

## phase 2 of the modernization of investment fund product regulation project – closed-end funds

### CSA proposes investment restrictions for closed-end funds

*This is the third in a series of McMillan bulletins relating to the Canadian Securities Administrators project to modernize the regulation of publicly offered investment funds. The bulletins will separately address how the modernization project affects different types of investment fund products. The [previous bulletin](#) focused on the changes affecting open-end mutual funds. This bulletin will focus on the proposed introduction of investment restrictions affecting non-redeemable investment funds (closed-end funds or CEFs). A future bulletin will focus on proposed core operational requirements and prohibitions on paying organizational costs by closed-end funds.*

As discussed in our [recent bulletin](#), on March 27, 2013 the Canadian Securities Administrators (CSA) published for comment proposed changes to the regulatory regime governing investment funds pursuant to Phase 2 of its Modernization of Investment Fund Product Regulation Project (the Modernization Project). The proposed changes, which reflect the first stage of Phase 2 of the Modernization Project, are largely aimed at bringing certain closed-end funds into the regulatory framework that governs open-end mutual funds by introducing core operational

requirements and investment restrictions that did not previously exist for closed-end funds.

The central focus of Phase 2 is to address perceived market efficiency, investor protection and fairness issues that arise out of the different regulatory requirements applicable to investment funds by implementing investment restrictions and operational requirements for CEFs. While CEFs are subject to many of the same continuous disclosure, prospectus and independent review committee requirements as other publicly-offered investment funds, traditionally few investment restrictions and operational requirements have been applied to CEFs. In addition to investor protection and fairness issues, the CSA cite a key aspect of the Phase 2 amendments is to "level the playing field" among CEFs and open-end mutual funds (as well as exchange-traded funds) by reducing the potential for regulatory arbitrage.

In this installment in our series of bulletins and updates on the Modernization Project, we summarize and discuss the expected impact of core investment restrictions proposed to be applied to CEFs.

## background to investment restrictions

In response to the CSA's request for comments on the implementation of the Modernization Project published in 2011<sup>1</sup> many commenters expressed the view that investment restrictions should not be adopted for CEFs as it would impede their ability to offer investors returns associated with different asset classes and innovative investment strategies. However, the CSA have taken the position that such distinctions do not provide a sufficient policy basis for the lack of investment restrictions and propose to make CEFs subject to the restrictions and practices contained in National Instrument 81-102 *Mutual Funds* (NI 81-102) which currently

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<sup>1</sup> 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 (Staff Notice 81-322).

apply to open-end mutual funds, with certain modifications to account for the differences in these types of funds. In the CSA's view, these requirements establish basic fundamental parameters for offering pooled investments to retail investors, promote prudent management and prohibit strategies that are not consistent with passive investment vehicles. The CSA observed that many CEFs have typically adopted similar investment restrictions which reflect best practices in the industry. The CSA view the principal differences between mutual funds and CEFs as being the manner in which they distribute securities (continuous distribution versus one time offerings and subsequent re-openings), the redemption rights they offer securityholders (redemptions on demand versus only an annual redemption at a fund's net asset value (NAV)), and the dealers that sell their securities (individual mutual fund dealers versus a syndicate of investment dealers).

We note that the proposed investment restrictions are intended to apply to CEFs that employ conventional investment strategies and that the CSA are proposing to redesign National Instrument 81-104 Commodity Pools (NI 81-104), which currently governs commodity pools, to establish a regime for "alternative funds" that will encompass both mutual funds and CEFs that use investment strategies that are not permitted under NI 81-102 (a topic that will be explored in a future bulletin).

### concentration restriction of 10%

The CSA propose to extend the "concentration restriction" in NI 81-102 to CEFs, which would prohibit these funds from purchasing securities of an issuer, entering into specified derivatives transactions or purchasing index participation units if, immediately after the transaction, more than 10% of the fund's net assets would be invested in the securities of such issuer (measured by market value at the time of the transaction). The concentration restriction would not apply to purchases of government securities, securities issued by clearing corporations, index participation units issued by an investment fund or securities of other investment

funds (purchased in accordance with the fund-of-fund restrictions in NI 81-102).

The proposed changes would permit CEFs that are "fixed portfolio funds" to exceed the 10% limit for purchases of equity securities in accordance with their investment objectives. A "fixed portfolio fund" would include a closed-end fund with a fundamental investment objective of holding a fixed portfolio of publicly traded equity securities of issuers named in its prospectus.

In determining compliance with the concentration restriction, a closed-end fund would be required to include in its calculations the underlying interest of a long position in a specified derivative as well as its proportionate share of securities represented by an index participation unit, unless: (a) such underlying interest represents less than 10% of a stock or bond index; or (b) such securities represent less than 10% of securities represented by an index participation unit. A closed-end fund would not be required to include the underlying interests of specified derivatives held for hedging purposes.

We note that the concentration restriction applies at the time of the transaction. If the market value of the assets changes, the fund may continue to hold them indefinitely.

The CSA seek comment on whether a 10% concentration restriction is appropriate for CEFs and, if not, why a higher limit would be appropriate and how it would benefit CEFs. The CSA notes that many CEFs appear to have already adopted a 10% concentration restriction for minimum diversification as a best practice in the industry. In addition, certain CEFs typically impose a 10% concentration restriction in order to satisfy one of the conditions necessary to be a "mutual fund trust" for the purposes of the *Income Tax Act* (Canada), which status entitles those funds to certain favourable tax treatment and ensures that their units are "qualified investments" for registered plans such as RRSPs or TFSA's.

## how much liquidity do they really need?

The CSA also propose to impose a restriction on investing in illiquid assets on CEFs, although they propose to allow them to hold more illiquid assets than currently permitted for open-end mutual funds. This is an example of the CSA recognizing that CEFs are structurally different from mutual funds in how they provide liquidity for securityholders.

Currently, mutual funds are prohibited from purchasing an illiquid asset if more than 10% of the fund's net assets (measured by market value at the time of the purchase) would consist of illiquid assets. Furthermore, if the market value of the fund's assets change in a way that results in illiquid assets representing 15% or more of the fund's net assets, it must reduce its illiquid assets to below 15% within 90 days. An "illiquid asset" is an asset that cannot be readily disposed of through market facilities at a price that at least approximates the amount at which it is valued in calculating the NAV of the fund. Restricted securities are also considered to be illiquid assets.

While the CSA propose to increase the limit on illiquid assets applicable to mutual funds when it comes to CEFs (as they generally do not offer regular redemptions at NAV and in theory need less liquidity in their portfolios), they expressed concern about a portfolio containing significant illiquid assets which may cause difficulties in calculating NAV. The CSA noted that management, performance and other fees paid by an investment fund are all based on NAV.

The CSA observed that many CEFs do not invest in substantial amounts of illiquid assets in any event and seek comments with respect to the appropriate limit on illiquid assets for CEFs, as well as whether a time period greater than 90 days would be appropriate to divest of illiquid assets if they exceed the imposed limit. The CSA also invites comments as to whether the limit on illiquid assets should be different for CEFs that do not offer any redemptions and funds that offer annual redemptions.

## to borrow or not to borrow – from whom and how much?

Open-end mutual funds are prohibited from borrowing cash except for specified purposes. The CSA propose to impose a limit on borrowing by CEFs of up to 30% of the fund's NAV, noting that current industry practice appears to limit cash borrowings to between 10% and 33% of NAV.

The proposed change would only permit CEFs to borrow from Canadian financial institutions (i.e., banks, loan corporations, trust companies and certain other financial institutions authorized to carry on business in Canada or a province or territory). The CSA noted that requiring a lender to be a Canadian financial institution could provide additional monitoring and controls over borrowing by CEFs.

The Phase 2 amendments would generally limit the leverage that could be utilized by CEFs to cash borrowing. NI 81-102, as proposed to be amended, would not permit CEFs to create leverage through the use of specified derivatives or short selling. If implemented as currently proposed, there would be a significant number of existing CEFs that would be offside the proposed restrictions relating to borrowing and use of leverage.

The CSA invite comments on whether the restriction on borrowing by CEFs is appropriate. The CSA also seek comments as to whether the requirement that the lender is a Canadian financial institution is appropriate or whether there should be greater flexibility to borrow from other lenders if, for example, a majority of a fund's assets are held outside Canada. We suspect that the proposal to restrict lenders to Canadian financial institutions might cause extra-territorial controversy from a market fairness perspective.

## investing in other funds, but not closed-end funds

Another proposed change is to impose the fund-of-fund requirements of NI 81-102 on CEFs with respect to investing in mutual funds. Under the CSA proposal, CEFs would not be permitted to invest in other CEFs due to the possibility of having resulting leverage greater than 30% (see above).

NI 81-102 contains a set of rules governing mutual funds that invest solely or primarily in other mutual funds (i.e., fund-of-funds). Generally, mutual funds are only permitted to invest in another mutual fund if the other mutual fund offers securities under a simplified prospectus and is a reporting issuer. In addition, the other mutual fund may not hold more than 10% of its NAV in securities of other mutual funds. Although, NI 81-102 provides an exemption from this requirement for so-called "three-tiered" fund-of-fund structures, provided that: (a) the top fund is a clone fund; or (b) the other mutual fund (second tier) is a money market fund or a mutual fund that issues index participation units.

The CSA note that the investment restrictions applicable to mutual funds are generally more restrictive than what is being proposed for CEFs. With this in mind, the CSA seek comments as to what measures would be appropriate in a fund-of-fund structure to enable an underlying mutual fund to invest in accordance with the investment restrictions applicable to a top fund that is a closed-end fund. In addition, under the proposed amendments, the underlying mutual fund would have to be a reporting issuer in every jurisdiction in which the top fund is a reporting issuer, and the CSA also seek comments in this regard.<sup>2</sup>

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<sup>2</sup> Securities regulators have granted exemptive relief from the fund-of-fund requirements on a case-by-case basis to permit the underlying mutual fund to only become a reporting issuer in Québec (or Québec and Ontario), while the top mutual fund would be a reporting issuer in every province and territory. Although closed end-funds were not subject to the fund-of-fund requirements of NI 81-102,

In light of the Federal Government's budget announcement on March 21, 2013, which included proposed measures that effectively put an end to "character conversion transactions" (see our [bulletin](#) on the subject here), it is unclear what the future holds for fund-of-fund structures.

## restrictions on certain types of securities – mortgages and physical commodities

The proposed Phase 2 amendments would impose restrictions on CEFs with respect to investing in mortgages and physical commodities.

The CSA propose no limit on investments in mortgages by CEFs, although any such investments would be restricted to mortgages that are fully and unconditionally guaranteed by a government or government agency. CEFs would not be permitted to invest in non-guaranteed mortgages (the CSA noted that such investments may not be appropriate for publicly offered investment funds). The CSA observed that there is currently a limited number of CEFs with investment objectives of investing in non-guaranteed mortgages, and they propose a 24 month transition period for these funds to divest their holdings of non-guaranteed mortgages or transition into the regulatory regime for issuers that are not investment funds. The CSA seek comments on the impact of the proposed restriction and the appropriate length of the transition period, as well as whether a grandfathering provision would be warranted.

The CSA also propose to limit investments by a closed-end fund in physical commodities or permitted gold certificates (or specified derivatives the underlying interests of which are physical commodities or permitted gold certificates), to an amount equal to 10% of the fund's net asset value. The CSA are not seeking

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underlying funds in two-trust structures have traditionally become reporting issuers in Québec (or Québec and Ontario).

specific comments relating to this proposed restriction, but do note that closed-end funds that wish to focus on physical commodities or derivatives that provide exposure to physical commodities may choose to be "alternative funds" and regulated under a redesigned version of NI 81-104.

## restrictions on securities lending, repurchases and reverse repurchases

The CSA propose to apply the same investment restrictions relating to securities lending, repurchase and reverse repurchase transactions applicable to mutual funds to CEFs as well. These requirements govern documentation, supervision, controls and records and prescribe who is permitted to act as a fund's agent, the value of cash or other collateral a fund must hold in order to support such activities, and the permitted aggregate value of such transactions. Currently, the aggregate market value of securities loaned under securities lending transactions or sold in repurchase transactions may not exceed 50% of the fund's total assets (excluding collateral and cash received for the sold securities). The provisions of NI 81-102 mandate the appointment of a lending agent to administer a securities lending or repurchase transactions, but it is not strictly required for reverse repurchases.

The CSA have proposed amendments to NI 81-102 that would limit the amount of securities loaned or sold in securities lending, repurchase and reverse repurchase transactions by a closed-end fund to 50% of the NAV of the fund, rather than the current 50% of the total assets. As a result, CEFs would be unable to include any borrowed funds in determining the maximum value of securities that may be loaned or sold in connection with such transactions. The impact of these proposed amendments may be considerable for CEFs (in light of the proposal to permit them to borrow up to 30% of NAV) as the changes will reduce the amount of securities available to be loaned or sold by the liabilities (including leverage) of the closed-end fund.

Under the proposed amendments, prior to entering into any securities lending, repurchase and reverse repurchase transactions, CEFs would be required to issue a news release containing prescribed disclosure and securityholders would have to be provided with 60 days prior written notice before the fund enters into such transactions.

The CSA are seeking feedback on recommended approaches to ensure that financial statements of an investment fund provide adequate disclosure about the revenue and costs of securities lending transactions, including the share of revenue paid to the lending agent. Specifically, the CSA have requested comments on various measures that they propose to require as additional disclosure in an investment fund's management reports of fund performance, as well as the usefulness of adding the lending agent to the list of service providers detailed in an investment fund's prospectus or annual information form and information on indemnities obtained by an investment fund from the lending agent. The CSA also seek feedback on whether the agreements entered into between an investment fund and a lending agent should be required to be filed on SEDAR.

## transition periods

As noted above, in the first stage of Phase 2, the CSA propose certain core operational requirements and investment restrictions for CEFs. The CSA note that the proposed core operational requirements would come into force in advance of the proposed investment restrictions, which would be expected to come into effect at the same time as the "alternative fund framework" that would see changes to NI 81-104.

The CSA propose that there would be an 18-month transition period for existing CEFs to comply with the new investment restrictions after the coming into force of the Phase 2 amendments. New CEFs established after the coming into force date would have to comply immediately. The CSA also seek

comments on whether a grandfathering provision for existing CEFs would be appropriate.

### next steps

The deadline for submitting comments to the CSA on the proposed amendments in Phase 2 is June 25, 2013. Please contact one of the authors of this bulletin listed below or another member of our Investment Funds & Asset Management Group if you have any questions or seek assistance with the preparation of a comment letter relating to these proposals.

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### a cautionary note

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