

NOTICE AND REQUEST FOR COMMENT**PROPOSED NATIONAL INSTRUMENT 81-106
AND COMPANION POLICY 81-106CP
*INVESTMENT FUND CONTINUOUS DISCLOSURE, AND
FORM 81-106F1
CONTENTS OF ANNUAL AND QUARTERLY MANAGEMENT REPORTS
OF FUND PERFORMANCE*****Introduction**

The Canadian Securities Administrators (the “CSA”), with this Notice, are publishing for comment proposals that would implement a new regulatory regime governing the continuous disclosure provided by investment funds. The proposed regulatory regime attempts to address the need to provide more timely and useful ongoing financial and non-financial information about an investment fund to investors and advisers.

It is anticipated that the form of financial disclosure prescribed by the proposed National Instrument will allow an average investor to better assess an investment fund’s performance, position and future prospects. Improving the quality and timeliness of financial disclosure should increase the likelihood that investors, or potential investors, will use the information to compare investments and to make appropriate investment decisions. Likewise, it is expected that the proposed form of financial disclosure will assist advisers in selecting and recommending appropriate investments that are consistent with their clients’ goals. Further, the adoption of the proposed regulatory regime on a national basis will serve to harmonize reporting requirements for investment funds across the jurisdictions.

The proposed National Instrument and Form are expected to be adopted as a rule in each of British Columbia, Alberta, Manitoba, Ontario, Quebec, Nova Scotia and Newfoundland and Labrador, as a Commission regulation in Saskatchewan and as a policy in all other provinces and territories. The proposed Companion Policy is expected to be implemented as a policy in all provinces and territories.

The implementation of the proposed National Instrument will also include certain consequential amendments (the “Consequential Amendments”) to National Instrument 81-101 Mutual Funds Prospectus Disclosure (“NI 81-101”) and its related forms, Companion Policy 81-101CP (“81-101CP”), National Instrument 81-102 Mutual Funds (“NI 81-102”), Companion Policy 81-102CP (“81-102CP”), National Instrument 13-101 - System for Electronic Document Analysis and Retrieval (SEDAR) (“NI 13-101”) and OSC Rule 41-502 - Prospectus Requirements for Mutual Funds (“OSC Rule 41-502”).

Substance and Purpose of Proposed National Instrument, Form and Companion Policy

The key features of the proposed National Instrument, Form and Companion Policy are: (i) the introduction of annual and quarterly management reports of fund performance, (ii) the revision and updating of the requirements relating to annual and interim financial statements and (iii) changes to current filing and delivery requirements.

The proposed National Instrument is intended to apply to all types of investment funds, including but not limited to, mutual funds, labour sponsored investment funds (“LSIFs”), exchange traded funds, split share corporations, closed end funds and scholarship plans.

Summary of Proposed National Instrument, Form and Companion Policy

Annual and Quarterly Management Reports of Fund Performance

To address the concern expressed about the timeliness and relevance of financial information provided by investment funds, the CSA are proposing the introduction of annual and quarterly management reports of fund performance. These reports, required to be prepared in accordance with Form 81-106F1, will present both quantitative and qualitative information about the fund in a concise and plain language manner. It is intended that quarterly reporting will provide investors and advisers with current information about the investment fund without all the details of full interim or annual financial statements.

A key element of the management reports of fund performance is the Management Discussion of Fund Performance (“MDFP”). MDFP is an analysis and explanation that is designed to supplement an investment fund’s financial statements. It addresses two main topics - past performance and the strategic position of the fund going forward. Past performance is analysed within the framework of a fund’s investment objectives and strategies. The MDFP should highlight those aspects of the objectives or strategies that had material impacts on performance. Any changes to the level of risk of the fund are required to be identified. Discussion of the strategic position of the fund going forward should focus on known material trends, commitments, events, risks or uncertainties that might reasonably be expected to affect a fund’s future performance or investment activities.

The annual management report of fund performance will provide financial highlights for a fund for the past year, but will not include the full, traditional financial statements. The quarterly management reports of fund performance will contain less detailed information than an annual management report of fund performance and will serve to highlight significant changes from the information in the last annual management report of fund performance of the fund. The investment fund’s auditor will be expected to follow the requirements of Section 7500 of the CICA Handbook with respect to their involvement with the annual management report of fund performance.

Financial Statement Requirements

The proposed National Instrument contains revised and updated content requirements for the annual and interim financial statements of investment funds. The aim is to have a

consistent set of rules governing financial statement disclosure for investment funds across Canada and to update the current requirements to improve the usefulness of these financial statements.

Part 7 of the proposed National Instrument requires specified disclosure in the annual and interim financial statements of an investment fund on securities lending, repurchase and reverse repurchase transactions. Note that this part of the proposed National Instrument restates the requirements currently contained in Part 14 of 81-102CP. In addition, Part 7 of the proposed National Instrument provides guidance on the accounting of incentive and performance fees, costs of continuous distribution of securities and trailing commissions.

Part 8 of the proposed National Instrument contains provisions setting out when financial and performance information relating to more than one investment fund and to multiple class mutual funds may be bound into one document. Note that management reports of fund performance for more than one investment fund are prohibited from being bound together. In addition, Part 8 sets out certain specific accounting requirements for LSIFs and scholarship plans. In particular, it should be noted that LSIFs have the option of not disclosing the fair value of securities for which a market value is not readily available in their statement of investment portfolio, provided the LSIF has obtained and filed a formal valuation prepared in accordance with Part 9 of the proposed National Instrument. Any formal valuation obtained in accordance with Part 9 must have been prepared by an independent valuator having appropriate qualifications.

Filing and Delivery Requirements

The National Instrument proposes to give security holders the option of choosing whether to receive any or all of a fund's financial statements and management reports of fund performance. This presents a departure from the current regime which requires that the annual financial statements required to be filed with the regulators also be delivered to all security holders. The CSA are proposing this change in recognition of the cost involved in the delivery of financial statements. In addition, given the public availability of financial statements on the SEDAR website (www.sedar.com) as well as on the manager's website (if any), the mandated delivery of such documents to investors does not seem necessary to ensure full disclosure.

Accordingly, the National Instrument requires an investment fund to ask investors on an annual basis whether they would like to receive any or all of the fund's annual and quarterly management reports of fund performance, and interim and annual financial statements. Delivery of these documents is only required to be made to those holders who specifically request them. However, the transitional provision in Part 18 of the proposed National Instrument requires that the first annual management report of fund performance that is prepared by an investment fund must be sent to all investors.

Finally, the proposed National Instrument shortens the time periods for the filing of annual and interim financial statements with the regulators. The time for filing annual financial statements is reduced from 140 days after year end to 90 days after year end,

while the time for filing interim financial statements is reduced from 60 days to 45 days after the end of the interim period. Management reports of fund performance are required to be filed at the same time as financial statements. The time periods for filing have been reduced in order to improve the timeliness of financial information such that the information will be more current and relevant and useful to investors and advisers in their investment decisions.

The shortened time periods for the filing of annual and interim financial statements are consistent with the time periods set out in proposed National Instrument 51-102 Continuous Disclosure Obligations (“NI 51-102”) for senior issuers. Investment funds are distributed both through primary distributions, generally on a continuous basis, and on an exchange. The CSA believes that disclosure in accordance with the shortened time periods is necessary for information to be relevant and useful to investors.

Other Continuous Disclosure Obligations

Part 11 of the proposed National Instrument provides that if a material change (in the case of a non NI 81-102 investment fund) or a significant change (in the case of a NI 81-102 investment fund) occurs, an investment fund is required to promptly issue and file a news release disclosing the nature and substance of the change and to post such news release on the website of the investment fund or fund manager. In addition, a material change report containing the information required by Form 51-102F3 is required to be filed no later than 10 days after the date on which the change occurs. This reporting requirement replaces the significant change requirement for mutual funds currently in NI 81-102.

Finally, it should be noted that the proposed National Instrument requires investment funds to comply with certain parts of NI 51-102 as if those parts of the rule applied to investment funds, eg. the solicitation of proxies (Part 12), restricted share disclosure (Part 13) and change of auditor (Part 14).

Summary of the Proposed Consequential Amendments

Proposed Amendments to NI 81-101 Mutual Fund Prospectus Disclosure

The CSA are proposing a change to NI 81-101 to allow for the incorporation of the annual and quarterly management reports of fund performance into the simplified prospectus by reference. Corresponding changes are made to the introductory language required to be made in a prospectus by Item 3 of Part A of Form 81-101F1, and to a related discussion in section 2.4 of 81-101CP.

The most significant change to NI 81-101 is the deletion of the top ten holdings, past performance and financial highlights information (Items 8, 11 and 13.1 of Part B) from Form 81-101F1. This information is being deleted from the simplified prospectus for the reason that it would otherwise be duplicated by the financial highlights, past performance and summary of portfolio investments information which is proposed to be disclosed in the annual and quarterly management reports of fund performance in accordance with Form 81-106F1. In addition, given the frequency with which management reports of fund performance will be produced, investors and advisers will be provided with more

current and therefore more useful financial highlights, past performance, and holdings data on which to base their investment decisions.

Finally, an instruction is proposed to be added to Item 15 of Form 81-101F2 to indicate that the disclosure concerning executive compensation for management functions carried out by employees of a mutual fund may be made in accordance with the disclosure requirements of NI 51-102, specifically Form 51-102F6 Statement of Executive Compensation.

Proposed Amendments to NI 81-102 Mutual Funds

The CSA are proposing the following amendments to NI 81-102:

1. amending the definition of “report to securityholders” to include annual and quarterly management reports of fund performance;
2. amending the definition of “sales communication” so as to include annual and quarterly management reports of fund performance to the list of documents which are not considered to be “sales communications”;
3. deleting section 5.10 relating to significant changes as it is replaced by the provisions of Part 11 of the proposed National Instrument;
4. deleting Part 17 relating to financial statement requirements as it is replaced by the provisions of Part 7 of the proposed National Instrument; and
5. deleting the discussion on financial statement requirements for securities lending, repurchase and reverse repurchase transactions from Part 14 of 81-102CP.

Proposed Amendment to NI 13-101 System for Electronic Document Analysis and Retrieval

An amendment is proposed to NI 13-101 so as to add annual and quarterly management reports of fund performance to the list of mandated electronic filings for mutual funds and other issuers in Appendix A of NI 13-101.

Proposed Amendments to OSC Rule 41-502 Prospectus Requirements for Mutual Funds

Section 10.1 of OSC Rule 41-502, which provides an exemption from the requirement to file an AIF in accordance with subsection 81(2) of the Securities Act (Ontario), is deleted. This change is being made because the same exemption is being provided for in Part 10 of the proposed National Instrument. As a result, the exemption from the requirement to file an AIF, which is currently only exists on a local (Ontario only) level, is being made available on a national level.

Withdrawal of Staff Accounting Communique 52-708 - Initial Offering Costs of Closed-End Investment Funds

The Commission will withdraw Staff Accounting Communique 52-708 - Initial Offering Costs of Closed-End Investment Funds upon the coming into force of the proposed National Instrument.

Specific Questions of the CSA Concerning Proposed NI 81-106.

1. Management Reports of Fund Performance

Proposed Part 6 of NI 81-106 requires all investment funds that are reporting issuers to prepare, file and make available to those who request it, a quarterly management report of fund performance. The purpose of the quarterly management report of fund performance is to provide up-to-date information about the fund to current and prospective investors and to advisers and dealers who analyze funds and recommend them to their clients. It is expected that the quarterly management reports of fund performance will be approximately two pages in length.

Since quarterly updated financial information will be available in the quarterly management report of fund performance, it is proposed that NI 81-101 be amended to remove the financial highlights, top 10 holdings and performance data from the simplified prospectus.

The CSA invite comments as to whether the quarterly management reports of fund performance will achieve the goals that they are intended to achieve. Should there be more or less frequent disclosure of fund performance information and why? Should there be quarterly reporting for all investment funds? Does the proposed type of information allow an investor or an adviser to make informed investment decisions?

2. Financial Statements

The purpose of the annual and interim financial statements of an investment fund is to communicate information that is useful to investors, advisers and other users in making their investment allocation decisions and/or assessing management stewardship. The users of an investment fund's financial statements include: investors, advisers and dealers, financial analysts, management, regulators and creditors.

A key characteristic of financial statements is comparability. With over 2000 investment funds in Canada, investors and advisers need to be able to compare the financial information of different types of investment funds. A certain level of detail within the financial statements is considered necessary to assist comparability and consistency of financial information.

The CSA invite comment on whether the financial statement requirements set out in the proposed Rule meet the needs of the users of the financial statements? Does the amount of detail provided in the proposed National Instrument assist with the preparation, consistency and comparability of the financial statements? Is the proposed National Instrument too detailed? Is more detail or specific direction necessary?

The majority of investment funds currently prepare and file six month interim financial statements. Should all investment funds be required to prepare and file quarterly financial statements in addition to the proposed quarterly management reports of fund performance?

3. Disclosure of Risk and Volatility

Investors and advisers require information to assess the risk of an investment. The proposed management reports of fund performance would include disclosure of how material or significant changes to the investment fund have affected the overall level of risk associated with an investment in the fund. The concepts of risk and volatility are also reflected in the required disclosure of financial highlights, performance data and the summary of the investment portfolio.

The CSA invite comments on whether alternative methods of disclosing risk and volatility should be used. For example, should there be disclosure of the fund's best and worst quarter returns or disclosure of the correlation of the fund to a benchmark index? Is there additional disclosure that would provide useful information to the investors and advisers?

Authority for the Proposed National Instrument (Alberta)

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

In Alberta, the following provisions of the *Securities Act* (Alberta) provide the Alberta Securities Commission with authority to make the proposed National Instrument and Form:

- section 223(f): governs the regulation of commodity pools
- section 223(g): governs the regulation of derivatives
- section 223(p): governs the regulation of mutual funds including the form and content of reports to be filed by the management company of a fund
- section 223(q): governs the regulation of scholarship plans
- section 223(r) and (s): governs the provision of documents under Parts 12 and 13 of the Act and the prescription of disclosure requirements under Parts 10, 12 and 13 including the forms required for disclosure purposes
- section 223(v): governs the regulation of the format, preparation, form, contents, execution, certification, dissemination of all documents under the Act and regulations. This includes preliminary prospectuses, prospectuses, interim financial statements, financial statements, proxies and information circulars.
- section 223(gg): governs the variations of time periods set in the Act and regulations

Alternatives Considered

While developing the regime contained in the proposed National Instrument, the following alternatives were also considered:

Status Quo

Currently, mutual funds are required to prepare audited annual financial statements that are to be delivered to investors within 140 days of the mutual fund's fiscal year end. Mutual funds are also required to prepare unaudited semi-annual interim financial statements that are to be delivered and filed within 60 days of the period end. Many mutual funds utilize the exemptive provisions of National Policy 41 - Shareholder Communications that sets out an exemption from delivering interim financial statements subject to the maintenance of a supplementary mailing list.

This alternative does not address either of the issues of timeliness and usefulness of financial information or harmonization of financial disclosure requirements.

Implement Reporting requirements similar to non-mutual fund reporting issuers

Non-mutual fund reporting issuers have the same annual audited financial statement requirements as mutual funds. However, non-mutual fund reporting issuers are also required to file and deliver quarterly interim financial statements and management discussion and analysis (MD&A).

This approach would address the issue of timeliness by requiring information to be provided on a quarterly rather than semi-annual basis. However, it was felt that this approach would not address the issues of the usefulness of the information or the harmonization of regulation. Indeed, concerns have been expressed in the media and elsewhere that the investment funds industry continues to offer products that many people find difficult to understand. Traditional financial statements do not adequately capture the business of investment funds. The investment funds industry focuses on assets carried at market value and the performance and risk of those assets. Therefore, it was decided that the needs of investors would not be well met by simply requiring traditional financial statements more frequently.

Related Amendments

Related consequential amendments are proposed to be made to:

- NI 81-101 *Mutual Fund Prospectus Disclosure*, Companion Policy 81-101CP *Mutual Fund Prospectus Disclosure*, Form 81-101F1 *Contents of Simplified Prospectus* and Form 81-101F2 *Contents of Annual Information Form*;
- NI 81-102 *Mutual Funds*, Companion Policy 81-102CP *Mutual Funds*;
- NI 13-101 *System for Electronic Document Analysis and Retrieval (Sedar)*.

Under the Ontario Securities Act, OSC Rule 41-502 will be amended.

Unpublished Materials

In proposing the National Instrument, Form and Companion Policy, the CSA have not relied on any significant unpublished study, report, decision or other written materials.

Anticipated Costs and Benefits

The proposed National Instrument, Form and Companion Policy are designed to promote the readability and usefulness of continuous disclosure documents to investors and advisers. The information to be included in management reports of fund performance will be organized in a clear, concise and standardized manner, which will increase the effectiveness of the information, as well as mitigate the risk of selective disclosure. The MDFP will bring a qualitative aspect to continuous disclosure by providing management insight and perspective into a fund's performance. Consequently, it is expected that the proposed regime will better equip investors and advisers to make informed investment decisions.

The CSA acknowledge that the disclosure system outlined in the proposed National Instrument may result in new costs to industry participants because of the introduction of the requirement to prepare and file annual and quarterly management reports of fund performance. However, it is anticipated that these costs will be more than offset by the fact that delivery of financial statements and management reports of fund performance to all securityholders will not be mandatory (other than the first annual management report of fund performance for an investment fund), but rather will only be required at the request of the securityholder. As the proposed Companion Policy indicates, the annual document request forms to be sent to securityholders can be sent together with other mailings or electronically. As such, the annual notice requirement should not add significant additional cost. In addition, the CSA expect that there will be significant cost savings by the removal of the financial highlights, performance data and top ten holdings from the simplified prospectus.

The CSA do not anticipate that the option for LSIFs to prepare and file a formal valuation in a prescribed manner should create additional costs for most LSIFs as certain provincial legislation governing LSIFs already require an independent valuation.

The CSA have prohibited the consolidation of management reports of fund performance for more than one investment fund. The CSA understand that the technology to prepare and print such reports individually already exists and is being used by a number of funds. Any additional costs that some fund managers may incur in the short run to modify their systems are expected to be offset in subsequent years. The CSA believe the benefit to investors of receiving only that information that pertains to their investment outweighs any potential costs.

On balance, the CSA are of the view that the benefits to investors and also to the investment fund industry that are expected by the proposed National Instrument and Form will outweigh any costs to industry participants.

Regulations to be Amended or Revoked (Alberta)

The Alberta Securities Commission proposes to repeal sections 148, 149, 150 and 152 to 159 of the Alberta Securities Commission Rules (General) made under the *Securities Act* (Alberta) in conjunction with the making of the proposed National Instrument as a rule.

Comments

Interested parties are invited to make written submissions with respect to the proposed National Instrument, Form and Companion Policy. Submissions received by December 19, 2002 will be considered.

Submissions should be sent to all of the Canadian securities regulatory authorities listed below, in care of the Ontario Securities Commission, 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
Department of Government Services and Lands, Newfoundland and Labrador
Registrar of Securities, Government of Northwest Territories
Registrar of Securities, Government of Yukon
Registrar of Securities, Government of Nunavut

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8
E-mail: jstevenson@osc.gov.on.ca

Submissions should also be addressed to the Commission des valeurs mobilières du Québec care of:

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

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

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

Questions may be referred to any of:

Noreen Bent
Manager and Senior Legal Counsel
British Columbia Securities Commission
Tel: (604) 899-6741
or 1-800-373-6393 (in B.C. and Alberta)
nbent@bcsc.bc.ca

Patricia Gariepy
Senior Legal Counsel
Alberta Securities Commission
(403) 297-5222
patricia.gariepy@seccom.ab.ca

Bob Bouchard
Chief Administrative Officer & Director
Manitoba Securities Commission
Tel: (204) 945-2555
Bbouchard@gov.mb.ca

Wayne Bridgeman
Senior Analyst, Corporate Finance
Manitoba Securities Commission
Tel: (204) 945-4905
Wbridgeman@gov.mb.ca

Anne Ramsay
Senior Accountant, Investment Funds
Capital Markets
Ontario Securities Commission
Tel: (416) 593-8243
aramsay@osc.gov.on.ca

Raymond Chan
Accountant, Investment Funds
Capital Markets
Ontario Securities Commission
Tel: (416) 593-8128
rchan@osc.gov.on.ca

Annie Smargiassi,
Analyste
Service du financement des sociétés
Direction des marchés des capitaux
Commission des valeurs mobilières du Québec
Tel: (514) 940-2199 ex 4435
annie.smargiassi@cvmq.com

Jean Hébert
Mutual Fund Analyst
Commission des valeurs mobilières du Québec
Tel: (514) 940-2199 ex 4359
jean.hebert@cvmq.com
Anick Ouellette
Mutual Fund Analyst
Commission des valeurs mobilières du Québec
Tel: (514) 940-2199 ex 4379
anick.ouellette@cvmq.com

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