

1.1.2 CSA Staff Notice 81-322 – Status Report on the Implementation of the Modernization of Investment Fund Product Regulation Project and Request for Comment on Phase 2 Proposals



CSA STAFF NOTICE 81-322

STATUS REPORT ON THE IMPLEMENTATION OF THE MODERNIZATION OF
INVESTMENT FUND PRODUCT REGULATION PROJECT
AND
REQUEST FOR COMMENT ON PHASE 2 PROPOSALS

May 26, 2011

Purpose

This Notice provides an update on the implementation of the Canadian Securities Administrators' (CSA) project to modernize the product regulation of publicly offered investment funds (the Modernization Project). We also seek feedback from investors and industry stakeholders on the CSA's proposal to focus next on developing an operational rule for non-redeemable investment funds, as part of a staged approach to proceeding with the Modernization Project.

Background

The Modernization Project's mandate is to review the product regulation of publicly offered investment funds and to consider whether our current regulatory approach sufficiently addresses product and market developments in the Canadian investment fund industry, and continues to adequately protect investors. The types of investment funds that are within the scope of the Modernization Project include: (i) open-end mutual funds¹, (ii) exchange-traded mutual funds² and (iii) non-redeemable investment funds.³

Open-end mutual funds rose in popularity subsequent to the passage of changes to the *Income Tax Act* (Canada) in the late 1950's, which enabled them to rapidly flourish as vehicles for registered retirement savings plans. By the late 1960's, assets under management by open-end mutual funds had considerably surpassed those under management by non-redeemable investment funds, which prior to that time had been the most prevalent form of publicly offered investment fund. The quick rise to mass appeal of the open-end mutual fund product led to much of the literature written on the need for regulation of mutual funds in Canada, and subsequent regulatory initiatives which focused on open-end mutual funds. Such initiatives included National Policy 39 – *Mutual Funds* (NP 39), an amalgamation of mutual fund policies from the 1970's and 1980's, which was implemented in November 1987. NP 39 was subsequently reformulated into National Instrument 81-102 *Mutual Funds* (NI 81-102) in January 2000. As a result, the investment fund product regulation we have today was drafted primarily with the traditional open-end mutual fund in mind.

Over the last decade, however, the gamut of publicly-offered investment fund products available to retail investors has expanded. Exchange-traded mutual funds have proliferated, with assets under management growing from approximately \$6 billion in December 2000 to approximately \$41 billion in March 2011⁴. Non-redeemable investment funds, although not new to the product landscape, have evolved in structure and complexity. In a time of rapid market development and innovation and increasing complexity of investment fund products, we think it is important that we assess the current regulatory framework that applies to different types of publicly offered investment funds to ensure our investor protection, fairness and market efficiency objectives are being met.

¹ Open-end mutual funds generally issue an unlimited number of units or shares from treasury on a continuous basis and provide a regular redemption feature, typically daily, at the fund's net asset value (NAV).

² Exchange-traded mutual funds are open-end mutual funds whose units trade on an exchange. It is typically only large institutional investors (designated brokers) that purchase or redeem exchange-traded mutual fund units directly from the exchange-traded mutual fund at the fund's NAV, and then only in large blocks, which are usually exchanged in-kind with baskets of the underlying securities. Individual retail investors typically buy and sell units of exchange-traded mutual funds on the exchange at prevailing market prices, which may be at a premium or discount to a fund's NAV.

³ Non-redeemable investment funds typically issue a finite number of units or shares on an initial public offering, following which the units or shares are generally traded on an exchange at prevailing market prices, which may be at a premium or discount to NAV. They may offer the opportunity to redeem on an infrequent basis at a price based on the fund's NAV. See footnote 8 for details.

⁴ Source: Investor Economics.

The Modernization Project is a continuation of the CSA's efforts to regulate comparable publicly offered investment fund products in a similar manner.⁵ Most recently, the CSA indicated that as part of the final stage of implementation of the point of sale disclosure proposals, we will consider point of sale disclosure requirements for other types of publicly offered investment funds, not just open-end mutual funds.⁶ We anticipate that our work on the Modernization Project may inform this effort.

We are carrying out the Modernization Project in two phases.

Status of Modernization Project – Phase 1

On June 25, 2010, the CSA published amendments to NI 81-102, as well as related consequential amendments (together, the Phase 1 Amendments), for a 90-day comment period.

The Phase 1 Amendments focus primarily on publicly offered "mutual funds", as defined under Canadian securities legislation. Open-end mutual funds and exchange-traded mutual funds are "mutual funds" as each of them have a redemption feature that "entitles the holder to receive on demand, or within a specified period after demand, an amount computed by reference to the value of a proportionate interest in the whole or in the part of the net assets"⁷. The Phase 1 Amendments propose to codify exemptive relief that has frequently been granted by the CSA to recognize market and product developments, particularly the proliferation of exchange-traded mutual funds. The Phase 1 Amendments are also intended to keep pace with developing global standards in mutual fund product regulation. This includes updates to the requirements related to money market funds.

The comment period for the Phase 1 Amendments ended on September 24, 2010. We received 24 comment letters. Subject to any material changes being made to the Phase 1 Amendments, the CSA anticipate publishing the amendments in final form by late summer 2011.

Status of Modernization Project – Phase 2

While work is underway to finalize the Phase 1 Amendments, we are beginning work on Phase 2 of the Modernization Project. The CSA's objective in Phase 2 is to identify and address any market efficiency, investor protection or fairness issues that arise out of the differing regulatory regimes that apply to different types of publicly offered investment funds. Our aim in Phase 2 is to reduce the potential for regulatory arbitrage that may exist within the current regulatory framework.

The CSA propose to proceed with Phase 2 of the Modernization Project in stages, as described below. A staged approach will allow us the opportunity to focus first on investor protection and fairness concerns we have identified that arise out of the lack of an operational rule for non-redeemable investment funds.

Phase 2 – Stage 1 Proposal

As securities of non-redeemable investment funds are not redeemable on demand based on net asset value, these funds are generally not considered by the CSA to be "mutual funds" under securities legislation and are accordingly not subject to the operational requirements of NI 81-102.⁸ These operational provisions include important self-dealing restrictions intended to protect mutual fund investors from transactions that may place the fund manager's interests ahead of theirs, and voting rights which enable investors to vote on proposed fundamental changes to the fund. In our view, securityholders of non-redeemable investment funds should similarly have these basic protections. While the structure and operations of mutual funds and non-redeemable investment funds may vary, both types of funds are fundamentally the same as they each offer investors the benefits of pooled investing and portfolio management services. We think this common primary purpose of investing money provided by their securityholders necessitates that both types of funds equally follow certain core investor protection and fairness principles.

We have begun to consider adopting certain core restrictions and operational requirements analogous to those in NI 81-102 for non-redeemable investment funds, to address certain investor protection and fairness concerns we have identified. Among these concerns are: protecting investors from transactions that give rise to a conflict of interest; providing investors with the

⁵ National Instrument 81-106 *Investment Fund Continuous Disclosure* (June, 2005) and National Instrument 81-107 *Independent Review Committee for Investment Funds* (November, 2006) apply to all types of retail investment funds.

⁶ See CSA Staff Notice 81-319 – *Status Report on the Implementation of Point of Sale Disclosure for Mutual Funds* (2010) 33 OSCB 5449, at page 5450.

⁷ See definition of "mutual fund" in s.1(1) of the *Securities Act* (Ontario) and similar definitions in the respective Securities Acts of the CSA jurisdictions.

⁸ Non-redeemable investment funds listed on stock exchanges may, on an infrequent basis, offer the ability to redeem at a price based on NAV. The CSA generally take the view that where this redemption opportunity arises more frequently than once per year (e.g. monthly or quarterly), the fund provides a regular redemption feature and is therefore considered to be a "mutual fund" subject to the requirements of NI 81-102. Where however this redemption opportunity arises no more frequently than once per year, the fund is not considered a "mutual fund" and escapes the application of NI 81-102.

opportunity to vote on important changes that may impact the investment fund and its investors; ensuring the proper safeguarding of the investment fund's assets; and, potentially, some core investment restrictions. We anticipate that a proposed new stand-alone rule will be published for comment in early 2012.

Phase 2 – Stage 2 Proposal

In the second stage of Phase 2 of the Modernization Project, we propose to re-examine the investment restrictions applicable to open-end mutual funds and exchange-traded mutual funds under Part 2 of NI 81-102 to assess what, if any, changes should be made in recognition of market and product developments.

Increasingly, open-end mutual funds and exchange-traded mutual funds have sought more flexibility to make certain investments and employ strategies not currently permitted under NI 81-102, such as investments in physical commodities and new derivatives strategies. We propose to consider in the second stage of Phase 2 whether it would be beneficial to investors if certain investment restrictions in NI 81-102 were loosened. Relaxing certain investment restrictions may also achieve a more fair and consistent regulatory framework across all investment fund products. At the same time, informed by past experience and recent market events, we will also consider whether additional investment restrictions on mutual funds are needed to further reduce product and market risks and to ensure a mutual fund's ability to satisfy redemptions on demand. We anticipate we may also during this stage consider requirements or restrictions for non-redeemable investment funds that are in addition to those we are initially proposing in the first stage of Phase 2. We anticipate publishing for comment any proposed amendments in 2013.

Specific Issues for Consideration on the Modernization Project – Phase 2

In the first stage of Phase 2, we propose to introduce a new stand-alone rule that would apply only to non-redeemable investment funds. We anticipate that the rule will initially impose certain core restrictions and operational requirements on non-redeemable investment funds that will promote the investor protection and fairness principles we think should apply to all types of publicly offered investment funds. Among the requirements the CSA have identified are:

- **Conflict of interest provisions** to prohibit certain self-dealing transactions between the non-redeemable investment fund and its manager, trustee or portfolio advisor, and to restrict certain investments in related persons or companies.

These could be similar to the restrictions that apply to mutual funds under Part 4 of NI 81-102 and under the mutual fund conflict of interest provisions in the Securities Acts of the various CSA jurisdictions. In some jurisdictions, consideration will be given to recommending amendments to the Securities Acts that would implement, or facilitate the implementation of, these requirements;

- **Securityholder and regulatory approval requirements** for specified fundamental changes to the non-redeemable investment fund (e.g. change of investment objective, merger with another fund, increase in fees, etc.) and to the management of the fund. These could be similar to the requirements for mutual funds in Part 5 of NI 81-102; and
- **Custodianship requirements** designed to ensure that the assets of the non-redeemable investment fund are sufficiently safeguarded.

Currently, custodianship requirements for non-redeemable investment funds are set out in Part 14 of NI 41-101 – *General Prospectus Requirements* (NI 41-101). The CSA propose to move these requirements out of NI 41-101 and into the stand-alone rule for non-redeemable investment funds.

The introduction of the above minimum requirements for non-redeemable investment funds will extend key protections and rights to investors in these funds that are currently available only to investors in retail open-end mutual funds and exchange-traded mutual funds.

Specifically, restrictions on self-dealing and related-party transactions for non-redeemable investment funds would mandate consistent treatment of these types of transactions under securities legislation by all types of retail investment funds. This would result in fund managers of non-redeemable investment funds being required to seek regulatory and/or independent review committee approval under NI 81-107 *Independent Review Committee for Investment Funds* to engage in these types of transactions, as is already required of fund managers of retail mutual funds.

The requirements would further ensure that investors of non-redeemable investment funds have consistent and guaranteed voting rights on important changes that may impact the investment fund or its management.

Finally, the requirements would ensure that all non-redeemable investment funds comply with the custodianship requirements, not just those who filed a prospectus under NI 41-101 since the coming into force of that rule in 2008.

Issues for comment:

1. Do you agree with our view that certain consistent, core investor protection requirements should apply equally to all types of publicly offered investment funds? We particularly seek feedback from investors.
2. Do you agree with our approach to develop a stand-alone operational rule for non-redeemable investment funds? If not, what approach would you propose? What are the advantages and disadvantages of this approach?
3. We seek feedback on the initial restrictions and operational requirements we have identified for non-redeemable investment funds. If you disagree, what restrictions and operational requirements would be appropriate for non-redeemable investment funds and why? If you think no requirements are needed, please explain why.
4. Are there other investor protection principles and/or requirements of NI 81-102 which the CSA should consider for non-redeemable investment funds at this time? If so, please explain.
5. In addition to the initial requirements the CSA has identified for non-redeemable investment funds, we are considering the possibility of imposing certain investment restrictions, similar to those set out under Part 2 of NI 81-102. Please identify those core investment restrictions that, in your view, should apply to these funds and explain why. If you think no investment restrictions are needed, please explain why.
6. What do you foresee as the anticipated cost burdens in complying with the initial restrictions and operational requirements we are proposing for non-redeemable investment funds? Specifically, we request data from the investment fund industry and service providers on the anticipated costs of complying with the Phase 2 proposals.

Deadline for Comments

We have raised specific issues for comment in this Notice. We also welcome your comments on other aspects of our proposals for Phase 2 of the Modernization Project, including our general approach and any changes we should make. We will consider these comments and then follow our usual rule-making process to seek input from, and work collaboratively with, all stakeholders.

Submissions we receive are not confidential. All comments will be posted on the Ontario Securities Commission website at www.osc.gov.on.ca. Thank you in advance for your comments.

We will accept your comments on our proposals until July 25, 2011.

Please send your comments electronically in Word format.

Where to Send Your Comments

Please address your comments to all CSA members, as follows:

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

Please send your comments only to the addresses below. Your comments will be forwarded to the remaining CSA member jurisdictions.

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