FAIR | Canadian Foundation *for* Advancement *of* Investor Rights

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RE: Comments on CSA's Proposed Amendments to NI 81-102 *Mutual Funds* and NI 81-106 *Investment Fund Continuous Disclosure*, and Related Consequential Amendments

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A. Introduction

A.1. We are pleased to offer our comments on the Proposed Amendments to NI 81-102 *Mutual Funds* and NI 81-106 *Investment Fund Continuous Disclosure*, and the related consequential amendments (the "**Proposed Amendments**") as set out in the "Request For Comments" section of (2010) 33 OSCB at 5833 *et. seq*. (the "**Notice**").

A.2. Thank you for the opportunity to provide these comments.

A.3. The Canadian Foundation for Advancement of Investor Rights ("FAIR Canada") is an independent non-profit organization dedicated to representing the interests of Canadian investors in securities regulation. The mission of FAIR Canada is to be a national voice for investors in securities

regulation and a catalyst for enhancing the rights of Canadian shareholders and individual investors.

A.4. We understand that the current project of which the Proposed Amendments are a part, will occur in two phases, that the Proposed Amendments represent the culmination of Phase 1, and that Phase 2 of the project will consider and review the different regulatory regimes applicable to mutual funds (in particular NI 81-102) and other investment funds. We understand that Phase 2 will look at these different regimes with a view to harmonization, and whether such harmonization is either desirable or practical, with a view to investor protection as well as other issues.

A.5. FAIR Canada, as an organization with a specific commitment to the protection and defence of investor rights, would like to make representations to the CSA in some fashion at an early stage of the Phase 2 review. Please let us know through how we can best make such representations. We will not deal with Phase 2 issues in these Comments.

A.6. Our comments fall into seven categories:

1. Comments regarding Proposed Amendments related to exchange-traded funds in continuous distribution;
2. Comments regarding the Proposed Amendments related to exchange-traded funds not in continuous distribution;
3. Comments regarding the Proposed Amendments related to fund-on-fund investments or the "tiering" of mutual fund investments, including "funds of funds";
4. Comments regarding the Proposed Amendments related to short selling and the use of specified derivatives by mutual funds;
5. Comments regarding the Proposed Amendments related to the regulation of money-market mutual funds;
6. Comments regarding the Proposed Amendments related to "Mutual Fund Ratings Agencies"; and
7. Comments regarding the Proposed Amendments related to other consequential Proposed Amendments.

1. Comments regarding Proposed Amendments related to exchange-traded funds in continuous distribution ("Open-Ended ETFs")

1.1. We have two principal comments regarding the Proposed Amendments related to Open-Ended ETFs, including a request for clarification of one aspect of the Proposed Amendments.

1.2. First, we would like to commend the CSA for proposing that investors be allowed to use cash and securities or a combination thereof to purchase units of ETFs. This is a welcome step and provides flexibility for investors and for funds.

1.3. We have concerns, however, with the proposal to amend subsection 10.4(3) to permit the payment of redemption proceeds:

> with the prior written consent of the securityholder, by making good delivery to the securityholder of portfolio assets, the value of which is equal to the amount at which those portfolio assets were valued in calculating the net asset value per security used to establish the redemption price.

1.4. Our concern stems from the ability of funds to further devalue redemption proceeds paid to investors. We understand that it is accepted practice to design redemption mechanisms for exchange-traded funds (including Open-Ended ETFs) that permit funds to allow redemptions only at less than a full-value basis, such as 95% of NAV. However, if Open-Ended ETFs are permitted to further use portfolio assets instead of cash to pay redemptions, it will be open to such funds to redeem in illiquid securities, overvalued securities, or securities the fund thinks are likely to underperform.

1.5. For example, in an (admittedly rare) situation where an investor chose to redeem units of an Open-Ended ETF, market price may trail NAV significantly, and NAV may only be calculated on a weekly basis. In such an instance, if a fund were allowed to rely on some time of pre-existing consent to redeem in securities, it could choose to redeem in securities that were high-value at the date NAV was calculated (which will be the reference price for redemption) but low-value at the date of redemption. The fund is therefore allowed not only to discount the redemption price, but to pay it in price-inflated securities.

1.6. We would support the ability of investors to *choose* to receive redemption proceeds in the form of

portfolio assets, however, as many funds currently permit. **We therefore would request that the CSA clarify what it means by "with the prior written consent of the securityholder."** It is our view that the *only* such consent that should be permitted in such circumstances is a consent that is contemporaneous with the redemption request. We understand that it is common within the industry to permit this, and that many Open-Ended ETFs have redemption mechanisms that allow investors to choose to receive portfolio assets of one kind or another in lieu of cash. However, we do not know if the CSA shares this restrictive definition of "prior written consent". We would welcome some clarification.

1.7. We do not consider the requirements to maintain some cash (or liquid securities) on hand to potentially fund redemptions for investors who wish to redeem securities to be onerous. It is normal practice to see redemptions capped at an aggregate amount for the fund for a specific period; we observe that funds can use these caps effectively to keep liquidity to a minimum where desired. We consider preserving the ability of investors to insist on cash redemptions in all (reasonable) circumstances to be more important.

1.8. Second, we would like to address the proposal to allow Open-Ended ETFs to permit the calculation of the redemption price of fund units based on the market price of such units.

1.9. Because of the traditional "haircut" to redemption price in the redemption mechanisms of Open-Ended ETFs, such a measure further forces investors towards the market in order to liquidate their holdings in fund units, rather than to redemptions. We do not consider this a negative result for investors and concede that this is part and parcel of the generally accepted structure of redemption mechanisms for Open-Ended ETFs. However, we would like to point out to the CSA that, in each instance, regulations have been changed to make it more difficult to allow investors to exercise their legal and equitable rights to redeem their trust units. In circumstances where trading is light or where market price is significantly trailing NAV for any reason, investors needing to liquidate will be the ones hurt and funds will benefit commensurately. We would like investors to be able to rely on the NAV of a mutual fund to obtain a fair price, and not be subject to the potential vagaries of pricing paradoxes or fluctuations.

2. Comments regarding the Proposed Amendments related to exchange-traded funds not in continuous distribution ("Closed-End ETFs")

2.1. We have two principal comments regarding the Proposed Amendments related to Closed-End ETFs. First, however, we would like to comment briefly and commend the proposal to allow Closed-End ETFs to borrow cash and give security in order to finance the acquisition of portfolio assets *during the IPO stage only.* We think this is wise as it will, at least in theory, allow Closed-End ETFs to make better allocation decisions regarding pricing and asset acquisition, by spreading out the period in which acquisitions can be made.

2.2. **Our first comment is that we note that the CSA proposes to exempt Closed-End Funds from the current prohibition on reimbursing the costs of organization. We would advise against the permanent adoption of such a change.**

2.3. As the CSA explains, the reason for the prohibition within the current rules is so that initial investors in mutual funds generally (who will pay prices from which organization costs would be deducted) are not hurt at the expense of later investors (whose prices will be determined on the basis of NAV, in which the costs do not appear). We appreciate that within a typical Closed-End ETF, no such price discrimination would exist, as all investors will be making purchases of units in the same limited offering period. However, we note that Closed-End ETFs may make a secondary offering. Once a secondary offering occurs, pricing discrimination issues apply. As such, unless Closed-End ETFs are prevented from making secondary offerings, the problems CSA has previously identified would potentially exist, and the prohibition would be necessary.

2.4. Our second comment is that the CSA proposes to codify the ongoing, routine exemption allowing Closed-End ETFs to permit redemption at a redemption price that is only a *fraction* of NAV, as we have discussed above.

2.5. **We would urge the CSA to combat the gradual trend within the industry to make the redemption option less and less attractive to investors.** As such, we would propose a lower limit of 95% of NAV as the lowest allowable fraction of NAV at which Closed-End ETFs will be permitted to redeem units. Investors in Closed-End ETFs are already hamstrung, at times, with thin markets for their units, and in certain circumstances markets could become very thin. The practice of allowing

funds to preferentially inflate the unit values of remaining investors at the expense of liquidating investors is discriminatory between similarly-situated investors.

2.6. We urge the CSA to consider the redemption option for investors not to be a nuisance to be minimized or done away with in preference to market sales, but instead as protection for investors, which investors can access in a non-punitive way.

3. Comments regarding the Proposed Amendments related to fund-on-fund investments or the "tiering" of mutual fund investments, including "funds of funds"

3.1. We have three specific comments regarding the Proposed Amendments regarding the investments in mutual funds by other mutual funds, which we will refer to as "tiering" of mutual funds for the purposes of this letter. However, first we would like to provide general comments regarding the tiering of mutual funds.

3.2. Generally, we consider tiered mutual fund structures to be entirely antithetical to the concept of a mutual fund, in which a fund manager is engaged to invest the fund's assets according to that manager's best skill and ability, in line with the investment objectives of the fund. Tiered mutual funds instead result in fund managers investing in each other's products. What is almost inevitably tiered in such arrangements is not profit, but fees, eating into the returns investors should earn with no real benefit in the first place. It makes little sense for expert investors to replace the judgements of others for their own, yet the tiering of mutual funds accomplishes little else. Management fees, loads, commissions and other expenses are incurred, at both levels, with no additional benefit for the ultimate investor.

3.3. We recognize that there is a place in the mutual fund world for a low-fee "fund of funds" approach, in which an entire sector of the mutual fund industry is purchased by a single fund in order to provide maximum diversification. However, the key to such funds is that they should be as low-fee as possible and do as little active trading as possible. We believe that the Proposed Amendments do not require or even encourage low-fee approaches to the tiering of mutual funds.

3.4. We encourage the CSA or any of its members, before adopting measures such as those in the

Proposed Amendments, to study the issue of fees charged in tiered mutual fund structures. It is our belief that tiered funds provide no substantial benefits either to performance or risk, but carry significantly higher erosion to the investor in the form of tiered fees. We would note that, although certain fees are not permitted to be charged in tiered structures, many fees are so permitted. We would like to know if total fees (on a look-through basis) paid by mutual fund investors are growing as a result of increased tiering, and if tiering results in higher net fees on that same look-through basis.

3.5. Our first specific comment is that proposed sections 2.1, 2.2 and 2.5 allow "top funds" in tier structures to be exempt from concentration restrictions when investing in other mutual funds. We object to the Proposed Amendments to this extent. Mutual funds can, potentially, be used to "cascade" holdings in particular securities to a greater extent than could be generated directly. There is no reason, in our view, why individual CSA members could not and should not retain oversight of concentration restrictions as they do currently, and to the extent that hard concentration limits apply to mutual funds, such limits should apply on a *look-through* basis so that funds monitor the holdings of mutual funds they themselves hold, and so that concentration restrictions that are in place for investor protection are not disregarded as a result of tiering.

3.6. Finally, there are two specific proposals in the Proposed Amendments which we would encourage the CSA to adopt. The first is the proposal to require underlying funds in a tiered structure to be reporting issuers in the same jurisdictions as the top funds in the tiered structure. We consider this a positive amendment, appropriate for investor protection. Second, we would encourage the proposal to allow funds to hold UK index participation units as well as Canadian and US units. We consider such index participation units to generally be low-cost, diverse, and able to provide international diversification that is frequently helpful to funds and to investors. We would even suggest and recommend that the CSA consider that funds be allowed to hold index participation units for a far greater number of stock exchanges than those currently permitted. The *Income Tax Act* (Canada) and its associated regulations have a lengthy list of "designated stock exchanges" and we would not object to the extension of the Proposed Amendment to any or all such exchanges.

4. Comments regarding the Proposed Amendments related to short selling and the use of specified derivatives by mutual funds.

4.1. The Proposed Amendments relating to revising the existing mutual fund prospectus forms to ensure reasonably prominent disclosure of short selling are in our view a positive change. However, we would ask the CSA to consider further, tougher requirements on short selling disclosure, not merely in Part B, but under Item 4 of Part A, which details general risks. Substantial amounts of short selling, even at the limited levels permitted by the Proposed Amendments, may make some mutual funds completely inappropriate for some investors.

4.2. Regarding the cash cover requirements in the Proposed Amendments for both short selling and for specified derivatives, we have no particular comment on the revised definition of cash cover. We are unaware, however, of what research was done or information received that led the CSA to specifically choose a 150% figure for the cash cover requirements for short sales and whether this is higher than strictly necessary for a value that is calculated on a daily basis. This represents a substantial amount of cash, a portion of which might indeed be better put to other investment uses within the fund. We would appreciate any possible clarification of this point.

5. Comments regarding the Proposed Amendments related to the regulation of money market mutual funds

5.1. We congratulate the CSA on following through with the Proposed Amendments related to the regulation of money market mutual funds that arose from the responses to the CSA's 2008 consultation on the market crash. The review of money market fund regulation is welcome. We have four specific comments related to aspects of these Proposed Amendments. The CSA are proposing to:

1) *Allow money market funds to invest in other money market funds.*

5.2. The Proposed Amendments would permit money market funds to invest in other money market funds. We do not consider this a good idea from an investor protection perspective. As discussed above in item 3 of our comments, the tiering of mutual funds involves the inevitable stacking of fees,

especially management fees. Furthermore, because the funds in question are money market funds, the investments typically held in them would be both relatively anodyne, and difficult to differentiate. As such, we feel that neither investor returns nor investor risk will be well-served by allowing money market fund managers to avoid undertaking their own investment objectives by relying on other managers to invest for them.

2) Disallow money market funds from engaging in short selling or using specified derivatives.

5.3. We congratulate the CSA on this approach. We consider short selling entirely inappropriate for a money market fund, and consider the use of specified derivatives unnecessary in such a fund, even as a hedge against other assets.

3) Institute strict liquidity requirements.

5.4. The proposed liquidity requirements for money market funds (that 5% of assets be convertible to cash within one day and 15% within seven days) seem appropriate for such funds. We are not, however, aware of data that would allow us to establish whether these requirements would insulate typical money market funds against the redemption requests made on their worst-ever day. In fact, stress-test measures such as this one should (in our view) be even more forgiving.

5.5. We note that in the United States, the new Securities and Exchange Commission ("**SEC**") rules regarding money market funds have liquidity requirements that are double what is proposed here. We would like to solicit the CSA's views on why a less strict liquidity requirement is appropriate for the Canadian market. We would offer the view that the Canadian market – being smaller – may be more prone to shock than the U.S. market, and furthermore that we are not aware of any reasons why Canadian money market funds might be less susceptible to short-term redemption pressures than U.S. money market funds.

5.6. We believe that regulators should not be in a position to potentially allow mutual funds that are sold and marketed as money market funds to fall into a situation where they might not meet redemption requests. We hope that the CSA are under no circumstances taking this risk.

4) Dollar-weighted "average term to maturity" limits.

5.7. We note that the CSA proposes to keep the current 90-day limit and to add a new 120-day limit calculated on a strict end-of-term basis for floating-rate notes. However, as the CSA itself notes in the Notice, the new SEC rules provide a 60-day limit, considerably stricter and less susceptible to interest rate swings – the stated SEC purpose in setting those limits.

5.8. We would therefore ask the CSA to clarify why it considers (and why we should consider) Canadian money market funds to be more insulated from interest rate shocks than U.S. money market funds. Given the smaller size of the Canadian economy, the smaller economic footprint of the Canadian dollar, and the smaller market for Canadian securities, we would infer that Canadians appear to be less well insulated from interest rate shocks, despite the work of the Bank of Canada in stabilizing interest rates.

6. Comments regarding the Proposed Amendments related to "Mutual Fund Ratings Agencies"

6.1. We would like to commend the CSA for its leadership and innovation on these Proposed Amendments. We have one minor comment. Currently, these Proposed Amendments require that "detail" on the methodology be provided, in the form of an outline within the sales communication and a link to the website where more detail is provided. We would like to see this amended so that it is specified that ALL DATA used in the calculation of such ratings, and the complete methodology used to establish the ratings, be made available. That is, we would like the CSA, through the Proposed Amendments, to ensure that the methodologies used by Mutual Fund Ratings Agencies be entirely public and transparent and their results entirely reproducible.

7. Comments regarding the Proposed Amendments related to other consequential Proposed Amendments

7.1. Regarding the other consequential amendments set forth in the Notice, we have two brief comments.

7.2. First, regarding the Proposed Amendment to NI 81-106 eliminating the reporting of short-term debt on an aggregate basis within a mutual fund's statement of investments - we agree with this proposed change.

7.3. Second, regarding the Proposed Amendments to NI 81-106 concerning the calculation of NAV, we note that funds shall be required to make their NAV “available to the public”. We agree with the proposed change, but have a further suggestion: NI 81-106 should specify that the current (appropriate) calculation of NAV should be available immediately on request by mail, telephone, fax, e-mail, or via the World Wide Web, all at addresses or numbers made available in the fund's prospectus and in other disclosure of the fund.

7.4. We thank you for the opportunity to provide our comments and views on the Proposed Amendments and welcome the public posting of this submission. We would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-572-2282/ ermanno.pascutto@faircanada.ca or Ilana Singer at 416-572-2215/ ilana.singer@faircanada.ca.

Sincerely,

Canadian Foundation for Advancement of Investor Rights