

Note: [02 May 2001] - Changes to 81-102CP. Refer to ASC Notice announcing amendments to NI 81-102 dated 16 Feb 2001.

AMENDMENT TO COMPANION POLICY 81-102CP MUTUAL FUNDS

PART 1 AMENDMENTS

1.1 Amendments

- (1) Companion Policy 81-102CP is amended by the addition of the following as paragraph 5 of subsection 2.13(2):

- "5. (a) The mutual fund has become 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, and
- (b) Sufficient time has passed after the event described in paragraph (a) to enable the mutual fund to sell the collateral in a manner that maintains an orderly market and that permits the preservation of the best value for the mutual fund."

- (2) Companion Policy 81-102CP is amended by the deletion of subsection 2.16(2), the substitution of subsection (2) below as the new subsection 2.16(2) and the addition of subsection (3) below as subsection 2.16(3):

- "(2) Because of the broad ambit of the lead-in language to the definition, it is impossible to list every instrument, agreement or security that might be caught by that lead-in language but that is not considered to be a derivative in any normal commercial sense of that term. The Canadian securities regulatory authorities consider conventional floating rate debt instruments, securities of a mutual fund or commodity pool, non-redeemable securities of an investment fund, American depositary receipts and instalment receipts generally to be within this category, and generally will not treat those instruments as specified derivatives in administering the Instrument.
- (3) However, the Canadian securities regulatory authorities note that these general exclusions may not be applicable in cases in which a mutual fund invests in one of the vehicles described in subsection

- (2) with the result that the mutual fund obtains or increases exposure to a particular underlying interest in excess of the limit set out in section 2.1 of the Instrument. In such circumstances, the Canadian securities regulatory authorities are likely to consider that instrument a specified derivative under the Instrument.
- (3) Companion Policy 81-102CP is amended by the addition of the following as section 3.2, and the consequent renumbering of existing sections 3.2, 3.3, 3.4 and 3.5 as sections 3.3, 3.4, 3.5 and 3.6, respectively:

"3.2 Index Mutual Funds

- (1) An "index mutual fund" is defined in section 1.1 of the Instrument as a mutual fund that has adopted fundamental investment objectives that require it to
 - (a) hold the securities that are included in a permitted index or permitted indices of the mutual fund in substantially the same proportion as those securities are reflected in that permitted index or permitted indices; or
 - (b) invest in a manner that causes the mutual fund to replicate the performance of that permitted index or those permitted indices.
- (2) This definition includes only mutual funds whose entire portfolio is invested in accordance with one or more permitted indices. The CSA recognizes that there may be mutual funds that invest part of their portfolio in accordance with a permitted index or indices, with a remaining part of the portfolio being actively managed. Those mutual funds cannot avail themselves of the relief provided by subsection 2.1(5) of the Instrument, which provides relief from the "10 percent rule" contained in subsection 2.1(1) of the Instrument, because they are not "index mutual funds". The CSA acknowledge that there may be circumstances in which the principles behind the relief contained in subsection 2.1(5) of the Instrument is also applicable to "partially-indexed" mutual funds. Therefore, the CSA will consider applications from those types of mutual funds for relief analogous to that provided by subsection 2.1(5) of the Instrument.

- (3) It is noted that the manager of an index mutual fund may make a decision to base all or some of the investments of the mutual fund on a different permitted index than a permitted index previously used. This decision might be made for investment reasons or because that index no longer satisfies the definition of "permitted index" in the Instrument. It is noted that this decision by the manager will be considered by the Canadian securities regulatory authorities generally to constitute a change of fundamental investment objectives, thereby requiring securityholder approval under paragraph 5.1(c) of the Instrument. In addition, this decision would also constitute a significant change for the mutual fund, thereby requiring an amendment to the simplified prospectus of the mutual fund and the issuing of a press release under section 5.10 of the Instrument."
- (4) Companion Policy 81-102CP is amended by the addition of the following as section 3.7:

"3.7 Securities Lending, Repurchase and Reverse Repurchase Transactions

- (1) Section 2.12, 2.13 and 2.14 of the Instrument each contains a number of conditions that must be satisfied in order that a mutual fund may enter into a securities lending, repurchase or reverse repurchase transaction in compliance with the Instrument. It is expected that, in addition to satisfying these conditions, the manager on behalf of the mutual fund, in co-ordination with an agent, will ensure that the documentation evidencing these types of transactions contains customary provisions to protect the mutual fund and to document the transaction properly. Among other things, these provisions would normally include
 - (a) a definition of an "event of default" under the agreement, which would include failure to deliver cash or securities, or to promptly pay to the mutual fund amounts equal to dividends and interest paid, and distributions made, on loaned or sold securities, as required by the agreement;

- (b) provisions giving non-defaulting parties rights of termination, rights to sell the collateral, rights to purchase identical securities to replace the loaned securities and legal rights of set-off in connection with their obligations if an event of default occurs; and
 - (c) provisions that deal with, if an event of default occurs, how the value of collateral or securities held by the non-defaulting party that is in excess of the amount owed by the defaulting party will be treated.
- (2) Section 2.12, 2.13 and 2.14 of the Instrument each imposes a requirement that a mutual fund that has entered into a securities lending, repurchase or reverse repurchase transaction hold cash or securities of at least 102 percent of the market value of the securities or cash held by the mutual fund's counterparty under the transaction. It is noted that the 102 percent requirement is a minimum requirement, and that it may be appropriate for the manager of a mutual fund, or the agent acting on behalf of the mutual fund, to negotiate the holding of a greater amount of cash or securities if necessary to protect the interests of the mutual fund in a particular transaction, having regard to the level of risk for the mutual fund in the transaction. In addition, if the recognized best practices for a particular type of transaction in a particular market calls for a higher level of collateralization than 102 percent, it is expected that, absent special circumstances, the manager or the agent would ensure that its arrangements reflect the relevant best practices for that transaction.
- (3) Paragraph 3 of subsection 2.12(1) of the Instrument refers to securities lending transactions in terms of securities that are "loaned" by a mutual fund in exchange for collateral. Some securities lending transactions are documented so that title to the "loaned" securities is transferred from the "lender" to the "borrower". The Canadian securities regulatory authorities do not consider

this fact as sufficient to disqualify those transactions as securities loan transactions within the meaning of the Instrument, so long as the transaction is in fact substantively a loan. References throughout the Instrument to "loaned" securities, and similar references, should be read to include securities "transferred" under a securities lending transaction.

- (4) Paragraph 6 of subsection 2.12(1) permits the use of irrevocable letters of credit as collateral in securities lending transactions. The Canadian securities regulatory authorities believe that, at a minimum, the prudent use of letters of credit will involve the following arrangements:
 - (a) the mutual fund should be allowed to draw down any amount of the letter of credit at any time by presenting its sight draft and certifying that the borrower is in default of its obligations under the securities lending agreement, and the amount capable of being drawn down would represent the current market value of the outstanding loaned securities or the amount required to cure any other borrower default; and
 - (b) the letter of credit should be structured so that the lender may draw down, on the date immediately preceding its expiration date, an amount equal to the current market value of all outstanding loaned securities on that date.
- (5) Paragraph 9 of subsection 2.12(1) and paragraph 8 of subsection 2.13(1) of the Instrument each provides that the agreement under which a mutual fund enters into a securities lending or repurchase transaction include a provision requiring the mutual fund's counterparty to promptly pay to the mutual fund, among other things, distributions made on the securities loaned or sold in the transaction. In this context, the term "distributions" should be read broadly to include all payments or distributions of any type made on the underlying securities, including, without limitation, distributions of property, stock

dividends, securities received as the result of splits, all rights to purchase additional securities and full or partial redemption proceeds. This extended meaning conforms to the meaning given the term "distributions" in several standard forms of securities loan agreements widely used in the securities lending and repurchase markets.

- (6) Section 2.12, 2.13 and 2.14 of the Instrument make reference to the "delivery" and "holding" of securities or collateral by the mutual fund. The Canadian securities regulatory authorities note that these terms will include the delivery or holding by an agent for a mutual fund. In addition, the Canadian securities regulatory authorities recognize that under ordinary market practice, agents pool collateral for securities lending/repurchase clients; this pooling of itself is not considered a violation of the Instrument.
- (7) Section 2.12, 2.13 and 2.14 of the Instrument require that the securities involved in a securities lending, repurchase or reverse repurchase transaction be marked to market daily and adjusted as required daily. It is recognized that market practice often involves an agent marking to market a portfolio at the end of a business day, and effecting the necessary adjustments to a portfolio on the next business day. So long as each action occurs on each business day, as required by the Instrument, this market practice is not a breach of the Instrument.
- (8) As noted in subsection (7), the Instrument requires the daily marking to market of the securities involved in a securities lending, repurchase or reverse repurchase transaction. The valuation principles used in this marking to market may be those generally used by the agent acting for the mutual fund, even if those principles deviate from the principles that are used by the mutual fund in valuing its portfolio assets for the purposes of calculating net asset value.
- (9) Paragraph 6 of subsection 2.13(1) of the Instrument imposes a requirement concerning the delivery of sales

proceeds to the mutual fund equal to 102 per cent of the market value of the securities sold in the transaction. It is noted that accrued interest on the sold securities should be included in the calculation of the market value of those securities.

- (10) Section 2.15 of the Instrument imposes the obligation on a manager of a mutual fund to appoint an agent or agents to administer its securities lending and repurchase transactions, and makes optional the ability of a manager to appoint an agent or agents to administer its reverse repurchase transactions. A manager that appoints more than one agent to carry out these functions may allocate responsibility as it considers best. For instance, it may be appropriate that one agent be responsible for domestic transactions, with one or more agents responsible for off-shore transactions. Managers should ensure that the various requirements of sections 2.15 and 2.16 of the Instrument are satisfied for all agents.
- (11) It is noted that the responsibilities of an agent appointed under section 2.15 of the Instrument include all aspects of acting on behalf of a mutual fund in connection with securities lending, repurchase or reverse repurchase agreements. This includes acting in connection with the reinvestment of collateral or securities held during the life of a transaction.
- (12) Subsection 2.15(3) of the Instrument requires that an agent appointed by a mutual fund to administer its securities lending, repurchase or reverse repurchase transactions shall be a custodian or sub-custodian of the mutual fund. It is noted that the provisions of Part 6 of the Instrument generally apply to the agent in connection with its activities relating to securities lending, repurchase or reverse repurchase transactions. The agent must have been appointed as custodian or sub-custodian in accordance with section 6.1, and must satisfy the other requirements of Part 6 in carrying out its responsibilities.

- (13) Subsection 2.15(5) of the Instrument provides that the manager of a mutual fund shall not authorize an agent to enter into securities lending, repurchase or, if applicable, reverse repurchase transactions on behalf of the mutual fund unless there is a written agreement between the agent, the manager and the mutual fund that deals with certain prescribed matters. Subsection (5) requires that the manager and the mutual fund, in the agreement, provide instructions to the agent on the parameters to be followed in entering into the type of transaction to which the agreement pertains. The parameters would normally include
- (a) details on the types of transactions that may be entered into by the mutual fund;
 - (b) types of portfolio assets of the mutual fund to be used in the transaction;
 - (c) specification of maximum transaction size, or aggregate amount of assets that may be committed to transactions at any one time;
 - (d) specification of permitted counterparties;
 - (e) any specific requirements regarding collateralization, including minimum requirements as to amount and diversification of collateralization, and details on the nature of the collateral that may be accepted by the mutual fund;
 - (f) directions and an outline of responsibilities for the reinvestment of cash collateral received by the mutual fund under the program to ensure that proper levels of liquidity are maintained at all times; and
 - (g) duties and obligations on the agent to take action to obtain payment by a borrower of any amounts owed by the borrower.

- (14) The definition of "cash cover" contained in section 1.1 of the Instrument requires that the portfolio assets used for cash cover not be "allocated for specific purposes". Securities loaned by a mutual fund in a securities lending transaction have been allocated for specific purposes and therefore cannot be used as cash cover by the mutual fund for its specified derivatives obligations.
- (15) A mutual fund sometimes needs to vote securities held by it in order to protect its interests in connection with corporate transactions or developments relating to the issuers of the securities. The manager and the portfolio adviser of a mutual fund, or the agent of the mutual fund administering a securities lending program on behalf of the mutual fund, should monitor corporate developments relating to securities that are loaned by the mutual fund in securities lending transactions, and take all necessary steps to ensure that the mutual fund can exercise a right to vote the securities when necessary. This may be done by way of a termination of a securities lending transaction and recall of loaned securities, as described in paragraph 11 of subsection 2.12(1) of the Instrument.
- (16) As part of the prudent management of a securities lending, repurchase or reverse repurchase program, managers of mutual funds, together with their agents, should ensure that transfers of securities in connection with those programs are effected in a secure manner over an organized market or settlement system. For foreign securities, this may entail ensuring that securities are cleared through central depositories. Mutual funds and their agents should pay close attention to settlement arrangements when entering into securities lending, repurchase and reverse repurchase transactions."

- (5) Companion Policy 81-102CP is amended by the addition of the following as section 5.2:

"5.2 Securities Lending, Repurchase and Reverse Repurchase Transactions

- (1) As described in section 5.1, section 4.4 of the Instrument is designed to ensure that the manager of a mutual fund is responsible for any loss that arises out of the failure of it, and of any person or company retained by it or the mutual fund to discharge any of the manager's responsibilities to the mutual fund, to satisfy the standard of care referred to in that section.
- (2) The retention by a manager of an agent under section 2.15 of the Instrument to administer the mutual fund's securities lending, repurchase or reverse repurchase transactions does not relieve the manager from ultimate responsibility for the administration of those transactions in accordance with the Instrument and in conformity with the standard of care imposed on the manager by statute and required to be imposed on the agent in the relevant agreement by subsection 2.15(6) of the Instrument.
- (3) Because the agent is required to be a custodian or sub-custodian of the mutual fund, its activities, as custodian or sub-custodian, are not within the responsibility of the manager of the mutual fund, as provided for in subsection 4.4(5) of the Instrument. However, the activities of the agent, in its role as administering the mutual funds' securities lending, repurchase or reverse repurchase transactions, are within the ultimate responsibility of the manager, as provided for in subsection 4.4(6) of the Instrument."
- (6) Companion Policy 81-102CP is amended by the addition of the following as subsections 13.2(5),(6), (7) and (8):

- "(5) Subsections 15.8(2) and (3) of the Instrument require disclosure of standard performance data of a mutual fund, in some circumstances, from "the inception of the mutual fund". It is noted that paragraph 15.6(d) generally prohibits disclosure of performance data for a period that is before the time when the mutual fund offered its

securities under a simplified prospectus or before an asset allocation service commenced operation. Also, Instruction (1) to Item 5 of Part B of Form 81-101F1 Contents of Simplified Prospectus requires disclosure of the date on which a mutual fund's securities first became available to the public as the date on which the mutual fund "started". Therefore, consistent with these provisions, the words "inception of the mutual fund" in subsections 15.8(2) and (3) should be read as referring to the beginning of the distribution of the securities of the mutual fund under a simplified prospectus of the mutual fund, and not from any previous time in which the mutual fund may have existed but did not offer its securities under a simplified prospectus.

- (6) Paragraph 15.6(a) of the Instrument contains a prohibition against the inclusion of performance data for a mutual fund that has been distributing securities for less than 12 consecutive months. The creation of a new class or series of security of an existing mutual fund 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) unless the new class or series is referable to a new portfolio of assets.
- (7) Section 15.14 of the Instrument contains the rules relating to sales communications for multi-class mutual funds. Those rules are applicable to a mutual fund that has more than one class of securities that are referable to the same portfolio of assets. Section 15.14 does not deal directly with asset allocation services. It is possible that asset allocation services could offer multiple "classes"; the Canadian securities regulatory authorities recommend that any sales communications for those services generally respect the principles of section 15.14 in order to ensure that those sales communications not be misleading.
- (8) The Canadian securities regulatory authorities believe 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."

- (7) Companion Policy 81-102CP is amended by the deletion of section 14.1 and the substitution of the following:

"14.1 Calculation of Management Expense Ratio

- (1) Part 16 of the Instrument sets out the method to be used by a mutual fund in calculating its management expense ratio. The requirements contained in Part 16 are applicable in all circumstances in which a mutual fund calculates and discloses a management expense ratio.
- (2) Subsection 16.1(1) requires a mutual fund to use its "total expenses" before income taxes for the relevant period as the basis for the calculation of management expense ratio. Total expenses before income taxes will include interest charges and taxes of virtually all types, including sales taxes, GST and capital taxes, payable by the mutual fund. Income taxes, of course, would not be included in a calculation of total expenses before income taxes. In addition, Canadian GAAP would permit a mutual fund to deduct withholding taxes from the income to which they apply; therefore, withholding taxes would not be included as part of "total expenses".
- (3) Brokerage charges are not considered to be part of total expenses as they are included in the cost of purchasing, or netted out of the proceeds from selling, portfolio assets.
- (4) Subsection 16.1(4) of the Instrument makes reference to a mutual fund indicating, when providing management expense ratio information to a service provider that will arrange for public dissemination of the management expense ratio, whether management fees were waived or paid directly by investors during the relevant period. It is expected that the service providers will include this information in any disclosure of management expense ratio to the public in a manner that is clear and easily understandable by investors. Service providers may use symbols to inform the public of the different elements of a management expense ratio. If symbols are used, they should be accompanied by an explanatory legend.

- (5) Mutual funds are reminded to ensure that any management expense ratio provided to a service provider for public dissemination should be only the management expense ratio calculated as required by the Instrument."
- (8) Part 14 of Companion Policy 82-102CP is amended by
 - (a) the change of the title of the part to "Financial Disclosure Matters";
 - (b) the addition of the following as section 14.2:

"14.2 Financial Statement Requirements in Securities Lending, Repurchase and Reverse Repurchase Transactions - Mutual funds are required to follow Canadian GAAP in preparing financial statements, as supplemented as applicable by the requirements of other applicable securities legislation. The Canadian securities regulatory authorities wish to provide their views on the appropriate application of Canadian GAAP in circumstances where mutual funds enter into securities lending, repurchase and reverse repurchase transactions. Sections 14.3, 14.4 and 14.5 reflect the views of the Canadian securities regulatory authorities as to the steps those mutual funds should take in order to ensure that their financial statements comply with Canadian GAAP.";

- (c) the addition of the following as section 14.3:

"14.3 Financial Statement Requirements Concerning Securities Lending Transactions

- (1) A mutual fund, in the statement of investment portfolio included in the annual and interim financial statements of the mutual fund, or in the notes to that statement, should
 - (a) disclose the aggregate dollar value of securities that were lent in the securities lending transactions of the mutual fund

that remain outstanding as at the date of the statement; and

- (b) disclose the type and aggregate amount of collateral received by the mutual fund under securities lending transactions of the mutual fund that remain outstanding as at the date of the statement.

- (2) A balance sheet of a mutual fund that has received cash collateral in a securities lending transaction that remains outstanding as of the date of the balance sheet should fairly present

- (a) the cash collateral received by it as an asset; and
- (b) the obligation to repay the cash collateral as a liability.

- (3) The asset and liability referred to in subsection (2) should be shown as separate line items in the balance sheet.

- (4) An income statement of a mutual fund should fairly present income from securities lending transactions as revenue and not as deductions from expenses.";

- (d) the addition of the following as section 14.4:

"14.4 Financial Statement Requirements Concerning Repurchase Transactions

- (1) A mutual fund, in the statement of investment portfolio included in the annual and interim financial statements of the mutual fund, or in the notes to that statement, should, for each repurchase transaction of the mutual fund that remains outstanding as at the date of the statement, disclose the date of the transaction, the

expiration date of the transaction, the name of the counterparty of the mutual fund, the nature and market value of the securities sold by the mutual fund, the amount of cash received, the repurchase price to be paid by the mutual fund and the market value of the sold securities as at the date of the statement.

- (2) A balance sheet of a mutual fund that has entered into a repurchase transaction that remains outstanding as of the date of the balance sheet should fairly present the obligation of the mutual fund to repay the collateral as a liability.
- (3) The liability referred to in subsection (2) should be shown as a separate line item in the balance sheet.
- (4) An income statement of a mutual fund should fairly present income from the use of the cash received on repurchase transactions as revenue and not to offset expenses incurred in connection with the repurchase transaction."; and

(e) the addition of the following as section 14.5:

"14.5 Financial Statement Requirements Concerning Reverse Repurchase Transactions

- (1) A mutual fund, in the statement of investment portfolio included in the annual and interim financial statements of the mutual fund, or in the notes to that statement, should for each reverse repurchase transaction of the mutual fund that remains outstanding as at the date of the statement, disclose the date of the transaction, the expiration date of the transaction, the name of the counterparty of the mutual fund, the total dollar amount paid by the mutual fund, the nature and value or principal amount of the securities received by the mutual fund and the market value

of the purchased securities as at the date of the statement.

- (2) A balance sheet of a mutual fund that has entered into a reverse repurchase transaction that remains outstanding as of the date of the balance sheet should fairly present the reverse repurchase agreement relating to the transaction as an asset at market value.
- (3) The asset referred to in subsection (2) should be shown as a separate line item in the balance sheet.
- (4) An income statement of a mutual fund should fairly present income from reverse repurchase transactions as revenue and not as deductions from expenses.".

PART 3 EFFECTIVE DATE

3.1 Effective Date - This Amendment comes into force on May 2, 2001.