

**ALBERTA SECURITIES COMMISSION  
NOTICE**

**NOTICE OF PROPOSED CHANGES  
PROPOSED NATIONAL INSTRUMENT 81-104  
AND PROPOSED COMPANION POLICY 81-104CP  
*COMMODITY POOLS***

***Notice of Proposed Changes***

The Commission (we), together with the other members of the Canadian Securities Administrators (the CSA), have made changes to proposed National Instrument 81-104 Commodity Pools and proposed Companion Policy 81-104CP (the proposed National Instrument and the proposed Companion Policy or the proposed instruments) and are effective today publishing for comment a revised version of these proposed instruments.

We made changes primarily in response to comments received on the last versions of the proposed instruments published for comment in June 2000. We describe the most significant changes in this Notice and invite you to comment on them. You should provide your comments within the comment period and in the manner described below.

We intend to review any comments received and finalize the proposed National Instrument and Companion Policy as expeditiously as possible after the end of this comment period.

***Background***

The proposed National Instrument and Companion Policy are initiatives of the CSA and in Ontario reformulate OSC Policy Statement No. 11.4 - Commodity Pools Programs ("Policy 11.4"). These proposed instruments will regulate "commodity pools" (as that term is defined in the proposed National Instrument) which are specialized forms of mutual funds.

Pending the proposed National Instrument and Companion Policy coming into force, Policy 11.4 operates as a guideline for commodity pools in Ontario. If and when the proposed National Instrument and Companion Policy come into force, we will rescind Policy 11.4.

The CSA first published the proposed instruments for comment in June 1997<sup>1</sup> and received one comment letter during that comment period. The CSA published a revised version of the proposed instruments in June 2000<sup>2</sup> after consultation with commodity pool managers and distributors of commodity pools. We asked for comments on the changes made to the June 1997 version and also asked for comments on three specific matters. In response to our last request for

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<sup>1</sup> In Alberta, at (1997) 6 ASCS (Supplement to v.6, iss.26, June 27, 1997.

<sup>2</sup> In Alberta, at (2000) 9 ASCS 1896.

comments, we received eight submissions. The CSA have considered these additional submissions and the changes described in this Notice reflect the CSA's decisions made to respond to those comments. We list the names of the commentators and summarize the comments made in the Appendix to this Notice. Certain commentators gave answers to the questions asked by the CSA and we summarize these answers in the Appendix.

We expect that the proposed National Instrument will be adopted as a rule in each of British Columbia, Alberta, Manitoba, Ontario, Québec, Nova Scotia and Newfoundland, as a Commission regulation in Saskatchewan and as a policy in all other provinces and territories. The proposed Companion Policy is expected to be implemented as a policy in all provinces and territories.

The British Columbia Securities Commission proposes not to adopt some sections of the proposed National Instrument. These sections deal with the proposed rules for establishing new commodity pools, the proficiency requirements that apply to dealers in British Columbia selling securities of commodity pools in that province, and certain of the commodity pool prospectus and continuous disclosure requirements. Effective today, the British Columbia Securities Commission is also amending BCP 31-601, *Registration Requirements*, to liberalize the proficiency requirements for dealers wishing to sell securities of commodity pools in British Columbia.

### ***Substance and Purpose of National Instrument***

We seek to regulate publicly offered "commodity pools" through the proposed National Instrument and Companion Policy. The proposed National Instrument defines "commodity pools" as specialized publicly offered mutual funds that invest in, or use, commodities and/or derivatives beyond the scope permitted in National Instrument 81-102 Mutual Funds (NI 81-102). Since commodity pools are publicly offered mutual funds, they are subject to the mutual fund rules established by NI 81-102 and other applicable securities legislation unless those rules are specifically excluded or varied by the proposed National Instrument.

The proposed National Instrument sets out the specialized rules for commodity pools that are different from the general mutual fund rules and legislation (where applicable) in the following areas, among others:

- Seed capital requirements for new commodity pools
- Additional proficiency requirements for salespersons selling commodity pools and their supervisors
- Payment of incentive fees by commodity pools
- Redemption of units of commodity pools
- Net asset value calculations and disclosure
- Financial statements
- Prospectus disclosure.

We consider that the specialized rules for commodity pools are generally necessary because of the different investment objectives and risk profile of commodity pools when compared with mutual funds regulated by NI 81-102. You can read the Notices we published in June 1997 and June 2000<sup>3</sup> for additional descriptions of the rules contained in the proposed National Instrument, as well as the policies of the CSA set out in the proposed Companion Policy. The Notice published in June 1997 describes the approach we took in reformulating Policy 11.4 and which portions of Policy 11.4 we did not carry forward into the proposed National Instrument or Companion Policy.

### **Summary of Changes to the Proposed National Instrument from the June 2000 Version**

In this section we describe changes made in the proposed National Instrument from the version published in June 2000. Changes of a minor nature, or those made only for purposes of clarification or for drafting reasons are generally not discussed. All section references are to the proposed National Instrument.

#### *Section 1.1 - Definitions*

We have added three definitions – “Canadian Securities Course”, “Chartered Financial Analyst Program” and “mutual fund restricted individual”. These terms are used in Part 4 of the proposed National Instrument. As we outline below, we have changed Part 4 of the proposed National Instrument in response to comments.

#### *Section 2.1 - Investment Restrictions and Practices*

Section 2.1 has been amended in two ways; the first change is technical and the second represents a substantive amendment.

Subsection 2.1(1) is new. It provides the technically necessary relief from the concentration restriction in section 2.1 of NI 81-102 for counterparties acting in specified derivatives transactions with commodity pools. We added this subsection to ensure that commodity pools would not be restricted from entering into derivative transactions with any one counterparty due to the concentration restriction. Section 2.2(2) of the Companion Policy provides additional background to this change.

We have revised subsection 2.1(2) to exempt commodity pools from only certain provisions of section 2.7 of NI 81-102; paragraph 2.7(1)(a) and subsections 2.7(3), (4), and (5).

The June 2000 version of the proposed National Instrument gave commodity pools a complete exemption from section 2.7 of NI 81-102. We made this change to ensure that commodity

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<sup>3</sup>

See above notes 1 and 2.

pools will be subject to the rules in NI 81-102 prescribing acceptable counterparties for mutual funds. That is, as for other mutual funds, commodity pools will be able to only deal with counterparties who have an “approved credit rating” (this term is defined in NI 81-102). We propose this change since we believe that commodity pool investors should not be subject to any increased risk of counterparty failure than conventional mutual funds. We believe that all mutual funds should be subject to the same standards.

### *Part 3 - New Commodity Pools*

We have amended section 3.2(2) to clarify our intention that only the required \$50,000 of seed capital to be invested by the specified entities related to a commodity pool cannot be redeemed prior to dissolution or termination of the commodity pool. Any amounts invested over and above this minimum amount can be redeemed at the discretion of the applicable entity. This change is not substantive.

The British Columbia Securities Commission has decided not to impose these requirements for commodity pools only sold in British Columbia.

### *Part 4 - Proficiency and Supervisory Requirements*

Part 4 has been amended -- and the proposed requirements relaxed -- in response to comments.

Additional proficiency requirements will apply only to those salespersons whose registration restricts them to selling mutual funds; the new definition “mutual fund restricted individual” is intended to describe these individuals. These salespersons generally have only taken an educational course that gives them proficiency in selling conventional mutual funds. These courses do not cover the range of derivative instruments and strategies that can be used by commodity pools. Therefore, we believe that before these restricted salespersons can sell commodity pools, they should have additional proficiency, to bring them at least to the level of those salespersons authorized to sell a full range of securities. For example, generally salespersons employed by investment dealers must have taken the Canadian Securities Course and once registered as a salesperson of a dealer can sell any type of security, including mutual funds and commodity pools.

We have amended the proposed National Instrument so that salespersons (including mutual fund restricted individuals) associated with any category of dealer who have taken the Canadian Securities Course or who have taken the Derivatives Fundamentals Course (as defined in the proposed National Instrument) can sell commodity pools. Salespersons who have successfully completed the Chartered Financial Analyst Program (as defined in the proposed National Instrument) can also sell commodity pools.

However, we continue to believe that individuals employed by dealers (of any category) to supervise trades in commodity pools in Ontario need to have additional knowledge of derivative

instruments and alternative strategies in order to carry out that supervisory responsibility. Supervisors can obtain this additional knowledge either through taking the Derivatives Fundamentals Course or completing the Chartered Financial Analyst Program.

We believe that commodity pools are sufficiently different from conventional mutual funds in their ability to use derivatives to create leverage and short positions that additional proficiency is required for those salespersons and supervisors of trades in commodity pools noted in the proposed National Instrument.<sup>4</sup>

Commodity pool managers have asked us since June 2000 to clarify the existing requirements for dealers selling commodity pools across Canada. In Ontario, under the guidelines established by Policy 11.4 only salespersons who are employed by dealers who are licensed as dealers under the *Securities Act* (Ontario) and as futures commission merchants under the *Commodity Futures Act* (Ontario) can sell commodity pools. Effectively, this means that only certain investment dealers can sell commodity pools, since to date, no mutual fund dealer is so licenced. Other provinces have imposed similar requirements; for example, Alberta and Manitoba do not permit mutual fund dealers to sell commodity pools and British Columbia and Quebec have special requirements for distributors of commodity pools. Once the proposed National Instrument comes into force, these existing requirements will be repealed and replaced by the requirements of Part 4. The British Columbia Securities Commission has decided to liberalize requirements in British Columbia and effective today has amended BCP 31-601 *Registration Requirements* to reflect its decision which applies to sales of securities of commodity pools only in British Columbia.

#### *Part 5 of the 2000 Draft Instrument - Termination of Agreements*

Part 5 of the June 2000 version of the proposed National Instrument has been deleted in response to questions from commentators around its purpose. Although we proposed this Part in the first publication of the proposed National Instrument, after reflection, we see no compelling reason to treat commodity pools differently than conventional mutual funds in this context. We believe that managers of commodity pools, like managers of conventional mutual funds, will adequately address termination provisions in their service agreements without regulatory intervention.

#### *Part 5 - Incentive Fees*

Part 5 has been revised in response to comments.

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<sup>4</sup> The Commission des valeurs mobilières du Québec (CVMQ) is requesting specific comment on the additional proficiency requirements proposed for representatives and supervisors. The CVMQ is concerned with all the issues related to the proficiency requirements for industry participants who distribute units of commodity pools and, in cooperation with the Bureau des services financiers, is currently evaluating potential problems related to implementing additional proficiency requirements.

Commodity pools will be permitted to pay an incentive fee that is based on a “net new profits” methodology; as commodity pools can create both long and short positions, they have a neutral bias. The 90-day treasury bill benchmark proposed in the June 2000 version of the proposed National Instrument is not satisfactory as it does not represent a proxy for the risk or return profile of a commodity pool. In general, commodity pools seek to create positive returns for their securityholders (without reference to a benchmark or index). For this reason, we agree that an incentive fee which is based on cumulative positive performance is more appropriate for these investment vehicles and is more consistent with industry practice in other jurisdictions.

*Section 7.3 - Toll-free Telephone Number, Collect Telephone Calls and Website and Paragraph 9.2(n)*

Section 7.3 is new and complements section 13.4 of NI 81-102 (which is applicable to commodity pools).

Since, in general, the net asset value per unit of a commodity pool can change more rapidly and dramatically than a conventional mutual fund (generally because of leverage), we believe that it is important for investors to have access to the most current net asset value per unit of the commodity pool. Section 7.3 requires commodity pools to make this information available through the media noted.

Paragraph 9.2(n) has been added to require commodity pools to disclose in their prospectuses details on how investors can obtain information about the most current net asset value per unit.

*Section 8.5 - Leverage Disclosure and Paragraph 9.2(b)*

Section 8.5 is new. It requires a commodity pool to give investors information about the commodity pool’s use of leverage on a quarterly basis in the commodity pool’s financial statements. Paragraph 9.2(b) requires the commodity pool to include its leverage limits in its prospectus.

We have not defined the word “leverage” since we understand that industry participants do not have a universally accepted definition and may use the word to describe slightly different things. In recognition of this lack of uniformity, section 8.5 and paragraph 9.2(b) will require the commodity pool to describe what it means by “leverage” as well as the implications to investors of its strategy.

We have added these disclosure requirements mainly because the proposed National Instrument does not require that a commodity pool have any limits on leverage. Given the potential significance of the use of leverage on the risk profile of a commodity pool, we believe it is important that investors understand what limits, if any, the commodity pool has set for itself and how the commodity pool has complied with those limits. We note that the new prospectus disclosure requirements are intended to clarify the disclosure obligations for new commodity

pools, since existing commodity pools generally include such disclosure in their prospectuses. The financial statement disclosure requirements are new.

The British Columbia Securities Commission has decided to not impose the proposed National Instrument's requirements regarding quarterly financial statements for commodity pools sold only in British Columbia.

### *Section 9.2 - Prospectus Disclosure*

Section 9.2 outlines the additional prospectus disclosure requirements for commodity pools. We have made four changes to this section from the June 2000 version.

First, we added two sub-paragraphs to paragraph 9.2(b) to clarify a commodity pool's obligations to disclose leverage limits. We describe this change above.

Second, we amended paragraph 9.2(g)(ii) to remove the requirement to compare the performance of the commodity pool to a 90 day treasury bill benchmark. We do not believe that the 90 day treasury bill benchmark approximates the risk or the return profile for commodity pools. For this reason, a comparison to this benchmark in the required format could be misleading to investors.

Third, we added paragraph 9.2(m) to require a commodity pool to disclose the names and experience of the individuals managing its assets. Mutual funds must provide this disclosure in their annual information forms, and we think that commodity pools should be subject to the same requirements.

Fourth, we added paragraph 9.2(n). We describe this change above.

### *Section 11.3 - Delayed Coming into Force*

Section 11.3 has been deleted since it is no longer necessary as a result of the changes to the proficiency requirements in Part 4, including the decision of the British Columbia Securities Commission.

## **Summary of Changes to the proposed Companion Policy from the June 2000 Version**

In this section we describe changes made in the proposed Companion Policy from the version published in June 2000. Changes of a minor nature, or those made only for purposes of clarification or drafting reasons are generally not discussed. All section references are to the proposed Companion Policy.

### *Part 1 Purpose and Background*

We have added three sections to Part 1 of the Companion Policy. All sections are intended to provide users of the proposed National Instrument with more context and background.

Section 1.2 describes the type of investment vehicle that the proposed National Instrument is intended to regulate.

Section 1.3 gives the background to the development of the proposed National Instrument and describes how we currently regulate commodity pools.

Section 1.4 describes our underlying regulatory principles behind our proposal to regulate commodity pools through the proposed National Instrument.

### *Section 2.2 - Derivatives Use*

Subsection 2.2(2) of the Companion Policy is new. It explains the CSA's view on the operation of subsection 2.1(1) of the proposed National Instrument which is described above. Section 2.2(2) of the Companion Policy explains that the concentration restriction in section 2.1 of NI 81-102 does not apply to counterparties to derivatives contracts entered into by commodity pools, however the restrictions continue to apply to the market exposure of the underlying interest of the specified derivative by operation of the "look through" provision in subsection 2.1(3) of NI 81-102.

Subsection 2.2(3) of the Companion Policy has been amended to clarify which investment restrictions in NI 81-102 continue to apply to commodity pools, and which do not apply. Commodity pools continue to be prohibited from selling securities short and from purchasing securities on margin (i.e., by way of loan). However, commodity pools are able to *use derivatives* to create leverage and short positions.

### *Part 3 - Prospectus Disclosure*

Part 3 has been added to the proposed Companion Policy as background to Part 9 of the proposed National Instrument. It provides guidance on:

1. commodity pools' use of a long form prospectus
2. standardized risk measurement disclosure, if included by commodity pools, and
3. use of performance benchmarks for commodity pools.

### *Part 4 - Limited Liability*

Part 4 generally covers the same content as did Part 3 of the June 2000 version of the proposed Companion Policy. We clarified our views on the status of limited liability for investors in commodity pools under the common and civil law of trusts. We also re-ordered the sections.



### **Authority for the proposed National Instrument (Alberta)**

In those jurisdictions in which the proposed National Instrument is to be adopted or made as a rule or regulation, the applicable securities legislation provides the securities regulatory authority with rule-making or regulation-making authority in respect of the subject matter of the proposed National Instrument.

In Alberta, the following provisions of the *Securities Act* (Alberta) will provide the Commission with the authority to make the proposed National Instrument into a rule.

- section 196 (f) governs commodity pools
- section 196(g) governs derivatives
- section 196(m) governs mutual funds

### **Anticipated Costs and Benefits**

We described the anticipated costs and benefits to commodity pools of the proposed National Instrument in the June 1997 Notice. We believe that none of the proposed changes outlined in this Notice will serve to increase costs to commodity pools, and may reduce costs of compliance for commodity pools and industry participants. The proposed change to the proficiency requirements for sales representatives and supervisors is expected to reduce the impact of the proposed National Instrument on the distribution of commodity pools through participating dealers when compared with the requirements proposed in the previous versions of the proposed National Instrument.

### **Revocation of Ontario Securities Commission Policy 11.4 - Commodity Pool Programs**

Effective the date that the proposed National Instrument comes into force, the Ontario Securities Commission will rescind OSC Policy 11.4.

### **Regulations to be Revoked or Amended**

The Commission will amend section 158 of the Rules to the Act in conjunction with the making of the proposed National Instrument as a rule by adding the following after subsection 158(6):

“(7) Subsections (1) to (6) do not apply to a commodity pool subject to National Instrument 81-104 Commodity Pools.”.

### ***Comments***

You are invited to comment on the changes to the proposed National Instrument and Companion Policy we outline in this Notice. Please submit your comments in writing before March 18, 2002.

Please send us your comments addressed as follows:

British Columbia Securities Commission  
Alberta Securities Commission  
Saskatchewan Securities Commission  
The Manitoba Securities Commission  
Ontario Securities Commission  
Office of the Administrator, New Brunswick  
Registrar of Securities, Prince Edward Island  
Nova Scotia Securities Commission  
Securities Commission of Newfoundland  
Securities Registry, Government of the Northwest Territories  
Registrar of Securities, Government of the Yukon Territory  
Registrar of Securities, Government of Nunavut

c/o John Stevenson, Secretary  
Ontario Securities Commission  
20 Queen Street West  
Suite 800, Box 55  
Toronto, Ontario M5H 3S8  
e-mail: [jstevenson@osc.gov.on.ca](mailto:jstevenson@osc.gov.on.ca)

Please also send your comments to the Commission des valeurs mobilières du Québec as follows:

Denise Brosseau, Secretary  
Commission des valeurs mobilières du Québec  
800 Victoria Square  
Stock Exchange Tower  
P.O.Box 246, 22<sup>nd</sup> Floor  
Montréal, Québec H4Z 1G3  
e-mail: [consultation-en-cours@cvmq.com](mailto:consultation-en-cours@cvmq.com)

If you are not sending your comments by e-mail, please send us two copies of your letter, together with a diskette containing your comments (in either Word or WordPerfect format).

We cannot keep submissions confidential because securities legislation in certain provinces requires that a summary of the written comments received during the comment period be published.

***Questions:***

Please refer your questions to any of:

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British Columbia Securities Commission  
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**Proposed National Instrument and Companion Policy**

The texts of the proposed National Instrument and the Companion Policy follow.

**December 14, 2001**

## **Appendix A**

### **Summary of Comments on the June 2000 versions of the proposed National Instrument and the Companion Policy**

We asked for comment on versions of the proposed National Instrument and Companion Policy published on June 2, 2000. The comment period ended on August 4, 2000. We received eight letters from the following parties:

- AGF Funds Inc.
- Association for Investment Management and Research (AIMR)
- The Canadian Securities Institute
- Di Tomasso Group Inc.
- Dorsey & Whitney LLP on behalf of Friedberg Mercantile Group
- Fogler, Rubinoff on behalf of Friedberg Mercantile Group
- Matisse Investment Management Ltd.
- Mondiale Asset Management Ltd.

We have considered all comments provided by the above commentators and have made the changes described in this Notice in response to some of those comments. We summarize the specific comments provided, together with our responses to those comments in this Appendix. We thank all commentators for their thoughtful review of the proposed National Instrument and Companion Policy and for providing their written comments.

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

### **Specific Questions Asked**

In addition to asking for comments on the changes to the June 1997 version of the National Instrument, we asked for comment on three specific questions. Commentators provided the following answers to those questions:

*Question 1. Incentive Fees* - Should the National Instrument completely exempt commodity pools from the operation of section 7.1 of NI 81-102 and require only disclosure of the incentive fee and the basis on which it is calculated? And if so, will investors be able to make informed decisions about the performance of the commodity pool without any measure of that performance to a benchmark or index?

#### ***Answer and Our Response:***

One commentator suggested that a “net new profits” incentive fee model, being the industry practice in the United States, is the most appropriate model for these products. The commentator also noted, however, that the proposed mandatory benchmark of the 90 day treasury bill rate was satisfactory. Another commentator suggested a more flexible approach may be more appropriate. Customized benchmarks or traditional benchmarks (such as the 90-day treasury bill rate) should be permitted, which ever is best suited for the product.

We have amended Part 5 of the National Instrument in response to these comments and after further consideration. Part 5 now incorporates a cumulative "net new profits" methodology. Under this approach, if a commodity pool has negative historical returns, the pool would pay an incentive fee to the manager only when its subsequent positive returns made up for the past losses. A benchmark would not be required.

*Question 2. Risk Measures* - Are commodity pools sufficiently different from conventional mutual funds in their risk profile to warrant the CSA requiring disclosure of a standardized measure of risk? If so, would the disclosure be comprehensible to the average commodity pool investor? Does a common measure of risk exist in the commodity pool industry in Canada? In the United States?

#### ***Answer and Our Response:***

One commentator responded that it was not aware of a standardized measure of risk that would provide meaningful disclosure to investors in a prospectus. This commentator suggested that commodity pools are not sufficiently different from conventional mutual funds to warrant a standardized measure of risk which it noted is not required for conventional mutual funds. Additional risk measure disclosure would cause greater confusion and uncertainty. Another commentator suggested that an appropriate risk measure would be a “peak-to-valley” assessment and that such a measure should be limited to the two years preceding the date of the prospectus. This commentator did not provide any specific suggestions on how this “peak-to valley” risk measure would be calculated.

We have decided not to require any risk measurement disclosure for commodity pools -- other than the risk disclosure that is already proposed by the National Instrument. We believe that further study is needed on the appropriateness of risk measures for mutual funds generally. However, since we believe that commodity pools have a different risk profile than conventional mutual funds, we have included our views in section 3.1 of the proposed Companion Policy that we will not object to a commodity pool including disclosure of a standardized risk measure in its prospectus.

*Question 3. Risk of Loss of Limited Liability* - The proposed National Instrument requires that a commodity pool address the possibility of loss of limited liability in specialized circumstances in its prospectus. Is this risk sufficiently important and material that front page disclosure should be given?

***Answer and Our Response:***

Two commentators responded that the potential loss of limited liability is not a prominent risk to investors. By requiring disclosure on the front page of the prospectus, the National Instrument would create unwarranted confusion and misunderstanding of the significant risks of investing in a commodity pool. This type of disclosure may over-emphasize this risk to investors while having the practical effect of de-emphasizing other significant risks. In addition, this requirement would cause commodity pools to be perceived in all cases, unfairly, as a riskier product. We agree with the commentators that the National Instrument need not mandate front page risk disclosure of this nature. Our views on the nature of the risks of loss of limited liability are given in Part 5 of the proposed Companion Policy. We have made changes of a clarifying nature to this Part.

**Specific Comments**

**1. Initial Investment by the Promoter**

One commentator suggested that the \$500,000 initial investment threshold be inclusive of the \$50,000 seed capital investment to be made by the promoter, manager, sponsor or portfolio advisor of the pool. Also, the commentator suggested the removal of the prohibition on returning the seed capital, unless the pool is dissolved or terminated.

***Our Response:***

Similar comments were received in the previous comment period. No change has been made to the National Instrument for the reasons described in our previous Notices, other than to correct an unintended anomaly in section 3.2(2) of the proposed National Instrument. We describe our changes to subsection 3.2(2) above. We believe that the minimum seed capital of \$50,000 should remain in the commodity pool for the duration of the commodity pool's existence and that the \$500,000 initial investment required by this Part should be in addition to the seed capital invested in the commodity pool by the parties noted.

The British Columbia Securities Commission has decided to permit commodity pools sold only in British Columbia to use the seed capital rules available for conventional mutual funds as set out in NI 81-102.

## **2. Concentration Restriction in NI 81-102**

One commentator suggested that the 10 percent concentration restriction in section 2.1 of NI 81-102 should not apply to commodity pools. The concentration restriction in section 2.1 of NI 81-102 could preclude a commodity pool from entering into over-the-counter (“OTC”) traded commodity derivatives when the positions taken with one issuer/counterparty of OTC derivatives represented exposure greater than 10 percent of the net assets of the commodity pool. This situation is more relevant to commodity pools, than conventional mutual funds, as they are permitted to take significant positions in specified derivatives through the use of leverage. Imposing this type of restriction on a commodity pool would not meet the reasonable expectations of investors. No similar restrictions apply to commodity pools in the United States.

This commentator also questioned why the investment restrictions in section 2.6(a), (b),(c) and (d) continue to apply to commodity pools when they appear to be inconsistent with the nature of commodity pools.

### ***Our Response:***

Subsection 2.1(1) has been added to the National Instrument. Subsection 2.1(1) exempts commodity pools from the 10 percent concentration restriction in s. 2.1(1) of NI 81-102 for counterparties of derivatives transactions, as *issuers* of the derivative instruments. Section 2.2(2) of the Companion Policy states our views that the concentration restriction continues to apply with respect to the market exposure of the *underlying interest* of the derivative instruments.

No change has been made to the investment restrictions in sections 2.6(a) [the restriction on borrowing], 2.6(b) [the prohibition on purchasing on securities on margin], 2.6(c) [the prohibition on selling securities short] and 2.6(d) [the prohibition on purchasing securities for which contributions may be due] of NI 81-102 which continue to apply to commodity pools under the proposed National Instrument. Commodity pools are specialized mutual funds and therefore, the rules, regulations and policies of the CSA for mutual funds should apply to commodity pools, unless commodity pools need different rules because of their investment objectives and strategies or their structure. We believe that commodity pools do not need to be exempt from the investment restrictions listed above in order to carry out their investment objectives and strategies. We have, however, provided further clarity to the relevant rules in section 2.2 of the proposed Companion Policy, since the commentator may have misunderstood the relationship between section 2.6 of NI 81-102 and section 2.1 (2) of the proposed National Instrument.



### **3. Proficiency Standards for Salespersons and Supervisors**

Several commentators, who currently manage commodity pools, disagreed that salespersons need additional proficiency (or knowledge) before they can sell commodity pools. They suggested that the additional proficiency requirements in the June 2000 version of the proposed National Instrument do not reflect the product and how the product is managed. Commentators argued that the requirements would unfairly disadvantage commodity pools vis a vis other investment products. Also, commentators argued that commodity pools have proven less risky and less volatile, historically, than other professionally managed asset classes. An equity or bond fund, or a commodity pool, all have the same liability potential, that is the loss of an investors' entire investment.

Several commentators suggested that the majority of investment dealer salespersons would not take the time to get the extra level of education to sell commodity pools, which is a minority asset-class product.

One commentator suggested that no additional requirements should be required for the products which only use exchange traded derivatives. This commentator said that the proposed course requirements provided no additional level of protection to investors and that commodity pools do not differ significantly from conventional mutual funds except for their potential use of leverage and their ability to create short positions with derivatives. Due to their similarities to conventional mutual funds, additional proficiency requirements should be evaluated on a case-by-case basis when the use of leverage is limited by a commodity pool.

If the CSA keep the requirements, salespersons who currently sell commodity pools ought to be grandfathered under the proposed National Instrument. The six month transition period (suggested by section 11.3 of the proposed National Instrument) to finish the Derivatives Fundamental Course is not long enough. Concerns were raised that without some changes to the National Instrument, sales representatives may unwind their client's positions without regard for the client's best interests.

Another commentator felt that regulatory emphasis should be placed on product structure, disclosure, industry professional education, as well as investor education. Commodity pools should be regulated in the same way as conventional index mutual funds that use futures contracts to achieve their objectives. This commentator noted that the current proficiency proposals give certain bank products (i.e. guaranteed bank notes that are linked to managed futures programs) a marketing edge. This commentator also noted that the regulation of investment products should ensure that the investor and his or her salesperson have the information required to know everything they need to know to make a suitable investment decision. Proficiency standards should be addressed from the perspective of the whole industry and commodity pools should not be singled out.

***Our Response:***

We have amended the proposed National Instrument to address some of the concerns raised by the commentators -- and in ways that are described in this Notice above. Part 4 of the National Instrument requires sales representatives restricted to selling mutual funds for dealers and supervisors of commodity pool trades for all dealers to acquire additional proficiency prior to selling commodity pools. We believe that commodity pools have significant differences from conventional mutual funds, including those conventional mutual funds that use derivative instruments, given their ability to create leverage and short positions. Although some conventional mutual funds do use specified derivatives to achieve their investment objectives, the rules for the use of derivatives by conventional mutual funds contained in NI 81-102 prevent these funds from using derivatives to create leverage or short positions.

We believe that salespersons who are not limited, through their registration, to selling only conventional mutual funds have sufficient knowledge to make suitability evaluations of whether a commodity pool is an appropriate investment for an investor. Such salespersons, on a daily basis, decide on the suitability for investors on a wide range of investment products. Salespersons registered to sell only mutual funds cannot sell a similarly broad product base. Generally such salespersons have taken an educational course that teaches them how conventional mutual funds use derivative strategies and the applicable restrictions that apply to conventional mutual funds. They do not teach salespersons about the risks of leverage, short selling or commodity investing. For these reasons the proposed National Instrument requires additional proficiency for such persons.

The British Columbia Securities Commission has decided to liberalize their current proficiency requirements for dealers trading in commodity pools in British Columbia. Part 4 will not apply to dealers selling securities of a commodity pool in British Columbia.

**4. Proficiency Requirements**

One commentator suggested that the eligible proficiency requirements in the National Instrument should be expanded to include individuals who have passed the Level I exam of the CFA Program, or in the alternative, individuals who have earned the CFA program designation.

***Our Response:***

We have amended the proficiency requirements to include successful completion of the CFA Program (Level 3) as an acceptable proficiency standard. Since derivatives is not generally covered until Level 3 of the CFA program, we believe that successful completion of this level is important.

## **5. Requirements for Distributors and Dealers**

One commentator noted that the requirement to have an individual responsible for supervising trades “located in the local jurisdiction” as required by section 4.1(2)(a) of the June 2000 version of the proposed National Instrument was inconsistent with its terms of registration. The commentator suggested that the phrase “located in the local jurisdiction” be deleted from the National Instrument.

### ***Our Response:***

We have amended section 4.1(2)(a) to delete the reference to the phrase “located in the local jurisdiction”. We believe that any requirement to have local supervisory personnel should not be dealt with by the proposed National Instrument but in the registration process in each local jurisdiction.

## **6. Termination of Agreements**

One commentator suggested deleting the requirement in the June 2000 version of the proposed National Instrument that all service agreements entered into by commodity pools be terminable without penalty with no more than 60 days’ notice. This commentator saw no reason to differentiate between commodity pools and conventional mutual funds in this regard.

### ***Our Response:***

We have removed this requirement from the National Instrument, since we agree with the comments that there is no reason to retain this requirement.

## **7. Disclosure**

One commentator suggested the disclosure requirements in section 9.2(j) are so broad as to not provide meaningful guidance to issuers. Standard language should be mandated.

### ***Our Response:***

We have not changed the disclosure requirements in section 9.2(j) and are satisfied the disclosure requirements are appropriate.