

Notice and Request for Comment

Proposed Amendments to National Instrument 81-106 *Investment Fund Continuous Disclosure*, Form 81-106F1 and Companion Policy 81-106CP *Investment Fund Continuous Disclosure* and Related Amendments

Introduction

The Canadian Securities Administrators (CSA or we), are publishing for comment proposed amendments to:

- National Instrument 81-106 *Investment Fund Continuous Disclosure* (the Rule),
- Form 81-106F1 *Contents of Annual and Interim Management Report of Fund Performance* (the Form), and
- Companion Policy 81-106CP *Investment Fund Continuous Disclosure* (the Policy).

The Rule and the Form are together referred to as the Instrument.

We are also publishing for comment proposed amendments to:

- National Instrument 81-102 *Mutual Funds* (NI 81-102) and Companion Policy 81-102CP,
- Form 81-101F2 *Contents of Annual Information Form*, and
- proposed National Instrument 41-101 *General Prospectus Requirements* (NI 41-101) (a corresponding amendment to the one proposed for Form 81-101F2 is also proposed for the long form prospectus rule, which was published for comment on December 22, 2006).

We are publishing all of the proposed amendments with this Notice. You can also find the proposed amendments on websites of CSA members, including

- www.bcsc.bc.ca
- www.albertasecurities.com
- www.sfsc.gov.sk.ca
- www.msc.gov.mb.ca
- www.osc.gov.on.ca
- www.lautorite.qc.ca

Substance and purpose of the amendments

Background

The Instrument, which came into force on June 1, 2005, harmonized continuous disclosure (CD) requirements among Canadian jurisdictions and replaced most existing local CD requirements. It sets out the disclosure obligations of investment funds for financial statements, management reports of fund performance, material change reporting, information circulars, proxies and proxy solicitation, delivery obligations, proxy voting disclosure and other CD-related matters.

The proposed amendments primarily serve two purposes: (1) to modify the requirements regarding the calculation of net asset value following the introduction of section 3855 *Financial Instruments – Recognition and Measurement* of the CICA Handbook (s. 3855); and (2) to clarify or correct certain provisions of the Instrument.

Section 3855 mirrors an international accounting standard and applies to all industries. The new accounting requirements set out in s. 3855, which is effective for fiscal years beginning on or after October 1, 2006, provide more specific guidance on how to measure financial instruments at fair value for financial statement purposes when fair value measurement is required.

Implications of s. 3855

To comply with the guidance in s. 3855, investment funds would have needed to change how they value a large portion of the securities in their portfolios, particularly those that are traded on a recognized exchange. These securities would need to be valued at bid or ask price on each valuation day, whereas now they are predominantly valued at closing price.

The Rule currently requires investment funds to calculate net asset value in accordance with Canadian generally accepted accounting principles (GAAP). Maintaining this requirement after the introduction of s. 3855 would mean that investment funds would have to change long-standing industry valuation practices. The CSA granted an exemption until September 30, 2007 permitting investment funds to calculate net asset value for purposes other than financial statements without giving effect to s. 3855. CSA members will likely need to consider extending the exemption.

In December 2006 in a written submission to the CSA, the Investment Funds Institute of Canada stated that requiring investment funds to change their current valuation practice would not be in the best interests of securityholders for a number of reasons, including:

- generally, the bid price will be lower than closing price, which will decrease the value of the units of the fund when the change is implemented
- sophisticated investors could engage in arbitrage when the change is implemented
- the use of bid pricing may tend to cause ongoing systematic dilution of existing securityholders (portfolio securities purchased with new money are acquired at a price between bid and ask during the day, but the net asset value of the fund would be valued at bid at the end of the day)
- changing the manner in which net asset value is calculated would alter the commercial bargain made by current investors
- the change to bid pricing would require cost, time, and effort to modify existing systems and operations

- bid prices may not be available in all markets
- Canadian investment funds would be valued differently than funds in other countries, most notably the U.S. where the prevailing practice is to use closing price.

In addition to considering these submissions, we researched approaches in other countries and independently assessed the potential impact of s. 3855. We accept the industry's submissions and think that amendments to the Instrument are necessary in order to avoid potentially adverse consequences to investment fund securityholders due to the current link between the requirements in the Instrument for calculating net asset value and the changes to Canadian GAAP created by s. 3855.

Proposed approach

The proposed amendments will permit investment funds to have two different net asset values: one for financial statements, which will be prepared in accordance with Canadian GAAP (and referred to as "net assets"); and another for all other purposes, including unit pricing (referred to as "net asset value"). We propose to require a reconciliation between net assets and net asset value, and disclosure of how the valuation principles and practices established by the investment fund manager for the purposes of calculating net asset value differ from those required under Canadian GAAP.

We propose to remove the requirement in the Rule to calculate net asset value in accordance with Canadian GAAP and replace it with a requirement to fair value assets and liabilities. For this purpose, fair value of assets and liabilities will mean the current market value based on reported prices and quotations in an active market. When the current market value is not available or the manager determines that it is unreliable, fair value will mean a value that is fair and reasonable as determined by the manager.

We propose to mandate this approach to fair value instead of maintaining a link to Canadian GAAP for net asset value calculations as this approach maintains the principles of the existing requirement while allowing investment funds to maintain their current valuation practices. Although the calculation of net asset value will no longer be tied to Canadian GAAP, investment funds will be required to comply with the fair value standard established in the Rule. For the majority of investment funds, this should not be a significant change to their current valuation practices, while it ensures that the industry is subject to a more consistent standard than existed before the Instrument came into force.

We consulted with the investment fund industry throughout the process of developing our proposed approach and we understand that the industry is supportive.

Summary of proposed amendments

We summarized the significant proposed amendments in Appendix A. This is not a complete list of all the amendments.

We are publishing amending instruments as follows:

- for the Rule (Appendix B)
- for the Form (Appendix C)
- for the Policy (Appendix D)
- for NI 81-101 (Appendix E)
- for NI 81-102 (Appendix F)
- for 81-102CP (Appendix G)
- for proposed NI 41-101 (Appendix H)

We are also publishing black-lined versions of the Instrument and Policy that show the proposed changes (Appendix I).

Authority for proposed amendments – Saskatchewan

Appendix J sets out the provisions of *The Securities Act, 1988* (Saskatchewan) which provide the Saskatchewan Financial Services Commission with the authority to make the proposed amendments.

Alternatives considered

We considered other alternatives to address the issues created by the introduction of s. 3855:

No change to the Instrument

This option would have required investment funds to continue calculating net asset value in accordance with Canadian GAAP. We rejected it because of the implications of s. 3855 discussed above under “Substance and purpose of the amendments”.

Qualified audit opinions

This option would have permitted investment funds to continue to calculate net asset value in accordance with existing practice and file qualified audit opinions with their financial statements because that calculation would not be in accordance with Canadian GAAP. The qualified opinion would indicate that the investment fund had calculated net asset value in accordance with Canadian GAAP except for parts of s. 3855. This option was rejected because of potential investor concern about a qualified audit opinion and because it would have created problems for investment funds subject to other requirements (for example, in their constating documents or other applicable statutes) that they have unqualified financial statements. This option would have resulted in the Canadian investment fund industry being the only one where participants file qualified statements, and could have created a negative impression of the industry both domestically and internationally.

Other bases of accounting

One variation of this option would have permitted investment funds to prepare financial statements (and calculate net asset value) in accordance with U.S. GAAP. This option would have permitted investment funds to continue to calculate net asset value in accordance with existing practice, but have the advantage that the audit opinion would not be qualified because U.S. GAAP allows the use of closing prices. This alternative was rejected because

of concerns about whether adequate expert knowledge of U.S. rules exists in the Canadian investment fund industry and in the audit firms. There is also additional uncertainty as to how U.S. GAAP will align with international financial reporting standards in the future.

A second variation of this option would have allowed investment funds to prepare financial statements (and calculate net asset value) in accordance with a disclosed basis of accounting, other than GAAP. Under this option, the audit opinion would not have been qualified. We also rejected this option because financial statements prepared on this basis would not be general purpose financial statements and their use would be severely restricted to specified users, which may or may not include current and future investors.

GAAP except for “bid/ask”

This option would have essentially maintained the status quo – investment funds would file financial statements prepared in accordance with Canadian GAAP, and would have calculated a different net asset value in accordance with Canadian GAAP, except for the specific provisions of s. 3855 to use bid/ask prices to value actively traded securities. This option was rejected because the introduction of s. 3855 illustrated how future changes to Canadian GAAP could negatively affect investment funds and their securityholders. As a result, the CSA determined that maintaining a link to Canadian GAAP for non-financial statement purposes (such as the calculation of net asset value for fund pricing) could create on-going practical issues. There is the possibility that Canadian GAAP might change again as a result of further changes to international standards.

Anticipated costs and benefits

The proposed amendments to the calculation of net asset value are intended to avoid additional costs. If we do not amend the requirements regarding the calculation of net asset value, the investment fund industry will incur costs to modify their systems and operations so as to comply with s. 3855. In some cases these costs could be significant and any costs that are incurred could be passed along to securityholders.

We do not anticipate that the proposed requirement to fair value an investment fund’s assets and liabilities will result in increased costs. Prior to the introduction of s. 3855, investment funds were required to value their portfolio in accordance with the fair value principles articulated in Accounting Guideline 18 *Investment Companies*. The fair value standard included in the proposed amendments is intended to codify the industry’s current practice, essentially maintaining the status quo.

Some of the proposed amendments are intended to only clarify or correct certain provisions of the Instrument. We believe that they will not add any additional costs, and will generate benefits because ambiguities in the Instrument will be eliminated.

Related amendments

Local Amendments

We propose to amend Form 81-101F2 (annual information form for mutual funds) to add a requirement to disclose the differences between the valuation principles and practices established by the manager and those in Canadian GAAP. We also propose to make a corresponding amendment for the long form prospectus rule, proposed NI 41-101, which was published for comment on December 22, 2006. If proposed NI 41-101 is not adopted as a final rule, we will make consequential amendments to local rules (for example, Ontario Securities Commission Rule 41-501 *General Prospectus Requirements*) to include a disclosure requirement that corresponds to the one proposed for Form 81-101F2.

Unpublished materials

In proposing the amendments, we have not relied on any significant unpublished study, report or other written materials.

Request for Comments

We welcome your comments on the proposed amendments.

Please submit your comments in writing on or before August 31, 2007. If you are not sending your comments by email, you should also send a diskette containing your submission (in Windows format, Word).

Address your submission to all of the CSA member commissions, as follows:

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

Deliver your comments **only** to the addresses that follow. Your comments will be forwarded to the remaining CSA member jurisdictions.

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8

e-mail: requestforcomment@osc.gov.on.ca

Anne-Marie Beaudoin
Directrice du secrétariat
Autorité des marchés financiers
Tour de la Bourse
800, square Victoria
C.P. 246, 22^e étage
Montréal, Québec H4Z 1G3
Fax: (514) 864-6381
e-mail: consultation-en-cours@lautorite.qc.ca

We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period.

Questions

Please refer your questions to any of:

Vera Nunes
Senior Legal Counsel, Investment Funds
Ontario Securities Commission
416-593-2311
vnunes@osc.gov.on.ca

Stacey Barker
Accountant, Investment Funds
Ontario Securities Commission
416-593-2391
sbarker@osc.gov.on.ca

Raymond Chan
Senior Accountant, Investment Funds
Ontario Securities Commission
416-593-8128
rchan@osc.gov.on.ca

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

Christopher Birchall
Senior Securities Analyst
British Columbia Securities Commission

604-899-6722 or 1-800-373-6393 (in B.C. and Alberta)
cbirchall@bcsc.bc.ca

Cynthia Martens
Legal Counsel
Alberta Securities Commission
403-297-4417
cynthia.martens@seccom.ab.ca

Wayne Bridgeman
Senior Analyst, Corporate Finance
Manitoba Securities Commission
204-945-4905
Wayne.Bridgeman@gov.mb.ca

Jacques Doyon
Senior Investment Funds Analyst
Autorité des marchés financiers
514-395-0337, ext. 4474
jacques.doyon@lautorite.qc.ca

Pierre Martin
Senior Legal Counsel, Service de la réglementation
Autorité des marchés financiers
514-395-0337, ext. 4375
pierre.martin@lautorite.qc.ca

The text of the proposed amendments follows or can be found on a CSA member website.

June 1, 2007

APPENDIX A
SUMMARY OF PROPOSED AMENDMENTS

The Rule

Part 1 Definitions and Applications

Section 1.1

- amend the definition of “net asset value” to include a reference to Part 14 of the Rule

The term “net asset value” will mean the value calculated in accordance with Part 14 of the Rule, which is the value to be used for all purposes other than financial statements (for example, purchases and redemptions of the investment fund’s securities). The term “net assets” will mean net assets as determined under Canadian GAAP, which is the amount to be used for financial statements and certain information derived from the financial statements (for example, certain disclosure in the management reports of fund performance).

Part 2 Financial Statements

Section 2.9

- correct the requirements for interim financial statements in a transition year and a new financial year by removing the reference to statements of investment portfolio as these statements are not prepared on a comparative basis

Section 2.10

- clarify the requirement for a change in legal structure notice by indicating that this notice must be filed if the investment fund terminates

Part 3 Financial Disclosure Requirements

Section 3.1

- change the term “net asset value” to “net assets” on the statement of net assets

Section 3.2

- add a requirement to show revenue from repurchase and reverse repurchase transactions as a separate line item on the statement of operations
- add a requirement to show commissions and other portfolio transaction costs as a separate line item on the statement of operations

As s. 3855 requires portfolio transaction costs to be expensed, we have added a line item to the statement of operations for this disclosure and have removed the requirement to show this

amount in the notes to the financial statements. Portfolio transaction costs continue to be excluded from the management expense ratio.

Section 3.5

- add a look-through requirement to the statement of investment portfolio for investment funds substantially invested in only one underlying fund

This is consistent with the existing requirement for the summary of investment portfolio in the management report of fund performance and quarterly portfolio disclosure.

Section 3.6

- remove the requirement to show commissions and other transactions costs in the notes to the financial statements as this will be shown on the statement of operations (see section 3.2 above)
- add a requirement to provide a reconciliation in the notes to the financial statements between net asset value at the date of the financial statements and net assets as shown on the financial statements

Part 9 Annual Information Form

Section 9.2

- clarify the requirement for filing an annual information form – an investment fund must file an annual information form if it has not filed a prospectus within its last financial year

Part 10 Proxy Voting Disclosure for Portfolio Securities Held

Section 10.3

- clarify that the proxy voting record must be maintained for meetings of all publicly held companies

Part 14 Calculation of Net Asset Value

Section 14.2

- remove the requirement that investment funds calculate their net asset value in accordance with Canadian GAAP, and replace it with a requirement to determine a fair value for the investment fund's assets and liabilities
- add a requirement to establish written policies and procedures regarding the fair valuation of the investment fund's assets and liabilities

Part 15 Calculation of Management Expense Ratio

Sections 15.1 and 15.2

- exclude commissions and other portfolio transaction costs from the calculation of the management expense ratio

Part 18 Effective Date and Transition

Sections 18.2, 18.3, 18.4 and 18.5

- remove transitional provisions that are no longer necessary

The Form

Part A Instructions and interpretation

Item 1 – General

- add paragraph (f) to explain the difference between the term “net assets” (used only for references to financial statements) and “net asset value” (used for all purposes other than financial statements)

Part B Content Requirements for Annual Management Report of Fund Performance

Item 3 – Financial Highlights

- amend the financial highlights tables so that “The Fund’s Net Assets per [Unit/Share]” table contains information derived from the financial statements, while the “Ratios and Supplemental Data” table is based on the fund’s net asset value (usually calculated daily for conventional mutual funds)
- change the references to “net asset value” to “net assets” as appropriate

As there may be a difference between the net asset value at the end of the last financial year and the net assets at the beginning of the new financial year, investment funds may add an explanation of those differences to the financial highlights tables.

Item 5 – Summary of Investment Portfolio

- change the references to “net assets” to “net asset value” as appropriate

The Policy

The proposed amendments to the Policy reflect the changes to the Instrument, and add guidance to Part 9 concerning the requirement to calculate net asset value by determining a fair value for the investment fund’s assets and liabilities. The proposed amendments to the Policy also confirm that brokerage commissions and other portfolio transaction costs are not included in the management expense ratio (section 10.1).

Prospectus Disclosure

We propose requiring an investment fund to disclose the differences between the valuation principles and practices established by the manager and those in Canadian GAAP.