repurchase transactions.

Subsection 2.15(4) of the January Draft Amendments has been deleted, as have requirements that the manager of a mutual fund have reasonable grounds for believing that the mutual fund's custodian or sub-custodian is competent to act as an agent. The CSA have deleted these provisions since in their view the requirements did not add substantively to the existing legal framework for mutual fund managers in appointing agents for mutual funds. A discussion of the CSA's views regarding the appointment of lending agents has been added to subsection 3.6(12) of the Policy Amendments to CP81-102.

Section 2.16 - Controls and Records

The January Draft Amendments proposed a new section 2.16 which imposed reporting and review requirements on both the agent and the manager of a mutual fund.

Clause 2.16(2)(c) is new. The CSA have added this provision to highlight the need for agreed upon collateral diversification standards when running a securities lending program. Collateral diversification standards help to minimize a mutual fund's exposure to any one issuer's securities in the event of a borrower default where the mutual fund is required to realize on the collateral received from that borrower.

Section 2.17 - Commencement of Securities Lending, Repurchase and Reverse Repurchase Transactions by a Mutual Fund

Subsection 2.17(2) is new. This subsection clarifies that mutual funds that have entered into reverse repurchase transactions prior to the effective date of the Amendments pursuant to decisions of the securities regulatory authorities are not required to provide notice to securityholders of their intention to continue to enter into such transactions after the effective date of the Amendments. The CSA consider that these mutual funds have given their securityholders adequate notice of their reverse repurchase transactions practices.

Part 5 - Fundamental Changes - Sections 5.5, 5.6 and 5.9

The CSA proposed to amend section 5.5 in the June Draft Amendments through the addition of subsection (3) to permit the same procedures for securities regulatory approvals under Part 5 of NI 81-102 as are permitted for exemptions under section 19. In finalizing the Rule Amendments, the CSA noted that other sections in Part 5 needed to reflect this decision and accordingly the words "or regulator" have been added

to sections 5.5, 5.6 and 5.9 where appropriate.

Section 6.8 - Custodial Provisions relating to Derivatives and Securities Lending, Repurchase and Reverse Repurchase Agreements

The CSA have changed the name of this section to better reflect its contents.

The CSA proposed an amendment to subsection 6.8(3) in the January Draft Amendments. In response to the comments received and further consideration of this provision by the CSA, the CSA have not made this proposed amendment final and subsection 6.8(3) remains unamended. The CSA are satisfied that the safeguards currently built into Part 6 are adequate to protect the interests of security holders of mutual funds using over-the-counter derivatives to accomplish their investment objectives.

Subsection 6.8(5) is new. The CSA have added this subsection in response to comments, to allow a mutual fund to deliver its portfolio assets to a counterparty pursuant to a securities lending, repurchase or reverse repurchase transaction. Subsection 6.8(5) will permit this delivery to occur so long as the collateral, cash proceeds or purchased securities delivered by the counterparty is held under the custodianship of the custodian (or sub-custodian) as provided for by Part 6.

Section 15.6 - Performance Data - General Requirements

The June Draft Amendments proposed a clarification to section 15.6 relating to "young mutual funds" and the date that the applicable one year period ends. The CSA have further amended subparagraph 15.6(a)(i) to clarify that no sales communication pertaining to a mutual fund shall contain performance data unless the mutual fund has "distributed" (the June Draft Amendments used the word "offered") securities under a simplified prospectus in a jurisdiction for 12 consecutive months. The CSA consider this word to be a more readily understandable term that is consistent with applicable securities legislation.

Section 15.14 - Sales Communications - Multi-Class Mutual Funds

This section is new and re-orders rules proposed in the January Draft Amendments to reflect the increase in mutual funds offering multiple classes of securities that are referable to the same portfolio of assets. Proposed subsections 15.6(2) and (3) have been moved to form a separate new section 15.14 dealing with sales communications for multi-class funds. No substantive changes have been made to section 15.14 from the amendments proposed in the January Draft Amendments, although two clarifying changes have been made.

The CSA have clarified that these rules apply to mutual funds that distribute different classes or series of securities that are referable to the same portfolio of assets. In addition, the CSA have clarified that the requirement to provide performance data in a particular sales communication for each class or series relates only to each class or series that is referred to in the sales communication and not to all classes or series of

the mutual fund that are in existence.

The CSA note that they are continuing to consider the issues raised by multi-class mutual funds as they relate to the presentation of performance data and may propose additional rules in future proposed amendments to NI 81-102.

Section 16.1 - Calculation of Management Expense Ratio

In the June Draft Amendments, the CSA proposed a concept of a rolling 12 month management expense ratio to be calculated by mutual funds wishing to make public their management expense ratios, other than in financial statements and prospectuses. The CSA received conflicting comments in respect of this proposal; commentators were approximately equally divided either in favour or not in favour of this amendment. The CSA proposed this amendment largely in response to industry submissions following the coming into force of NI 81-102. Since no industry consensus appears to be present concerning the utility and practicality of this proposal, the CSA have decided not to proceed with the draft amendments for new subsections 16.1 (2) and (3). Accordingly mutual funds are governed by the existing rules contained in NI 81-102 regarding the calculation and presentation of management expense ratios, except that section 16.3, as proposed in the January Draft Amendments, has been made final as have the amendments described below proposed in the June Draft Amendments.

Subsection 14.1(5) of the Policy Amendments relating to CP81-102 is new and reflects the CSA's concern that mutual funds comply with section 16.1 in calculating and disseminating their management expense ratios.

The CSA have made final the proposed amendments contained in the June Draft Amendments to section 16.1 regarding the non-inclusion of income taxes in calculating management expense ratios and the requirements to provide note disclosure when a mutual fund provides its management expense ratio to the public media service providers.

Section 16.2 - Fund of Funds Calculation

Since the CSA have not proceeded with their proposal for a rolling 12 month management expense ratio, the changes proposed in the June Draft Amendments to section 16.2 which provides a formula for the calculation of total expenses for a fund of funds, have similarly been dropped from the Amendments.

The CSA have finalized subsections 16.2(2) and (3) which were proposed in the January Draft Amendments. These subsections have not been amended from the January Draft Amendments.

The CSA have added a new subsection (4) to section 16.2 to address a technical problem raised by a commentator in respect of the calculation of the management expense ratio for a top fund where management fees are rebated by an underlying fund to that top fund that invests in such underlying fund. The CSA have clarified that management fee rebates may be deducted from total expenses of the

underlying fund if the rebate is made for the purpose of avoiding duplication of fees between the two mutual funds.

Policy Amendment to CP81-102

Section 2.13 - "purchase"

The CSA proposed a new paragraph 5 for subsection 2.13(2) in the January Draft Amendments to clarify the application of the definition of "purchase" in the context of securities lending transactions. The CSA have finalized paragraph 5 by adding subparagraph (b), which reflects the CSA's response to comments received on the practical application of paragraph 5 as proposed in the January Draft Amendments. Paragraph 5 now accommodates the practical necessity for a mutual fund to have a reasonable period of time to sell any collateral that it becomes legally entitled to dispose of due to default of the counterparty, before that asset is considered a "purchase" for the purposes of section 2.1 of NI 81-102.

Section 3.6 - Securities Lending, Repurchase and Reverse Repurchase Transactions

The CSA proposed a new section 3.6 in the January Draft Amendments to give the CSA's views on certain matters relating to securities lending, repurchase and reverse repurchase transactions.

Several clarifying amendments have been made in the Policy Amendments relating to CP81-102 in response to comments received by the CSA.

Firstly, the words "having regard to the level of risk for the mutual fund in the transaction" have been added to the end of the second sentence of subsection 3.6(2). The CSA are of the view that a mutual fund and its lending agent should evaluate, among other prudent matters, the risks of a securities lending, repurchase and reverse repurchase transaction to the mutual fund in determining the appropriate level of over-collateralization as required by sections 2.12, 2.13 and 2.14 of the Rule Amendments.

Secondly, the CSA have added subsection 3.6(4). This subsection provides the CSA's views on the prudent use of letters of credit as collateral for securities lending transactions. Letters of credit should be irrevocable and the mutual fund should have the ability to draw down the full value of the loan upon default of the borrower. This subsection is a companion policy to new paragraph 6(d) of subsection 2.12(1) described above in connection with the Rule Amendments to NI 81-102.

Thirdly, the CSA have added subsection 3.6(6). This subsection clarifies the application of the terms "delivery" and "holding" of securities or collateral in the context of securities held by a lending agent for a mutual fund. The CSA recognize securities lending agents' industry practice of pooling collateral that is received from one borrower for several securities lending/repurchase transactions clients. Such pooling of collateral will not, of itself, violate the Rule Amendments.

Fourth, the CSA have added subsections 3.6(7) and (8). Both subsections are related and recognize industry practice that collateral requirements are calculated at the end of business on one day and any additional collateral delivered by borrowers on the next business day. Subsection 3.6(8) clarifies that a securities lending agent is permitted to use its valuation principles and practices when carrying out the requisite daily marking to market calculations.

Fifth, the CSA have added subsection 3.6(11). This subsection recognizes that the standard of care applicable to a securities lending agent applies to all the functions performed under a securities lending program for a mutual fund client, including the responsibility to reinvest cash collateral and proceeds of sale from repurchase transactions.

Sixth, the CSA have added subsection 3.6(12). This subsection clarifies that a securities lending agent must be properly appointed as a custodian or a sub-custodian in accordance with section 6.1 of NI 81-102. As custodian or sub-custodian, the securities lending agent must satisfy all the applicable requirements of Part 6 in carrying out its responsibilities.

Seventh, the CSA have amended clauses 3.6(13)(e) and (f) [in the January Draft Amendments, clauses 3.6 (7)(e) and (f)]. The amendments to clause (e) are to clarify the CSA's views that managers and mutual funds should provide securities lending agents with parameters regarding minimum requirements for diversification of collateral, as well as the amount of the collateralization. The amendments to clause (f) now recommend that managers and mutual funds provide direction and applicable parameters to lending agents on the lending agent's reinvestment of cash collateral to ensure that proper levels of liquidity of such reinvested collateral are maintained at all times.

Section 13.2 - Other Provisions

The CSA proposed subsection 13.2(5) in the June Draft Amendments and have finalized it without amendment.

The CSA have made three additions to section 13.2 of CP81-102 to articulate the CSA's views on the applicability of rules regarding sales communications to the new multi-class structures established by mutual funds since the coming into force of NI 81-102. As described above, the CSA's proposed rules in the January Draft Amendments are now contained in section 15.14 of the Rule Amendments. The three changes made by the CSA in the Policy Amendments relate to section 15.14 of the Rule Amendments to NI 81-102.

Subsection 13.2(6) is new. This subsection clarifies that the creation of a new class or series of security of a mutual fund that is referable to the same portfolio of assets does not constitute the creation of a new mutual fund and therefore does not subject the mutual fund to the restrictions of paragraph 15.6(a) of NI 81-102 which provides that no performance data is to be provided for a mutual fund if it has distributed its securities for less than 12 consecutive months.

Subsection 13.2(7) is new. This subsection clarifies that although section 15.14 of NI 81-102 does not deal directly with asset allocation services, the CSA recognize that it is possible that asset allocation services could offer multiple classes, and recommends that any sales communications for those services comply with the principles of section 15.14 to ensure that those sales communications are not misleading.

Subsection 13.2(8) is new. This subsection sets out the CSA's views that the use of hypothetical or *pro forma* performance data for new classes of securities of a multi-class mutual fund would generally be misleading.

Section 14.1 - Calculation of Management Expense Ratio

Subsection 14.1(5) is new. Given the CSA's decision not to proceed with the implementation of a rule that would require mutual funds to disclose their 12 month "rolling" management expense ratios in media other than prospectus documents and annual financial statements, subsection 14.1(5) reminds industry participants that all management expense ratios provided to service providers for public dissemination can only be the latest available management expense ratios as calculated in accordance with Part 16 of NI 81-102.

Rule Amendments to NI 81-101

Section 1.1 Definitions

"commodity pool"

Since the CSA have made the Amendments before finalizing National Instrument 81-104 Commodity Pools, the CSA have not finalized the amendments to the definition of commodity pool at this time, as they proposed in the June Draft Amendments.

Rule Amendments to Form 81-101FI

General Instructions

The CSA proposed instruction (21) in the June Draft Amendments in response to the renewed focus of Canadian mutual funds on offering multiple classes of securities referable to the same portfolio of assets. Instruction (21) has been finalized, with the clarification that it was intended to apply to those multi-class mutual funds whose classes are referable to the same portfolio. The CSA have added instruction (22) to the General Instructions to remind industry participants that classes or series of a mutual fund, where each class or series of a class of securities of the mutual fund is referable to a separate portfolio of assets, are considered to be separate mutual funds as provided in section 1.3 of NI 81-102.

Item 9 of Part B - Risks

The CSA proposed amendments to Item 9 of Part B in connection with the index fund amendments proposed in the June Draft Amendments. The CSA have finalized these amendments in the Rule Amendments with three changes made in response to comments received on the June Draft Amendments.

Firstly, subsection (6) of Item 9 now reflects that section 2.1 of NI 81-102 exempts mutual funds from the concentration restrictions in section 2.1 when they invest in government securities (as defined) or in securities issued by clearing corporations. A mutual fund investing in these securities is not required to provide the disclosure required by subsection (6) of Item 9 in respect of those investments.

Secondly, subsection (6) has been amended to clarify more precisely than did the June Draft Amendments, the nature of the disclosure that must be given by mutual funds investing more than 10 percent of their net assets in securities of any one issuer. Where subsection (6) requires disclosure, the mutual fund must disclose the name of the applicable issuer and the maximum percentage of the net assets of the mutual fund that the securities of that issuer represented during the applicable 12 month period.

Thirdly, the CSA have included new Instruction (6) to Item 9 of Part B. This Instruction clarifies that, in providing the disclosure required by subsection (6) of Item 9, a mutual fund is not required to provide particulars or provide a summary of each and every occurrence where more than 10 percent of its net assets were invested in the securities of an issuer in the past 12 months.

Rule Amendments to Form 81-101F2

General Instructions

The CSA amended or added instructions (14) and (15) to the General Instructions, as applicable, for the same reasons as are described above in connection with the General Instructions for Form 81-101F1.

Text of the Amendments

The text of the Amendments follow.

Dated: February 16, 2001

APPENDIX A

LIST OF COMMENTATORS
ON
THE JANUARY DRAFT AMENDMENTS
AND
THE JUNE DRAFT AMENDMENTS

On January 28, 2000, the CSA released for public comment the January Draft Amendments. During the comment period, which ended on April 30, 2000, the CSA received twenty-three letters from the following parties:

1. AIC Group of Funds
2. The Association of Global Custodians (an informal coalition of nine United States banks that act, directly or through affiliates, as global custodians or sub-custodians)
3. Barclays Global Investors Canada Limited
4. CIBC Mellon Global Securities Services Company
5. Desjardins Trust/Fiducie Desjardins
6. Elliott & Page Limited
7. Fidelity Investment Canada Limited
8. Global Strategy Financial Inc.
9. John E. Hall
10. Investment Dealers Association of Canada
11. The Investment Funds Institute of Canada
12. Investors Group Inc.
13. Kirkpatrick & Lockhart LLP, on behalf of Morgan Stanley & Co. Incorporated
14. McMillan Binch
15. Osler, Hoskin & Harcourt LLP
16. PaineWebber Global Portfolio Lending, a division of PaineWebber Incorporated
17. Royal Bank of Canada
18. Royal Bank Investment Management Inc.
19. Royal Trust Corporation of Canada
20. Scotia Securities Inc.
21. State Street Bank and Trust Company
22. Stikeman Elliott, on behalf of TAL Global Asset Management Inc.
23. TD Asset Management Inc.

On June 16, 2000, the CSA released for public comment the June Draft Amendments. During the comment period, which ended on September 14, 2000, the CSA received five letters from the following

parties:

1. C.I. Mutual Funds Inc.
2. Fraser Milner Casgrain
3. The Investment Funds Institute of Canada
4. Royal Mutual Funds Inc. and Royal Bank Investment Management Inc.
5. TD Quantitative Capital, a division of TD Asset Management Inc.

The CSA have considered all comments provided by the above commentators and have made the changes described in this Notice largely in response to those comments. The specific comments provided, together with the CSA's responses to those comments, are summarized in the following two appendices to this Notice. The CSA thank all commentators for their thoughtful review of the proposed rules and policies and for providing their written comments.

Copies of all comment letters may be viewed at Micromedia Limited, 20 Victoria Street, Toronto, Ontario (416) 312-5211 or 1- (800) 387-2689; at the British Columbia Securities Commission, P.O. Box 10142, Pacific Centre, 701 West Georgia Street, Vancouver, British Columbia (604) 899-6500; at the Alberta Securities Commission, 10025 Jasper Avenue, Edmonton, Alberta (780) 427-5201; and at the Commission des valeurs mobilières du Québec, Stock Exchange Tower, 800 Victoria Square, 22nd floor, Montréal, Québec (514) 940-2150.

APPENDIX B

SUMMARY OF COMMENTS RECEIVED ON THE JANUARY DRAFT AMENDMENTS ("THE SECURITIES LENDING AMENDMENTS") AND RESPONSES OF THE CANADIAN SECURITIES ADMINISTRATORS

GENERAL COMMENTS:

Commentators were generally supportive of the January Draft Amendments, particularly as they related to securities lending, repurchase and reverse repurchase transactions. The majority of comments dealt with the proposed securities lending/repurchase regime for mutual funds, although several comments were received in respect of the proposed amendment to subsection 6.8(3) of NI 81-102.

Both the Investment Dealers Association of Canada and The Investment Funds Institute of Canada, on behalf of their members, provided support for the securities lending amendments. The IDA summarized their views:

> "We commend the CSA for the overhaul of regulatory framework relating to mutual funds and we believe that by moving forward with the proposal to remove the restrictions currently in force will be beneficial to the liquidity of the capital markets and will increase returns to mutual fund unitholders. ... the changes will provide mutual funds with short term investment options that are more in line with pension funds and insurance companies. Allowing mutual funds use of the securities lending and repo markets will result in increased revenues for mutual funds, and thus mutual fund unitholders, and increase trading activity (liquidity) to the benefit of all participants in the Canadian capital markets."

IFIC described the proposed regime as "a very positive step for the industry". Another industry commentator noted that "in general, the Proposal's regulatory requirements and limitations are both prudent and consistent with sound industry practice", although this industry commentator was quite opposed to the requirements for a mandatory use of a securities lending agent.

Both the IDA and IFIC suggested that the industry and the CSA should agree to review the regime following at least a year's experience in working with the new rules to determine if changes should be made. The IDA, in particular, offered the expertise of its Securities Lending Committee for this purpose. The CSA agree that this review of the regime once some practical experience has been gained would be useful and encourage both the IDA and IFIC, and individual fund companies, lending agents and custodians to provide the CSA with their submissions once the Rule Amendments have been in force for at least twelve

completed months.

The CSA asked several specific questions in the Notice accompanying the release of the January Draft Amendments and received the answers noted below to those questions:

1. Should the CSA allow irrevocable letters of credit or other specified financial instruments to be accepted as collateral for securities lending/repurchase transactions by mutual funds?

Answer and CSA Response:

Commentators responding to this question unanimously endorsed the addition of irrevocable letters of credit, on specified conditions, as well as commercial paper, bankers acceptances and "widely traded debt". Most commentators noted that these financial instruments were widely accepted in the institutional lending industry and posed no increased risk to mutual funds. As discussed more throughly below, the CSA have changed the January Draft Amendments to permit mutual funds to accept irrevocable letters of credit, bankers acceptances and commercial paper, on the conditions set out in the Rule Amendments.

2. Does the condition that securities lending and repurchase transactions must be "securities lending arrangements" under the *Income Tax Act* (Canada) pose unnecessary restrictions on mutual funds wishing to engage in these transactions?

Answer and CSA Response:

Commentators answering this question suggested that this was an important and necessary condition to ensure that securities lending/repurchase transactions for mutual funds were carried out in a standard and certain fashion. The CSA have not removed this condition.

3. Do the proposed rules articulate appropriate term restrictions for securities lending/repurchase transactions? Are they too restrictive?

Answer and CSA Response:

Most commentators noted that the securities lending provisions were drafted correctly, but that the term requirements for repurchase and reverse repurchase transactions should be extended, since the terms proposed did not reflect industry practice, although commentators varied on the suggested length of the appropriate term. The CSA have not changed the securities lending provisions, but have amended the term restrictions for repurchase and reverse repurchase transactions from five business days to 30 days. Most commentators indicated that the risks to a mutual fund would not be substantially increased through this change.

4. Are the proposed rules on reinvestment of cash collateral too restrictive – should some level of

mismatch be permitted?

Answer and CSA Response:

Most commentators noted that mutual funds should be permitted to reinvest cash collateral in longer term instruments and that the level of mismatch inherent in such longer terms was both in accordance with prudent industry practice and did not expose mutual funds to greater risks. The CSA have accepted these comments and have amended the applicable provisions to provide that cash collateral can be reinvested in qualified securities having a term to maturity no greater than 90 days and that sale proceeds can be reinvested in qualified securities having a term to maturity no greater than 30 days.

5. Should the aggregate volume limit for mutual funds lending securities or sold pursuant to repurchase transactions be separate limits? If so, why. In addition, should the lending/repurchase regime impose limits on transactions with any one counterparty?

Answer and CSA Response:

Some commentators expressed concern about the clarity of the volume limit as drafted and some commentators suggested that either no limit was necessary or that separate limits should be permitted. No commentator was of the view that limits on transactions with counterparties were necessary given the other applicable controls and rules and current industry practices. Limits on transaction with individual counterparties should be left to the discretion of individual mutual funds and their managers. The CSA have amended the drafting of the volume limit, but have retained it as a aggregate limit for both types of transactions. No counterparty limit has been imposed.

6. Does the 102 percent over-collateralization requirement, when coupled with the requirement to supplement that collateral where warranted, reflect industry practices?

Answer and CSA Response:

Commentators were strongly in favour of the requirements as drafted in the January Draft Amendments. Most commentators indicated their support for the flexible "best practices" approach articulated in the proposed January Draft Amendments. The CSA have not amended this provision.

7. Will any of the restrictions proposed for securities lending/repurchase transactions unduly reduce the potential for revenues for mutual funds?

Answer and CSA Response:

Although most commentators did not specifically address this question, most commentators noted that the

limitations on collateral, the terms of repurchase and reverse repurchase transactions and the restrictions on the reinvestment of cash collateral and sales proceeds were unduly restrictive, particularly in relation to industry practices and the risks associated with these transactions. As noted, the CSA have amended the January Draft Amendments in response to these comments.

SPECIFIC COMMENTS

1. Definition of "cash cover"

One commentator requested that the definition of "cash cover" be expanded to include debt instruments with a remaining term to maturity of five years or less. This change would allow a bond fund to lengthen the duration of its bond holdings by using futures contracts without having to sell some of its bond holdings to meet cash cover requirements in NI 81-102. Similarly, this change would allow a bond fund to manage country risk in a similar manner. This same commentator also made suggestions for changes to the definition of "synthetic cash".

CSA Response:

The CSA do not agree that the "cash cover" or "synthetic cash" definitions and requirements should be expanded at this time to accommodate these specific requests. The CSA note that this comment was not in response to the January Draft Amendments, but was made by the commentator desiring additional flexibility for its mutual funds. The CSA note further that mutual funds wishing additional flexibility have the option of applying for exemptive relief, provided they can provide the CSA with appropriate reasons for the exemption and submissions on why the mutual fund would not be subject to additional risks having regard to the purpose of the cash cover requirements set out in NI 81-102.

2. Definition of "purchase"

The January Draft Amendments provided that when a mutual fund becomes legally entitled to dispose of the collateral, such an occurrence is a "purchase" for the purposes of the investment restriction tests in NI 81-102. One commentator recommended that mutual funds be given a reasonable period of time to dispose of the collateral prior to the collateral becoming an asset of the mutual fund for the purposes of the investment restrictions.

***CSA Response*:**

The CSA acknowledge this comment and have clarified the application of the definition of "purchase" in the Policy Amendments to CP81-102. Paragraph 5(b) of subsection 2.13(2) of the Policy Amendments

to CP81-102 reflects the CSA's views in response to this comment.

3. Definition of "qualified securities"

Many commentators recommended that the list of eligible collateral be expanded to include any or all of the following assets: widely-traded corporate debt, commercial paper, bankers' acceptances, letters of credit and guarantees, high quality common and preferred shares, deposit notes and agency debt. The commentators argued that without a broader list of eligible collateral, mutual funds would be at a competitive disadvantage with other Canadian institutional lenders, such as life insurance companies, financial institutions and pension plans, as provided for in the OSFI Guidelines. Another concern was raised that the current list of eligible collateral would place increased strains on the limited quantities of government securities currently in the market.

CSA Response:

The CSA have expanded the list of eligible collateral to include commercial paper, bankers' acceptances and irrevocable letters of credits, all on the conditions and specifications contained in the Rule Amendments to NI 81-102. The list of eligible collateral is now more consistent with the list of eligible collateral provided for in the OSFI Guidelines. Also these additions are consistent with the collateral that can be accepted by U.S. mutual funds for securities lending transactions.

The definition of "qualified security" and paragraph 6(d) of subsection 2.12(1) of the Rule Amendments to NI 81-102 have been amended to reflect the CSA's response to these comments. Subsection 3.6(4) of the Policy Amendments to CP81-102 provides the CSA's views on the use of irrevocable letters of credit as collateral.

4. Over-collateralization requirement

Commentators were supportive of the over-collateralization requirements in the January Draft Amendments, although two commentators suggested that 105 percent over-collateralization was appropriate, primarily to be consistent with the OSFI Guidelines. A higher margin of safety would increase the feasibility of a broader array of collateral. Two other commentators suggested that a 102 percent *initial* over-collateralization requirement with a maintenance margin of 100 percent would provide a sufficient buffer against price and market volatility.

***CSA Response*:**

The CSA have not made any changes to the applicable requirements, other than to emphasize in the Policy Amendments (subsection 3.6(2) of the Policy Amendments to CP81-102) that mutual funds should look at the level of risk for the transaction in determining appropriate levels of collateral. The CSA believe that the current over-collateralization requirements are consistent with the OSFI Guidelines. The Amendments require a mutual fund to take at least 102 percent of the value of the securities sold or lent in a particular transaction. The Policy Amendments clarify that a mutual fund must take additional collateral when best market practices so dictate. Similarly, the OSFI Guidelines require lenders to take the amount of collateral which reflect the best practices in the local market.

5. Daily marking to market

One commentator raised concerns over which valuation principles should be used to make the required daily mark to market calculation of collateral and securities sold or lent: those of the mutual fund or those of the lending agent. Another commentator suggested the requirements in the January Draft Amendments were not consistent with industry practice to carry out the mark to market calculation at the end of a business day and require that additional collateral be delivered during the following day.

***CSA Response*:**

The CSA acknowledge both comments and have provided their views in the Policy Amendments to CP81-102. The Policy Amendments state that a mutual fund may use the valuation principles of their lending agent. Also, the Policy Amendments confirm that delivery of additional collateral by the end of the next business day, in accordance with current market practices, does not violate the Instrument.

Subsection 3.6 (7) and (8) of the Policy Amendments to CP81-102 contain the applicable CSA views given in response to these comments.

6. Term of repurchase and reverse repurchase transactions

Many commentators recommended that the maximum term of a permitted repurchase or reverse repurchase transaction be lengthened. The recommended time periods varied. Some commentators felt that 30 days would be sufficient, while others proposed allowing for transactions of up to a year. The limit in the January Draft Amendments of five business days would create unnecessary administrative costs and would leave mutual funds with few options. As a result of this restriction, mutual funds would be limited to investing the proceeds of repurchase transactions in overnight investments. Overnight investments have lower yields and do not allow for appropriate diversification of investments. By extending the permitted term to 30 days or more, both of these concerns would be addressed.

CSA Response:

The CSA have extended the maximum term for permitted repurchase and reverse repurchase transactions to 30 days. The CSA believe that this change will allow mutual funds to reduce the administrative costs of renewing repurchase transactions after each five business day period when a mutual fund has no immediate intention to recall the securities. Also, mutual funds will be able to invest the cash proceeds as they believe is prudent in qualified securities with a term to maturity of up to 30 days. This added flexibility will permit a mutual fund to earn more yield and allow for increased diversification of its investments.

Paragraph 10 of subsection 2.13(1) and paragraph 9 of subsection 2.14(1) of the Rule Amendments to NI 81-102 reflect the CSA's decision.

7. Reinvestment of cash collateral or sale proceeds

Most commentators viewed the restrictions on reinvestment of cash collateral or sale proceeds as too restrictive. Commentators suggested that the January Draft Amendments would create a significant disincentive against accepting cash collateral or entering into repurchase transactions. Commentators recommended that cash reinvestment be examined from an investment portfolio basis, as opposed to a loan-by-loan basis. An example was given of U.S. mutual funds which effect their cash collateral reinvestment through collective investment vehicles, such as money market funds. Lending agents are capable of co-ordinating the reinvestment of cash collateral of their clients to ensure that proper levels of liquidity are maintained at all times.

CSA Response:

The CSA have provided for a portfolio approach to cash reinvestment. Specific parameters are set out in the Rule Amendments for repurchase transactions that cash proceeds must be invested in qualified securities with a remaining term to maturity of 30 days or less. For securities lending transactions, cash collateral may be invested in qualified securities with a remaining term to maturity of 90 days or less. The additional 60 days for cash collateral received from securities lending transactions recognizes that these transactions are open loans with no fixed terms. The lending agent in consultation with the mutual fund manages the cash collateral within the specified investment restrictions so as to maintain an adequate level of liquidity at all times.

Subsection 2.12(2) of the Rule Amendments to NI 81-102 sets out the changed rules for securities lending transactions, subsection 2.13(2) sets out the changed rules for repurchase transactions.

8. Aggregate lending and repurchase transaction limit

Commentators were generally supportive of the proposed volume limit of 33 1/3 percent of total assets of the mutual fund, including the collateral received, although some confusion was expressed on how the limit would be applied. The consistency to the regulatory restrictions applicable to U.S. mutual funds for securities lending was seen as appropriate. A few commentators suggested the overall limit should be raised to 50 percent of the total assets of the mutual fund. One commentator proposed that the percentage should be broken out by asset class (for example, 33 percent of total assets for equities and 75 percent for bonds). A few commentators suggested that the current limit was overly restrictive and that exposure of 75 to 100 percent of total assets could be justified.

***CSA Response*:**

The CSA have amended, and simplified, the applicable volume limit. The Rule Amendments now impose an aggregate limit of 50 percent of the total assets of the mutual fund, excluding the collateral or sales proceeds received under the transaction. The CSA note that this revised test is not a substantive change from the limit proposed under the January Draft Amendments and are of the view, echoed by some commentators, that the volume limit is appropriate at this time, particularly having regard to the limitations on U.S. mutual funds.

Paragraph 12 of subsection 2.12(1) of the Rule Amendments to NI 81-102 sets out the changed rules for securities lending transactions and paragraph 11 of subsection 2.13(1) sets out the changed rules for repurchase transactions.

9. Term to maturity restriction on securities purchased under a reverse repurchase transaction

Several commentators questioned the rationale for limiting the term to maturity of securities that a mutual fund may purchase under a reverse repurchase transaction. The limitation on the term of securities purchased under a reverse repurchase transaction is not reflective of how the reverse repurchase market works and will limit the ability of mutual funds to enter into these transactions. The risk which this restriction is attempting to address, is more suitably dealt with by the over-collateralization requirements, daily marking-to-market and the term of the reverse repurchase transaction.

***CSA Response*:**

The CSA agree with the comments and have not carried forward the restriction previously contained in paragraph 3 of subsection 2.14(1) of the January Draft Amendments to NI 81-102. Any risks to a mutual fund inherent with reverse repurchase transactions are better dealt with the over-collateralization

requirement, the daily marking to market requirements and the term limit on the reverse repurchase transaction.

10. Mandatory use of an agent for securities lending and repurchase transactions

Some commentators agreed that the mandatory use of a lending agent was appropriate given the infrastructure and systems required to operate a securities lending program. Custodial lenders devote substantial resources to operational systems, legal and tax advice and program efficiency. Other commentators suggested that the operational risks associated with repurchase transactions did not warrant the mandatory use of a lending agent. One commentator noted that the effect of this provision would be to "create a virtual monopoly in the Canadian fund industry for custodian lending agents".

One commentator suggested that some mutual fund managers have experience in direct lending and the use of an agent will result in additional costs without any incremental benefit. A mutual fund manager's fiduciary responsibilities should be sufficient to prevent a manager from engaging in an activity on behalf of its mutual funds for which it is not sufficiently expert. Another commentator suggested that the need for appropriate controls and systems could be addressed by using a single principal borrower that has proprietary lending systems and operational expertise.

Commentators opposed to this requirement generally noted that its effect will be to increase costs to mutual funds, while only incrementally minimizing risk. Several commentators urged the CSA to re-examine this requirement, if they decided to retain it, following practical experience with the new regime.

Several commentators suggested that the requirements in subsection 2.15(4) proposed by the January Draft Amendments precluded the use of a a third party lending agent unless the fund's custodian was believed to be incompetent at performing this function.

***CSA Response*:**

The CSA have not changed the requirements to engage an agent to carry out securities lending and repurchase transactions on behalf of mutual funds. Operating a securities lending and repurchase transaction program requires significant operational safeguards and a level of expertise and experience beyond the current scope of most mutual fund managers. A prudent securities lender operating a securities lending program must have safeguards to ensure daily marking to market calculations, collection of collateral and distributions, diversification of collateral and maintenance of credit standards on borrowers. A securities lender must also have access and in-depth knowledge of the market for a specific security that the mutual fund intends to lend. The CSA are of the view that to ensure the appropriate protection of the investors, at present, all mutual funds must use a lending agent for securities lending and repurchase

transactions. The CSA have made an exception for reverse repurchase transactions, since the CSA view reverse repurchase transactions as a cash reinvestment tool where special expertise and control systems are more widespread and the practices are more developed within the Canadian mutual fund industry.

As noted above, the CSA will welcome submissions on this point, amongst others, following practical experience with the rules.

The CSA note the comments in respect of the drafting contained in subsection 2.15(4) of the January Draft Amendments, and have deleted much of the provisions commented upon. A third party may act as a lending agent for a mutual fund so long as the agent is appointed as a sub-custodian of the mutual fund regardless of the mutual fund's views of its custodian's ability to perform this function.

Subsection 2.15(3) of the Rule Amendments to NI 81-102 contains the amended rules. The CSA have included a discussion of their views on this issue to subsection 3.6(12) of Policy Amendments to CP81-102.

11. Advance Notice to Mutual Fund Securityholders

One commentator suggested that the 60 days advance notice requirement to securityholders of mutual funds intending to enter into securities lending and repurchase transactions should not be required as commencing a program is not analogous to the commencement of the use of derivatives or other risk increasing strategies. In the alternative, the commentator argued that those currently engaging in reverse repurchase transactions should not be required to give a notice to continue in such investment activities.

***CSA Response*:**

The CSA believe that securityholders of a mutual fund should receive notice of the mutual fund's intention to enter into securities lending, repurchase or reverse repurchase transactions, since these transactions could have an impact both on the risks to the mutual fund and its potential revenues. However, the Rule Amendments clarify that for those mutual funds which currently enter into these transactions pursuant to exemptive relief decisions no notice is required to continue in those activities.

Subsection 2.17(2) of the Rule Amendments to NI 81-102 has been added to address the situation for those mutual funds that have exemptive relief to enter into reverse repurchase transactions.

12. Lending to Related Parties

One commentator provided views on the application of the self-dealing prohibitions proposed in section 4.2 of the January Draft Amendments to NI 81-102. The commentator noted that mutual funds sponsored by financial institutions should be able to lend securities to related parties, particularly their affiliated investment dealers or transfer agents and periodic reviews controls to ensure market rates on arm's length transactions should be imposed in place of the prohibitions.

***CSA Response*:**

The CSA have not amended section 4.2 in response to this comment and continue of the view that these prohibitions are necessary for mutual funds at this time. Any change to the prohibitory regime for related party transactions will be made in conjunction with a complete review of governance and conflicts of interest related to mutual funds.

13. Custodial Provisions as they Relate to Securities Lending and Repurchase Transactions

One commentator pointed to several technical changes that should be made to Part 6 of NI 81-102 to properly implement the securities lending and repurchase transaction regime.

***CSA Response*:**

The CSA have amended Part 6 in the manner noted above in the Notice to reflect the comments received.

14. Proposed changes to subsection 6.8(3) of NI 81-102

Many commentators argued that the proposed amendment to subsection 6.8(3) of NI 81-102 included with the January Draft Amendments would cause serious problems for many mutual funds which use over-the-counter forward contracts with one counterparty. In particular, this change would hamper the current structure of many RSP clone funds which had been structured in good faith on the current subsection 6.8(3). The proposed change would increase the cost of these forward contracts and may endanger the viability of these funds. The commentators explained that the current safeguards in Part 6 of NI 81-102 adequately protect a mutual fund's credit exposure under such forward derivative contracts, in three ways: (1) the counterparty must maintain an approved credit rating; (2) the mark-to-market exposure cannot exceed 10 percent of the fund's assets over a 30 day period; and (3) subsection 6.8(4) of NI 81-102 ensures that the records show the mutual fund as beneficial owner of those assets. One commentator noted that a pledge of collateral by a mutual fund does not expose the mutual fund to the credit risk of the counterparty and the risks of credit exposure to a counterparty have been adequately dealt with elsewhere in NI 81-102.

***CSA Response*:**

The CSA have not finalized the proposed amendment to subsection 6.8(3). The CSA are satisfied that the current safeguards which are currently built into NI 81-102 adequately protect the interests of securityholders of mutual funds which extensively use over-the-counter derivatives.

15. Sales Communications for Multi-Class Mutual Funds

Two commentators pointed out a technical deficiency in the drafting of proposed paragraph 15.6(2)(b) in the January Draft Amendments in that the rule could be interpreted to require all sales communications where performance data for one class is given, and the sales communications is designed to cover only that class, to provide the performance data for all classes. The commentators suggested the inclusion of the words "referred to in the sales communication" to make the intent of this section clear.

***CSA Response*:**

The CSA have amended section 15.14 of the Rule Amendments to NI 81-102 to clarify the meaning of this rule and have incorporated the drafting suggestion of the commentator.

16. Calculation of Management Expense Ratio

A commentator pointed out the need for clarity in the application of the rules regarding calculation of management expense ratios for those fund of funds, where the underlying funds rebate to the top fund management fees paid by the top fund, so as to ensure no duplication of management fees.

A second commentator noted that the task of re-stating management expense ratios for the past five years as required by the new management expense ratio calculation mandated by NI 81-102 to be too onerous and accordingly should not be required.

***CSA Response*:**

The CSA have added subsection 16.2(4) to the Rule Amendments to NI 81-102 to clarify the application of the applicable rules in response to the first comment.

The CSA note that in response to the second comment, that section 16.3 of the Rule Amendments to NI 81-102 clarifies the need for mutual funds to calculate management expense ratios in accordance with NI 81-102 for financial periods ending after February 1, 2000. The CSA further note that CSA staff published

CSA Staff Notice 81-306 Disclosure by Mutual Funds of Changes in Calculation of Management Expense Ratio to clarify staff's views. Staff have been addressing issues related to management expense ratios on a fund by fund basis since February 1, 2000 and note general industry compliance with the matters addressed in that notice.

17. Accounting issues

One commentator recommended that repurchase transactions be treated as off balance sheet items in order to conform with the balance sheet treatment of securities loans. Since the lending agent is not acting as the portfolio manager for a mutual fund, these transactions should be treated as being off the balance sheet. Note disclosure to the financial statements could adequately describe the transactions. Another commentator asked for guidance on how revenue received by a securities lending program should be treated.

CSA Response:

The CSA believe that generally accepted accounting principles in Canada (GAAP) apply in determining the accounting treatment for these transactions. Under GAAP, a repurchase transaction is a sale and must be disclosed as such on the balance sheet of the applicable mutual fund. This treatment is consistent with the accounting used by U.S. mutual funds. With respect to guidance on how revenues should be treated, subsections 14.3(4), 14.4(4) and 14.5(4) of the Policy Amendments to CP81-102 require that income from securities lending, repurchase and reverse repurchase transactions be presented as revenue and not as a deduction from expenses. No changes to the rules proposed in the January Draft Amendments have been made.

APPENDIX C

SUMMARY OF COMMENTS RECEIVED
ON
THE JUNE DRAFT AMENDMENTS
("THE INDEX FUND AMENDMENTS")
AND
RESPONSES OF THE CANADIAN SECURITIES ADMINISTRATORS

GENERAL COMMENTS

Four of the five commentators provided comments on specific provisions contained in the June Draft Amendments relating to the proposed changes designed to permit index mutual funds to better meet their investment objectives. One commentator focussed exclusively, and the other commentators also commented, on the rolling 12 month management expense ratio proposed in the June Draft Amendments.

All commentators were supportive of the proposed regime to permit mutual funds to better meet their investment objectives; one commentator commended the CSA for recognizing the "special nature of index mutual funds and the importance of meeting their fundamental investment objectives".

SPECIFIC COMMENTS

1. Definition of "index mutual fund"

One commentator proposed that the words "attempt to" ought to be inserted before the word "replicate" in the definition of index mutual fund in order to clarify that a mutual fund would still be considered an index fund if it attempts to replicate an index but does not identically replicate that index at all times.

Another commentator queried whether the definition of "index mutual fund" would include index mutual funds that track multiple indices. This commentator also asked whether the definition would include a fund that is invested in other index mutual funds (i.e. a fund of funds), and if so, whether an additional subparagraph should be added to the definition of "index mutual fund" to state that an index mutual fund means a mutual fund that has adopted fundamental investment objectives that require the mutual fund to invest in other "index mutual funds" as defined in that section.

CSA Response:

The CSA are of the view that the definition of "index mutual fund" is adequate and that no change is required in response to the comments received. In particular, with respect to the second comment, the CSA believe that the definition of "index mutual fund" is sufficiently broad enough as drafted to include index mutual funds that track multiple indices, as well as index mutual funds that are invested in other index mutual funds.

2. Definition of "permitted index"

Two commentators expressed concerns with the potential ambiguity of the requirement that the "permitted index" be one that is "widely quoted". For example, does this term mean widely quoted in the media or by money managers? Commentators proposed that the words "widely quoted" be deleted from the definition, since the most important consideration should be whether the index is administered by a non-affiliate ((a) of the definition) and is widely recognized and used ((b) of the definition), not whether it is widely quoted.

Another commentator suggested that clear parameters should be established around what would constitute a "widely recognized and used" index.

CSA Response:

The CSA have deleted the words "widely quoted" from the definition of index fund in response to the comments. The definition now provides that a "permitted index" must be either one that is (a) both administered by an organization that is not affiliated with any of the mutual fund, its manager, its portfolio advisor or its principal distributor, and one that is available to persons or companies other than the mutual fund, or (b) one that is widely recognized and used.

The CSA do not believe that it is necessary to expand on the meaning of the phrase "widely recognized and used".

3. Mandatory use of the word "index" in the name of the mutual fund

One commentator asked that the requirement to include the word "index" in the name of the index mutual fund should be removed since the disclosure already provided in the fundamental investment objective is adequate.

***CSA Response*:**

The CSA believe that investors are entitled to a clear and unambiguous indication that an index mutual fund is in fact an index fund that avails itself of exemptions from the customary rules applicable to other mutual funds. The CSA are of the view that the best way to provide this information is for the mutual fund to include the word "index" in its name. Index mutual funds not wishing to include this word in their name will not be able to utilize the exemption from the concentration restriction that is provided for in the Rule Amendments. No changes from the proposed rules in the June Draft Amendments have been made.

4. Mandatory Advance Notice to Securityholders

Two commentators suggested that index mutual funds that already benefit from an exemption which allows them to track their permitted index and invest up to 25 percent in any one issuer should not have to send out a 60 day notice to their securityholders given that their prospectuses have already been amended to disclose the exemption. The obligation for such funds to provide the 60 day notice would impose an additional and unjustifiable cost on these funds. Further, one commentator asked whether an index mutual fund that already benefits from an exemption from the concentration restriction would have to cease availing itself of the concentration relief during the 60 days notice period.

CSA Response:

The CSA confirm that an index mutual fund is required to provide 60 day written notice to its securityholders of its intention to rely on the exemption from the concentration restriction provided by subsection 2.1(5) of the Rule Amendments to NI 81-102, regardless of whether such mutual fund has obtained prior relief from the concentration restriction. However those index mutual funds whose prospectuses have since their inception contained the investment objective and risk disclosure referred to in subsection (5) of Item 6 and subsection (5) of Item 9 of Part B of Form 81-101F1 do not have to give advance notice.

The CSA note that they consider it very important that investors, both new and existing, understand the nature of an index mutual fund and how it differs from a conventional mutual fund that is subject to investment restrictions, including the concentration restriction. For this reason, the CSA have retained the notice requirement, however, index mutual funds should review this Notice under the heading "Transitional Matters" for the CSA's views on giving notices to securityholders before the effective date of the Rule Amendments.

5. Performance Data - General Requirements

One commentator proposed that the words "offered securities under a simplified prospectus in a jurisdiction for 12 consecutive months" as used in proposed subparagraph 15.6(a)(i), be clarified to mean the date on

which the fund or its manager actually made the securities available to the public, regardless of when the receipt for the prospectus was issued. It is often the case that mutual funds do not make their units publicly available until several months after the receipt has been issued.

CSA Response:

Subparagraph 15.6(a)(i) of the Rule Amendments to NI 81-102 has been amended to clarify that no sales communication pertaining to a mutual fund shall contain performance data unless the mutual fund has "distributed" (rather than "offered") securities under a simplified prospectus in a jurisdiction for 12 consecutive months.

6. 12 Month Rolling Management Expense Ratio

All commentators provided their views on the proposal contained in the June Draft Amendments to require a 12 month "rolling" management expense ratio in media other than the prospectuses and annual financial statements. No one consensus view as to the utility of a rolling management expense ratio was expressed in the comments.

Two commentators noted that a rolling management expense ratio, as proposed to be calculated, would not reflect any management decisions to change the expenses charged to a fund on a go-forward basis. For example, the manager of a fund may change the management fee and/or introduce a cap on the management fee, but these decisions would not be immediately reflected in published ratios. The impact would be that the publicly reported management expense ratios would not reflect the actual costs incurred by securityholders until the end of a 12 month rolling period.

One commentator suggested that the timing of large expenses could significantly impact the management expense ratio calculated on a rolling 12-month basis. For example, if the rolling period happened to capture two prospectus renewals, those costs would have a significant impact on the stated ratio. This could distort the management expense ratio for that period and could be misleading unless explained through detailed note disclosure.

Another commentator expressed the opinion that the 12 month rolling average is a historical measure of management expense ratio which, being an average measure, does not provide sufficient information as to the level of current fees being charged, and is therefore not useful for prospective investors, and of limited use for existing investors. This commentator further submitted that a historical 12 month rolling management expense ratio for those funds with increasing expenses will understate current fee levels, while for funds with decreasing expenses, the rolling management expense ratio will overstate current fee levels.

Finally, two commentators expressed concerns relating to mutual funds structured as funds of funds, where the underlying funds are mutual funds managed by parties unrelated to the manager of the top fund, may not be able to meet the month-end deadline for calculation of the rolling management expense ratio. Delayed reporting of updated management expense ratios could lead to securityholder confusion.

Commentators provided several recommendations as to acceptable substitutes for the proposed 12 month rolling management expense ratio:

- retain the current management expense ratio calculation and disclosure requirements, but permit a management expense ratio of a mutual fund to be recalculated if expense decisions are made that would materially impact the management expense ratio if taken into account;
- if the 12 month rolling management expense ratio is retained, it should be restricted to the publication of management expense ratios in non-mandatory media, so that semi-annual statements would be excluded from the rolling calculation and would include management expense ratios calculated on the basis outlined in section 16.1 of NI 81-102. Funds wishing to publish 12 month rolling management expense ratios in non-mandatory media could continue to do so;

- rather than using a 12-month rolling average, a current-month management expense ratio annualized (but not compounded) for a 12 months period would be more appropriate. Such a prospective management expense ratio would be based on the most recent month and could serve as supplementary information to the historical audited management expense ratio shown in the simplified prospectus, annual information form and annual financial statements. Audit verification should be required for both values and that notes as to the calculation of both ratios could be provided to avoid confusion between the two numbers.

***CSA Response*:**

The CSA note that their proposal for a rolling 12 month management expense ratio outlined in the June Draft Amendments was the result of industry submissions on the practical implications of section 16.1 of NI 81-102, particularly given the practices of industry participants in providing management expense ratios in non standardized formats to public media service providers. Section 16.1 of NI 81-102 requires management expense ratios to be calculated based only on annual audited financial data and does not permit any other calculation or dissemination of management expense ratios.

The CSA continue of the view that a management expense ratio for a mutual fund is a useful figure for investors, both new and existing, and one standard method of calculation should be adhered to by the industry. The commentators have suggested to the CSA that there is no industry consensus on the correct calculation of management expense ratios, other than one based on the historical annual audited financial statements. The CSA have accordingly decided not to proceed at this time with their proposal for a rolling

12 month management expense ratio as proposed in the June Draft Amendments. The CSA are concerned that industry participants do not continue the practice of providing management expense ratios, particularly to media service providers, calculated in ways that are not in compliance with section 16.1 of NI 81-102, and have therefore included an explicit statement to this effect in subsection 14.1(5) in the Policy Amendments to CP 81-102. Once an industry consensus has been developed, the CSA will consider further whether it is advisable to amend section 16.1 of NI 81-102.

7. Calculation of Management Expense Ratio

One commentator suggested that capital taxes should be excluded from the calculation of "total expenses" in the same manner that income taxes and foreign withholding taxes have been excluded. Capital taxes are not consumption taxes like GST that are directly related to expenses and capital taxes are only chargeable based on the level of capital as at the tax year-end of a mutual fund. Including capital taxes in the calculation of management expense ratios distorts the ratios. Given that capital taxes are only charged on corporate funds, it would make sense for comparability of management expense ratios among other mutual funds that capital taxes be excluded, much like income taxes.

***CSA Response*:**

The CSA have not made any changes in response to this comment. The CSA's views on the appropriate accounting treatment of capital taxes in determining the "total expenses before income taxes" for a mutual fund are set out in subsection 14.1(2) of the Policy Amendments to CP81-102. These views have not changed from the June Draft Amendments.

8. Risk disclosure

One commentator suggested that the proposed required disclosure regarding the impact of an increased concentration in any one issuer on the fund's liquidity should not be required. Those securities that are likely to exceed the prescribed 10 percent concentration limit are typically among the most liquid and have the largest trading volumes.

In addition, two commentators expressed concerns regarding the requirement to disclose occurrences during the 12 month period preceding the date of the simplified prospectus of a mutual fund where more than 10 percent of the fund's net assets were invested in the securities of an issuer and asked what the CSA expect this disclosure to include. In particular, they queried as to whether each and every instance where the 10 percent limit had been exceeded in the past 12 months would have to be disclosed. They suggested that, if so, a better approach would be to require disclosure based on how long the mutual fund has held the position in excess of 10 percent, or alternatively require this disclosure based on the numbers available

as at any month end during the preceding 12 month period.

***CSA Response*:**

The CSA have not changed the Rule Amendments to NI 81-101 to accommodate the first comment. The CSA are of the view that disclosure of the potential impact of exceeding the concentration restriction on the fund's liquidity must be disclosed and do not agree with the commentator's assertion that in all cases the subject securities will be large and liquid.

In response to the second comment, the CSA have amended paragraph (6) to Item 9 of Form 81-101F1 to clarify what disclosure must be provided. In addition, instruction (6) to Item 9 of Part B of Form 81-101F1 has been added to clarify that it is not necessary to provide particulars or a summary of each and every occurrence where the concentration restriction was exceeded by a mutual fund in the 12 months preceding the date of the simplified prospectus. Rather, the CSA believe it sufficient for a mutual fund to disclose only that at a time during the 12 month period referred to, the 10 percent concentration restriction was exceeded by the fund.