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

AND TO

FORMS 81-101F1
CONTENTS OF SIMPLIFIED PROSPECTUS

AND

FORM 81-101F2
CONTENTS OF ANNUAL INFORMATION FORM

Substance and Purpose of Proposed Amendments

Introduction

The Canadian Securities Administrators (the "CSA") recently completed two major initiatives that substantially update and reform many aspects of mutual fund regulation in Canada. The two initiatives are:

(a) National Instrument 81-102 Mutual Funds and Companion Policy 81-102CP, which replace National Policy Statement No. 39 ("NP39"); and

(b) National Instrument 81-101 Mutual Fund Prospectus Disclosure, Form 81-101F1 Contents of Simplified Prospectus, Form 81-101F12 Contents of Annual Information Form and Companion Policy 81-101CP, which replace National Policy Statement No. 36 ("NP36").

National Instruments 81-101 and 81-102 and the related forms and companion policies will come into force on February 1, 2000. Both instruments were published in Alberta on November 12, 1999 at (1999) 8 ASCS (Supp.).

In finalizing National Instrument 81-102, the CSA were aware that there remain a number of important regulatory issues relating to mutual funds that require the attention of the CSA and possible changes to the regulatory requirements. As noted by the CSA in the notice that accompanied the publication of National Instrument 81-102 in March 1999[1] for a second comment period, these issues include:

- Use of swap instruments by mutual funds;
- Securities lending by mutual funds and the use of repurchase agreements by mutual funds;
- Standardized regime for the structure of so-called “funds of funds”;
- Timing of transfers among financial institutions and among mutual funds;
- Principal trading in securities between mutual funds and entities related to the manager of the mutual fund;

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[1] In Alberta published at (1999) 8 ASCS (Supp.).

- Acquisition of securities by mutual funds from underwriters related to the mutual fund manager; and

- Inter-fund trading of securities.

The CSA explained in that notice that these issues would be addressed as part of a parallel process that will enable sufficient public comment and industry consultation regarding any revised rules. The CSA indicated that they would consider each of the comments not dealt with in National Instrument 81-102 as expeditiously as possible and publish proposed rules later as amending instruments. The CSA stated that they believed that this approach would permit appropriate regulatory and public consideration of the issues, as well as permit the timely replacement of NP 39 through the finalization of National Instrument 81-102.

The CSA dealt with one of the issues listed above by including rules in National Instrument 81-102 that permit mutual funds to directly use swaps.

The CSA, with this Notice, are publishing for comment proposals that would permit mutual funds to enter into securities lending, repurchase and reverse repurchase transactions on a basis that the CSA believe would be appropriate to both ensure investor protection and permit mutual funds to realize the potential benefits of these transactions for their securityholders. These proposals are proposed to be effected through amendments to National Instrument 81-102 and Companion Policy 81-102CP, and to Forms 81-101F1 and 81-101F2.

The CSA are continuing to work on the other issues listed above, and will propose their course of actions with respect to those issues in due course.

In addition, during the final comment period for National Instrument 81-102, the CSA received a number of useful comments that would have required additional changes to that National Instrument. After consideration of those comments, the CSA decided to deal with some of them by amending the National Instrument after it was in force, rather than making the change before the National Instrument came into force. Under the securities legislation of several jurisdictions, republication for comment of a rule or instrument is required if material changes have been made to a version previously published for comment. The CSA did not wish to delay the implementation of National Instrument 81-102 through a further comment period and so elected to deal with some of those subsidiary issues as part of this amending package.

Also included in these amending instruments are proposed revisions to the rules set out in National Instrument 81-102 deemed necessary as a result of comments received by the CSA after National Instrument 81-102 became final.

Substance and Purpose of the Proposed Amendments to National Instrument 81-102 and Companion Policy 81-102CP and Forms 81-101F1 and 81-101F2

The proposed amendments to National Instrument 81-102 amend the investment restrictions otherwise contained in that Instrument to permit mutual funds to enter into securities lending, repurchase and reverse repurchase transactions in accordance with specified conditions. A regime is established under which a mutual fund may enter into such transactions. The proposed amendments also would implement a number of miscellaneous amendments to National Instrument 81-102 not related to securities lending.

The proposed amendments to Companion Policy 81-102CP add to that Companion Policy discussion of the CSA's views on certain issues relating to securities lending, repurchase and reverse repurchase transactions, and provide interpretation of the provisions proposed to be added to National Instrument 81-102. Included with these amendments are the CSA's views on the appropriate application of Canadian generally accepted accounting principles in the context of mutual funds engaging in these types of transactions.

The proposed amendments to Form 81-101F1 add to the disclosure requirements for a simplified prospectus of a mutual fund that intends to lend its securities or use repurchase and reverse repurchase agreements.

The proposed amendments to Form 81-101F2 add to the disclosure requirements for an annual information form of a mutual fund that intends to lend its securities or use repurchase and reverse repurchase agreements by requiring that the mutual fund disclose its policies and practices in managing these investment strategies.

Background

The CSA received comments during the first comment period for National Instrument 81-102[2] urging them to permit mutual funds to lend their securities and use repurchase agreements and reverse repurchase agreements. The Investment Dealers Association of Canada (the "IDA") and The Investment Funds Institute of Canada ("IFIC") were strong advocates. Staff of the CSA worked with an IDA organized group following receipt of these comments to determine the extent to which it would be appropriate to permit mutual funds to engage in these investment practices. Staff also sought assistance from securities lending agents and mutual fund companies in understanding the risks inherent in these practices, and the extent to which proper parameters would alleviate these risks.

The CSA also reviewed a white paper on securities lending in the United States prepared by the Investment Company Institute[3] and the survey on securities lending practices world-wide prepared by the International Organization of Securities Commissions[4]. Both papers provided the CSA with valuable guidance and assisted in their understanding of the issues.

The CSA also reviewed the guidelines for securities lending by pension plans and life insurance companies (the "Guidelines") developed by the Office of the Superintendent of Financial Institutions ("OSFI").[5] As noted below, the CSA are seeking specific comment on their proposal that the collateral requirements for securities lending transactions and repurchase agreements be lower than the 105 percent levels suggested by the Guidelines.

Summary of Proposed Amendments to National Instrument 81-102

This section describes the amendments proposed to be made to National Instrument 81-102 under the proposed amendments. Section references, unless otherwise noted, are sections or proposed sections of National Instrument 81-102.

Section 1.1
The definition of *"cash cover"* contained in section 1.1 is proposed to be amended through the addition of two new types of portfolio assets that can be used as cash cover.

First, securities purchased by a mutual fund on a reverse repurchase transaction would be permitted to be used as cash cover, to the extent of the cash paid for those securities by the mutual fund. The CSA believe that this approach is appropriate because of the highly liquid nature of the securities permitted to be purchased by a

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2 National Instrument 81-102 was first published for a 120 day comment period in June 1997; in Alberta (1999) 8 ASCS (Supp).

3 Securities Operations Subcommittee and the Custodians Advisory Group, *Securities Lending for Mutual Funds*, (white paper) by Diane M. Butler et al., Washington D.C., U.S.A.: Investment Company Institute, October 30, 1998.

4 The International Organization of Securities Commissions (IOSCO), *Securities Lending Transactions: Market Development and Implications*, Joint Report by the Technical Committee and the Committee on Payment and Settlement Systems, Montreal, Canada: IOSCO, July 1999.

5 OSFI Guidelines Pensions - B-4 Securities Lending -Pension Plans (February 1992) and OSFI Guidelines Life Insurance Companies/Fraternal Benefit Societies - B-4 Securities Lending (February 1997).

mutual fund in a reverse repurchase transaction; under proposed section 2.14, only specified *"qualified securities"* (as defined in the proposed amendments) having the same term as the reverse repurchase agreement are permitted to be so purchased. In addition, the amount of those qualified securities that can be used as cash cover is limited to the amount of cash paid for them by the mutual fund. Because a mutual fund will be required to be over-collateralized with respect to the securities held by it, the amount of cash cover available will not be decreased when the reverse repurchase transaction settles.

Second, the CSA, in response to comments received during the second comment period of National Instrument 81-102, are proposing to amend the definition of *"cash cover"* to permit corporate commercial paper to be used as cash cover, rather than only government commercial paper. The CSA are proposing this change having regard to the general liquid nature of the commercial paper market and the declining supply of government commercial paper. To be eligible for cash cover, the commercial paper must have a term to maturity of less than 365 days and have an approved credit rating (as defined in National Instrument 81-102).

The proposed amendments also add a definition of *"qualified security"* to section 1.1. The proposed definition is identical to paragraphs (a) and (b) of the definition of "cash equivalents" contained in National Instrument 81-102, but without the requirement that the remaining term to maturity of the instrument be 365 days or less. The proposed definition of *"qualified security"* is used in section 2.12 to limit the type of collateral that a mutual fund may receive in a securities lending transaction. The definition is also used in the proposed requirements contained in subsection 2.12(2) and 2.13(2), that a mutual fund may use cash delivered to it as collateral in a securities lending or repurchase transaction to invest in qualified securities. Subsection 2.14(1)3 permits a mutual fund to purchase only qualified securities with a remaining term to maturity of 365 days or less in a reverse repurchase transaction.

Section 1.3

Section 1.3 of National Instrument 81-102 is proposed to be amended through the creation a new subsection 1.3(2), which would be an interpretative provision providing that a mutual fund that renews or extends a securities lending, repurchase or reverse repurchase agreement "is entering into" such a transaction for purposes of sections 2.12, 2.13 or 2.14. This provision would have the effect of requiring that no outstanding transaction be renewed or extended unless all of the conditions to the transaction contained in sections 2.12, 2.13 or 2.14 are satisfied as if the transaction was being entered into for the first time by the mutual fund.

Section 2.7

Section 2.7 is proposed to be amended to impose a requirement that a debt-like security acquired by a mutual fund have an approved credit rating. This change is proposed as a consequence of further consideration by the CSA of the derivatives rules applicable to mutual funds contained in National Instrument 81-102. The other types of instruments referred to in section 2.7 are required to have an approved credit rating, accordingly, the CSA are of the view that mutual funds should only invest in debt-like securities that also have an approved credit rating. This proposed change is unrelated to the securities lending and repurchase transaction amendments.

Section 2.12

The CSA propose a new section 2.12, which would contain the conditions to be satisfied by a mutual fund in order for it to enter into a securities lending transaction as lender.

Section 2.12 permits a mutual fund to enter into such a transaction "despite any other provision" of National Instrument 81-102. This provision is necessary as mutual funds are otherwise prevented from lending portfolio assets by paragraph 2.6(h).

The conditions proposed by the CSA for a mutual fund lending its securities are designed to ensure that the mutual fund in entering into the transaction is properly protected. Similar conditions are proposed to be required for repurchase and reverse repurchase transactions; these conditions are discussed below.

Subsection 2.12(2) requires that a mutual fund may only use cash delivered to it as collateral for a securities loan to purchase qualified securities having a remaining term to maturity no longer than the term of the securities loan, or securities under a reverse repurchase agreement permitted by section 2.14 having a term to maturity no longer than the securities loan. These requirements are designed to permit the mutual fund to maximize the return that it receives on the cash held by it during a securities lending transaction on a low-risk basis that ensures that the mutual fund will be able to settle the securities loan on its maturity. This provision seeks to limit the risk to the mutual fund of a "mismatch" between the term of the securities loan and the term of the qualified securities in which it has invested any cash collateral.

Subsection 2.12(3) requires that a mutual fund retain all non-cash collateral received by it on a securities lending transaction. This requirement is designed to ensure that the mutual fund will take no action to jeopardize its ability to settle outstanding securities lending transactions. In addition, this provision is important to ensure that a mutual fund not leverage its portfolio through securities lending. For example, the mutual fund could double its market exposure to securities it has lent out by selling the collateral received and using the sale proceeds to purchase identical securities to those that it has lent out. Subsection 2.12(3) prohibits such an investment strategy.

Section 2.13

Section 2.13 is an analogous section to section 2.12, and sets outs the conditions and other requirements relating to repurchase transactions. Subsection 2.13(2) is analogous to proposed subsection 2.12(2), and imposes similar requirements on a mutual fund in connection with cash proceeds received by it on a repurchase transaction.

Section 2.14

Section 2.14 is an analogous section to sections 2.12 and 2.13, and sets outs the conditions and other requirements relating to reverse repurchase transactions.

Once in force the rules for the use of reverse repurchase transactions by mutual funds will supersede the discretionary relief granted to those mutual fund companies who have applied for relief from the prohibition on lending money contained in NP39. The CSA encourage those mutual fund companies that have experience with reverse repurchase agreements to carefully review the proposed amendments relating to reverse repurchase agreements.

There are no analogous provisions in section 2.14 to subsections 2.12(2) and (3), as mutual funds acquire qualified securities under reverse repurchase agreements. Therefore, there is no need for a provision that mandates how a mutual fund must deal with cash held by it received from such a transaction.

Conditions to Transactions Proposed by Sections 2.12, 2.13 and 2.14

Proposed sections 2.12, 2.13 and 2.14 impose a number of similar conditions to be satisfied by a mutual fund before it can enter into a securities lending, repurchase or reverse repurchase transaction. The most important conditions are as follows:

1. The transactions must be effected only as part of a program that satisfies the requirements of proposed sections 2.15 and 2.16. As discussed below, this requires or, in the case of reverse repurchase transactions, permits, transactions to be entered into by the mutual fund

and its manager through an agent. These sections also require appropriate internal controls to be established and monitored by the manager of a mutual fund.

2. The transactions must be made under written agreements that reflect the requirements of the relevant section. The CSA are of the view that the conditions specified in the proposed amendments generally reflect existing good practice, and do not anticipate that substantial changes would have to be made to agreements currently used in the market. However, mutual funds and their managers would have to ensure that the agreements reflect the requirements of National Instrument 81-102.

3. The conditions set out the nature of the collateral or proceeds that may be received by the mutual fund in the transaction and, ensure that the collateral or proceeds are received by the mutual fund contemporaneously to when the mutual fund delivers securities or cash.

4. The conditions require that the mutual fund hold collateral or sale proceeds (in the case of a repurchase agreement) equal to at least 102 percent of the value of the securities or cash delivered by the mutual fund in the transaction. The conditions also require a daily mark-to-market of the collateral and readjustments when required.

5. The conditions require that the written agreement give the mutual fund remedies in the case of events of default by its counterparty.

6. In the case of securities lending and repurchase transactions, the conditions require the counterparty of the mutual fund to pay to the mutual fund an amount equal to dividends, interest and distributions made on the securities loaned or sold by the mutual fund.

7. The conditions require that the relevant transaction be a "securities lending transaction" under section 260 of the *Income Tax Act* (Canada).

8. The conditions impose term limits on the transaction. In the case of a securities lending transaction, the mutual fund must be entitled to terminate the transaction at any time and recall the loaned securities within the normal and customary settlement period for securities lending transactions. In the case of a repurchase or reverse repurchase transaction, the term of the transaction can be no longer than five business days.

9. The conditions also provide that the aggregate value of all securities loaned or sold under securities lending and repurchase transactions must not exceed 33 1/3 percent of the total assets of the mutual fund. No limits are set for reverse repurchase agreements and no limits are proposed on the amounts that may be loaned or sold to any one counterparty.

Section 2.15

The proposed amendments would create a new section 2.15, which would set out the requirements relating to the use of an agent by the mutual fund to administer its securities lending, repurchase and reverse repurchase transactions.

Under proposed subsection 2.15(1), the use of an agent to act on behalf of the mutual fund in administering the securities lending and repurchase agreement transactions of the mutual fund would be mandatory. Under proposed subsection 2.15(2), the use of an agent in connection with the reverse repurchase transactions of the mutual fund would be optional.

The CSA are of the view that control of operational risks to mutual funds resulting from deficiencies in

information systems or internal controls is of utmost importance. Operational risks are associated with, among other things, the requirements to daily mark to market the collateral and the securities lent, carrying out prompt margin calls and taking prompt action to close out a position (by selling the collateral) to limit any loss if any events of default occur. Therefore, the CSA are proposing that a mutual fund and its manager always use an agent to carry out the mutual fund's securities lending and repurchase agreement transactions. A mutual fund may carry out its reverse repurchase agreement transactions in-house, in recognition that reverse repurchase agreements are short-term investment instruments which are used by mutual funds as a cash management tool.

Proposed subsections 2.15(3) and 2.15(4) set out the requirements concerning the appointment of an agent. Subsection 2.15(3) requires the agent to be the custodian of the mutual fund, so long as the manager of the mutual fund is confident of the competence of the agent and its ability to satisfy the requirements of the National Instrument. If the manager is not so satisfied, the manager may appoint another person or company to act as agent; that person or company must be, or must become, a sub-custodian of the mutual fund.

Subsection 2.15(5) would require the mutual fund, its manager and the agent to enter into an agreement outlining the terms of engagement of the agent. Subsection 2.15(5) provides that the agreement would contain

(a) instructions from the mutual fund and the manager to the agent on the parameters to be followed by the agent in entering into the type of transactions to which the agreement pertains;

(b) an agreement by the agent to comply with the National Instrument, accept the standard of care imposed on the agent by the National Instrument and to ensure that all transactions conform with the National Instrument; and

(c) an agreement by the agent to provide regular reporting to the mutual fund and the manager concerning the transactions.

Subsection 2.15(6) would impose on an agent a standard of care similar to that of a custodian of a mutual fund.

Section 2.16

Proposed section 2.16 imposes reporting and review requirements on both the agent and the manager of a mutual fund. The section requires that certain specified matters relating to the securities lending, repurchase or reverse repurchase transactions are dealt with in the internal controls of the agent or manager. The section would also impose on the manager of a mutual fund an annual obligation to review the transactions and ensure that they are being conducted in accordance with the requirements of the National Instrument and to ensure that the instructions given to the agent in respect of the transactions continue to be appropriate.

Section 2.17

Proposed section 2.17 would prohibit a mutual fund from entering into a securities lending, repurchase or reverse repurchase transaction unless its simplified prospectus contains the mandated disclosure concerning those transactions, or unless the mutual fund gives 60 days' notice to its securityholders of its intent to enter

into those transactions. Proposed section 2.17 is similar to section 2.11 of National Instrument 81-102, which imposes similar requirements in connection with the commencement of use of specified derivatives by a mutual fund.

Section 4.2

Section 4.2 of National Instrument 81-102 is proposed to be amended to prohibit a mutual fund from entering into a securities lending, repurchase or reverse repurchase transaction with one of the related parties listed in

that section. The proposed amendment expands the existing prohibitions against related party transactions, which pertain only to the sale or purchase of a security.

Section 4.4

Subsections 4.4(5) of National Instrument 81-102 is proposed to be replaced and a new subsection 4.4(6) is proposed in order to provide that the standard of care provisions of section 4.4 do not apply to the actions of a custodian in administering a securities lending, repurchase or reverse repurchase transaction. The separate standard of care specified in proposed subsection 2.15(6) would be the applicable standard of care for an agent in that regard.

Section 6.8

Subsection 6.8(3) of National Instrument 81-102 is to be amended to provide that a mutual fund may not deposit with any one counterparty more than 10 percent of its net assets as collateral for specified derivatives transactions. This provision is analogous to the general 10 percent investment restriction contained in National Instrument 81-102 and is designed to limit the credit exposure of the mutual fund to any one counterparty. This amendment is unrelated to the securities lending and repurchase agreement amendments.

Sections 11.4 and 12.1

Subsections 11.4(1) and 12.1(4) of National Instrument 81-102 are being amended to reflect the recent creation of the Canadian Venture Exchange Inc. through the merger of the Vancouver Stock Exchange and the Alberta Stock Exchange.

Section 15.6

Proposed subsections 15.6(2) and (3) are new rules that would clarify how performance data may be presented in sales communications for mutual funds that have different classes or series of securities.

Subsection (2) would require a sales communication for such a mutual fund to specify clearly the class or series of security to which any performance data contained in the sales communication relates. The subsection would also require performance data to be provided for all classes or series of securities if performance data is provided for any one class or series; this is designed to prevent "cherry picking" of performance data.

Subsection (3) would prevent a sales communication for a new class or series of securities from containing performance data relating to an existing class or series unless the sales communication clearly explained any differences between the new and existing class or series that could affect performance.

These sections are as a result of CSA consideration of industry developments, particularly the establishment of mutual funds with different classes or series. This provision is unrelated to the securities lending and repurchase agreement amendments.

Section 16.2

Proposed subsections 16.2(2) and (3) are new rules that deal with the calculation of the management expense ratio for a mutual fund that has exposure to one or more other mutual funds through the use of specified derivatives. Subsection (2) has the effect of modifying the method of calculation contained in subsection 16.2(1), which relates to calculation of management expense ratio for mutual funds that invest in other mutual funds. Under this method of calculation, the mutual fund taking exposure through specified derivatives to other mutual funds is charged, for purposes of the management expense ratio calculation, with a proportionate amount of the expenses of those other mutual funds. Subsection (3) would make subsection (2) inapplicable

if the use of the specified derivatives do not expose the mutual fund to expenses that would be incurred by a direct investment in the other mutual fund. That is, if the use of derivatives does not actually expose the investing mutual fund to expenses relating to the other mutual funds, then no expenses should be charged to the investing mutual fund for the purposes of the calculation.

This section is a result of CSA consideration of industry developments, particularly the establishment of mutual funds that gain exposure to other mutual funds through the use of derivatives, such as forward contracts. This provision is unrelated to the securities lending and repurchase agreement amendments.

Section 16.3

Section 16.3 is a new section designed to clarify the application of section 16.1 of National Instrument 81-102 to mutual funds whose financial periods ended before the National Instrument comes into force. After the publication in final form of National Instrument 81-102, the CSA received submissions from IFIC and fund companies to the effect that calculating management expense ratios for periods ending before February 1, 2000 in accordance with section 16.1 would be very difficult, and in some cases, virtually impossible due to the lack of data. As outlined in the Notices accompanying the publication of National Instrument 81-102 for comment and as a final rule, section 16.1 changes the method of calculation of management expense ratios for mutual funds. Without the addition of proposed section 16.3, mutual funds would have been obliged to re-calculate the management expense ratios for financial periods that ended prior to the coming into force of the National Instrument, when they disclosed these ratios for those periods. The CSA acknowledge the submissions of the fund industry on the difficulties inherent in re-stating prior periods' management expense ratio, and propose that mutual funds must calculate management expense ratios in accordance with the National Instrument on a go-forward basis and have the option of re-stating management expense ratios for prior periods in accordance with the National Instrument or disclosing management expense ratios for those periods as calculated in accordance with securities legislation in force as of January 31, 2000.

The CSA are examining the implications of this proposed rule amendment in the context of Canadian generally accepted accounting principles and mutual fund financial statement presentation. The CSA will provide guidance either by way of notice or in the Companion Policy, once made final, on the need to disclose the effect of a change to the calculation of the management expense ratio for a period, when compared to the management expense ratio for prior periods calculated differently.

Section 20.3

Section 20.3 of National Instrument 81-102 is proposed to be amended for similar reasons behind the addition of proposed section 16.3. After the publication in final form of the National Instrument, IFIC and fund companies made submissions to the CSA explaining that many funds have financial years that end on December 31. Section 20.3 of National Instrument 81-102 would require the annual reports for those funds that were not printed before February 1, 2000 to comply with National Instrument 81-102, whereas annual reports for those funds that were printed before February 1, 2000 need not be in compliance with the National Instrument. Many mutual funds with financial years that ended on December 31, 1999 have not yet printed

their annual reports. The CSA did not intend for this result and accordingly, propose to amend section 20.3 to clarify that the National Instrument does not apply to reports to securityholders that include only financial statements that relate to financial periods that ended before the National Instrument comes into force.

Summary of Proposed Amendments to Companion Policy 81-102CP

This section describes the amendments proposed to be made to Companion Policy 81-102CP. Section references, unless otherwise noted, are sections or proposed sections of Companion Policy 81-102CP.

Section 2.13

Subsection 2.13(2) is proposed to be amended by the addition of a new paragraph 5, which would state that a "purchase" of a security under National Instrument 81-102 would generally occur when the mutual fund becomes legally entitled to dispose of the collateral held by it under a securities loan or repurchase agreement and to apply proceeds of realization to satisfy the obligations of the counterparty of the mutual fund under the transaction. This issue will be relevant in connection with the investment restrictions of National Instrument 81-102, as a mutual fund that realizes on collateral held by it in securities lending or repurchase transaction will have to consider that realization as a purchase.

Section 3.6

Section 3.6 would be a new section of the Companion Policy, and would contain a number of interpretative or practice comments by the CSA on securities lending, repurchase or reverse repurchase transactions.

Subsection (1) contains recommendations concerning a number of matters that should be contained in securities lending, repurchase and reverse repurchase agreements in order to properly protect the mutual fund.

Subsection (2) discusses the 102 percent collateralization requirements of proposed sections 2.12, 2.13 and 2.14 of the National Instrument. Among other things, the subsection recommends higher collateralization if necessary to protect the mutual fund or if local market practices dictate these higher levels.

Subsection (3) discusses the use of the term "loan" or "lending" transactions. The term should be interpreted to include securities "transferred under a securities lending transaction".

Subsection (4) comments on the requirements contained in the securities lending and repurchase transaction requirements of the National Instrument that the counterparty of the mutual fund be contractually obligated to pay to the mutual fund, among other things, all distributions on the securities that are the subject of the transaction. Subsection (4) emphasises the breadth of the term "distribution".

Subsection (5) comments on the inclusion of accrued interest in the calculation of the market value of securities sold as contemplated by paragraph 6 of subsection 2.13(1) of the National Instrument.

Subsection (6) discusses the possibility of a mutual fund appointing two agents for its securities lending and repurchase agreement transactions. For instance, geographic expertise may make such an allocation of responsibility based on domestic or off-shore transactions appropriate for the mutual fund.

Subsection (7) relates to the requirement proposed to be contained in subsection 2.15(5) of the National Instrument that the manager and the mutual fund provide an agent with instructions concerning the parameters to be followed in entering into securities lending, repurchase or reverse repurchase agreements. Subsection (7) provides a number of examples of the types of parameters that should be dealt with in the agreement between the agent and the manager and the mutual fund.

Subsection (8) reminds market participants that securities loaned by a mutual fund in a securities lending transaction cannot be used as "cash cover" by the mutual fund.

Subsection (9) reminds managers and portfolio advisers of mutual funds to monitor corporate developments relating to securities that are loaned to ensure that the mutual fund can exercise its right to vote those securities in appropriate circumstances.

Subsection (10) reminds managers of mutual funds, and their agents, to ensure that all transactions of securities in securities lending, repurchase or reverse repurchase transactions are effected in a secure manner over an organized market or settlement system.

Section 5.2

Section 5.2 discusses the liability regime of National Instrument 81-102 in the context of securities lending, repurchase and reverse repurchase transactions. The section notes that the retention of an agent to administer a mutual fund's transactions does not relieve the manager of the mutual fund from its ultimate responsibility for these transactions.

Part 14

Part 14 of National Instrument is proposed to be amended through the renaming of this Part as “Financial Disclosure Matters” and by the addition of four new sections, all dealing with the financial disclosure regime applicable to mutual funds lending securities or entering into repurchase or reverse repurchase agreements.

Proposed section 14.2 reminds mutual funds that engage in securities lending and repurchase transactions that they are required to follow Canadian GAAP in preparing financial statements, as supplemented by applicable securities legislation. The CSA explain their views on the application of Canadian GAAP in circumstances where a mutual fund engages in these transactions in new sections 14.3, 14.4 and 14.5.

Proposed section 14.3 contains financial disclosure requirements under Canadian GAAP for mutual funds that enter into securities lending transactions.

Subsection (1) contains the requirements of GAAP related to the statement of investment portfolio of a mutual fund concerning disclosure of the aggregate dollar value of loaned securities that remain outstanding as at the date of the statement and disclosure of the type and aggregate amount of collateral received by the mutual fund. Subsection (2) outlines the required treatment for securities lending transactions on the balance sheet of a mutual fund. Cash collateral from securities lending transactions is to be treated as an asset and the obligation to repay the collateral as a liability. These items would be shown as separate line items in the balance sheet, as required by subsection (3).

Subsection (4) describes that an income statement of a mutual fund present income from securities lending transactions as revenue and not as deductions from expenses.

Proposed section 14.4 contains analogous requirements to section 14.3 and relates to repurchase transactions. Proposed section 14.4 is generally similar to section 14.3.

Proposed section 14.5 contains analogous requirements to section 14.4 and pertains to reverse repurchase transactions. As with repurchase transactions, details of all individual reverse repurchase transactions are required to be made in the statement of investment portfolio of a mutual fund.

Summary of Proposed Amendments to Forms 81-101F1 and 81-101F2

This part of this Notice describes the amendments proposed to be made to Forms 81-101F1 and 81-101F2. Section references, unless otherwise noted, are item numbers of those forms.

Form 81-101F1

Form 81-101F1, which contains the disclosure requirements for a simplified prospectus of a mutual fund, is proposed to be amended by additions to Items 7 and 9 of Part B (fund-specific information) of that form.

Item 7 of Part B, which contains the requirements relating to the disclosure of the investment strategies of a mutual fund, would be amended by the requirement that a mutual fund state its intent to enter into securities lending, repurchase and reverse repurchase transactions, and provide various details concerning its intentions with respect to those transactions. The required disclosure is similar to the disclosure required to be made by

a mutual fund with respect to the use of specified derivatives.

Item 9 of Part B, which contains the requirements concerning risk factor disclosure, would be amended to require a mutual fund to provide risk factor disclosure concerning securities lending, repurchase and reverse repurchase transactions to be entered into by it.

Form 81-101F2

Form 81-101F2, which contains the disclosure requirements for an annual information form of a mutual fund, is proposed to be amended by additions to Item 12 of that form.

Item 12, which relates to disclosure of fund governance practices, would be amended by requirements that a mutual fund disclose its policies and practices to manage the risks associated with securities lending, repurchase and reverse repurchase transactions, and to provide disclosure concerning the organization and administration of the mutual fund's transactions. The required disclosure is similar to the disclosure required to be made by a mutual fund with respect to the management of its specified derivatives programs.

Specific Questions of the CSA

In addition to welcoming submissions on any provision proposed in the proposed amendments relating to securities lending, repurchase and reverse repurchase transactions, the CSA seek comment on the specific matters referred to below.

The CSA note that the regulation of securities lending in the United States contains elaborate provisions where the collateral for a securities loan is irrevocable letters of credit issued by financial institutions. The U.S. regulations also permit other forms of collateral. The CSA have not provided for irrevocable letters of credit to be used as collateral and propose that the only appropriate collateral be those instruments defined as “qualified securities”. The CSA invite comment on whether the definition of "qualified securities" should be expanded to include irrevocable letters of credit or other specified financial instruments as eligible collateral. If so, what parameters should be developed. The CSA would appreciate comments as to why any such additional financial instruments would be appropriate collateral for a securities loan.

A condition placed on securities loans, repurchase and reverse repurchase transactions in proposed sections 2.12, 2.13 and 2.14 is that the transaction must be a "securities lending arrangement" under section 260 of the *Income Tax Act* (Canada) (the "ITA"). The CSA invite comment on whether this condition is too restrictive and whether a reference to the ITA is necessary. The CSA would appreciate an explanation on why this condition is restrictive, if applicable.

The proposed amendments require that a securities loan be an overnight transaction. A mutual fund must be able to recall loaned securities within normal and customary settlement periods. Similarly, repurchase and reverse repurchase agreements must be no more than five business days, before any extension or renewal that requires the consent of both the mutual fund and the counterparty. The CSA invite comment on the appropriateness of these restrictions on the terms of the transactions; in particular specific information regarding the practicality of these restrictions with reference to increases in risks to the mutual fund associated with longer terms.

Cash received (either as collateral or as proceeds of sale) may only be invested in qualified securities or in a reverse repurchase transaction having a term to maturity no longer than the initial transaction. The CSA invite comment on whether this reinvestment restriction is appropriate and practical with regard to these transactions. The CSA invite these comments to address the appropriateness and level of mismatch risk that a mutual fund should be allowed to achieve in investing cash that it receives under its securities lending and repurchase

transactions.

Proposed sections 2.12 and 2.13 provide for an aggregate volume limit on the market value of securities of the mutual fund that can be out on loan or sold pursuant to repurchase transactions. This limit is currently 33 1/3 percent of the total assets of the mutual fund, including collateral received under the transaction. The CSA invite comment on whether this aggregate limit should be a separate limit for securities loans and a separate limit for repurchase transactions and if so, why, with reference to any increased risks to the mutual fund. No limits are proposed for transactions with any one counterparty. The CSA invite comment on whether limits are necessary or whether counterparty risk is adequately dealt with through the over-collateralization requirements, the limits on the types of collateral to be received and the requirement to use an agent.

As noted above, the CSA are aware that the OSFI Guidelines require that the lender take an adequate amount of collateral which is at least 105 percent (in Canada) of the market value of the securities lent. The CSA chose to include the lower level of over-collaterization of 102 percent, as that level reflects current practice in the United States, and increasingly, also in Canada. The proposed amendments to the Companion Policy 81-102CP underscores that the 102 percent collateral requirement must be supplemented if best practices in the local market require greater levels of collateral.

The CSA invite comment on whether the proposed collateral requirement is too low, and if so, comment on what additional risks are being taken on by a mutual fund with this level of over-collateralization. Conversely, if a commentator is of the view that the collateral requirements are not too low, the CSA would appreciate submissions on those views.

The CSA invite comment on whether any of the restrictions proposed for these transactions will unduly reduce the potential for revenues for mutual funds. Commentators who propose lesser restrictions should consider whether these lesser restrictions will increase the risks to mutual funds and comment on how these risks can be properly managed and balanced in favour of investor protection.

Authority for Proposed Amendments (Ontario)

In those jurisdictions in which the proposed amendments to National Instrument 81-102 and National Instrument 81-101 are to be adopted or made as rules or regulations, the securities legislation in each of those jurisdictions provides the securities regulatory authority with rule-making or regulation-making authority.

In Ontario, the following provisions of the *Securities Act* (Ontario) (the "Act") provide the Ontario Securities Commission ("OSC") with authority to make the proposed amendments to National Instrument 81-102 and National Instrument 81-101. Paragraph 143(1)13 of the Act authorizes the OSC to make rules regulating trading or advising in securities to prevent trading or advising that is fraudulent, manipulative, deceptive or unfairly detrimental to investors. Paragraph 143(1)16 of the Act authorizes the OSC to make rules varying the application of the Act to establish procedures for or requirements in respect of the preparation and filing of preliminary prospectuses and prospectuses, including requirements in respect of distribution of securities by means of a prospectus incorporating other documents by reference and requirements in respect of distribution of securities by means of a simplified prospectus. Paragraph 143(1)31 of the Act authorizes the OSC to make rules regulating mutual funds or non-redeemable investment funds and the distribution and trading of the securities of the funds, including in connection with certain enumerated matters. Paragraph 143(1)35 authorizes the OSC to make rules regulating or varying the Act in respect of derivatives, including prescribing requirements that apply to mutual funds. Paragraph 143(1)39 of the Act authorizes the OSC to make rules requiring or respecting the media, format, preparation, form, content, execution, certification, dissemination and other use, filing and review of all documents required under or governed by the Act, the regulations or the rules and all documents determined by the regulations or the rules to be ancillary to the documents.

Comments

Interested parties are invited to make written submissions with respect to the proposed amendments. Submissions received by April 30, 2000 will be considered.

Submissions should be sent to all of the Canadian securities regulatory authorities listed below in care of the Ontario Securities Commission, in duplicate, as indicated below:

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
jstevenson@osc.gov.on.ca

Submissions should also be addressed to the Commission des valeurs mobilières du Québec as follows:

Claude St. Pierre, Secretary
Commission des valeurs mobilières du Québec
800 Victoria Square
Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montréal, Québec H4Z 1G3
claude.stpierre@cvmq.ca

A diskette containing the submissions (in DOS or Windows format, preferably WordPerfect) should also be submitted. As securities legislation in certain provinces requires that a summary of written comments received during the comment period be published, confidentiality of submissions cannot be maintained.

Comments may also be sent via e-mail to the above noted e-mail addresses of the respective Secretaries of the Ontario Commission and of the Commission des valeurs mobilières du Québec, and also to any of the individuals noted below at their respective e-mail addresses.

Questions may be referred to any of:

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Proposed Amendments

The text of the proposed amendments to National Instrument 81-102, to Companion Policy 81-102CP and to Forms 81-101F1 and 81-101F2 follow, together with footnotes that are not part of the proposed amendments, but have been included to provide background and explanation.

DATED: January 28, 2000.