

HEDGE FUNDS &

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DYNAMIC MUTUAL FUNDS LTD. RECEIVES APPROVAL TO SHORT-SELL SECURITIES

On October 17, 2003, Dynamic Mutual Funds Ltd. obtained exemptive relief from the securities regulators in each province and territory of Canada from certain requirements of National Instrument 81-102 Mutual Funds. The relief will allow certain Dynamic mutual funds to effect limited short-selling of securities subject to the restrictions set out by the regulators.

Dynamic submitted its application for exemptive relief in October 2002. In its application, Dynamic argued that limited and controlled short-selling could benefit its funds, since short-selling would enable the funds to control volatility and enhance fund performance in a flat or declining market. Dynamic maintained that risk management strategies, such as daily marked-to-market rules, cash cover requirements and stop-loss orders, meant that the original rationale for prohibiting short-selling (i.e., the theoretical risk of unlimited losses) was no longer relevant. In addition, Dynamic submitted that there was no policy or public interest rationale in prohibiting short-selling while still permitting mutual funds to take short positions in specified derivatives as provided for in NI 81-102. Each of the Dynamic funds also held a special meeting at which security holders voted in favour of permitting limited short-selling.

The securities regulators granted relief from the prohibition against short-selling and related provisions subject to restrictions, which included the following:

- the aggregate market value of all securities sold short by each Dynamic fund must not exceed 10% of the total net assets of that fund on a daily marked-to-market basis;
- each Dynamic fund must hold “cash cover” (as defined in NI 81-102), including amounts deposited with dealers as security for securities borrowing, of at least 150% of the aggregate market value of all shorted securities on a daily marked-to-market basis;
- proceeds from short sales cannot be used to purchase long positions in securities other than cash cover;
- each Dynamic fund must maintain internal controls regarding its short sales, including written policies and procedures, risk management controls and proper books and records;
- short sale transactions in Canada must be made through dealers registered in Canada who are members of a self-regulatory organization that is a participating member of the Canadian Investor Protection Fund;
- short sale transactions outside of Canada must be made through dealers that are members of a stock exchange and that have a net worth in excess of \$50 million;
- the total amount of assets deposited with a borrowing agent (except where the borrowing agent is the custodian of a Dynamic fund) as security in connection with each fund’s short sale transactions must not exceed 10% of the total net assets of that fund;
- before conducting any short sales, each Dynamic fund, in its simplified prospectus, must provide disclosure on short-selling, related risks and details on that fund’s

- short sale strategy;
 - the annual information form of each Dynamic fund must disclose specific details about that fund's written risk management policies and procedures regarding short sales, and specific information must be included in each fund's financial statements; and
 - each Dynamic fund must provide its security holders with 60 days' prior written notice of its intention to begin short-selling.
- Dynamic also agreed that any securities sold short would be "liquid securities" (i.e., securities listed on a stock

exchange and of an issuer that has a market capitalization of at least \$500 million), the aggregate market value of all shorted securities of a particular issuer will not exceed 2% of the total net assets of each Dynamic fund and a stop-loss order will be placed with dealers in case the price of the securities exceeds a maximum of 108% of the price at the time of the short sale transaction.

In a press release, Dynamic reported that it plans to commence its mutual fund short-selling strategy in 2004. It can be expected that other mutual fund companies will seek similar decisions from the regulators in the near future.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

This Bulletin was authored by Tim Baron, Michael Campbell and Kimberly Poster who are members of our Structured Products Group. The McMillan Binch Structured Products Group is one of the largest groups in Canada dedicated to specialty products and funds offered in the Canadian marketplace. From compliance issues to the creation and implementation of exchange listed structured funds, our Structured Products Group services the needs of a broad range of market participants including securities dealers, market intermediaries, hedge funds and other money managers.

For further information, please contact one of the following team members listed below:

Tim Baron	416.865.7096	tim.baron@mcmillanbinch.com
Michael A. Burns	416.865.7261	michael.burns@mcmillanbinch.com
Michael Campbell	416.865.7114	michael.campbell@mcmillanbinch.com
Nicole Frew	416.865.7904	nicole.frew@mcmillanbinch.com
Mark Lobsinger	416.865.7107	mark.lobsinger@mcmillanbinch.com
Margaret C. McNee	416.865.7284	margaret.mcnee@mcmillanbinch.com
Gary K. Ostoich	416.865.7802	gary.ostoich@mcmillanbinch.com
Kimberly J. Poster	416.865.7890	kimberly.poster@mcmillanbinch.com
Michael Ward	416.865.7176	michael.ward@mcmillanbinch.com

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MCMILLAN BINCH LLP

TELEPHONE: 416.865.7000
 FACSIMILE: 416.865.7048
 WEB: WWW.MCMILLANBINCH.COM