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September 7, 2012

Ms Rhonda Goldberg
Director, Investment Funds
Ontario Securities Commission
20 Queen Street West
Suite 1903
Toronto, Ontario
M5H 3S8

Re: Accounting for Permitted Short Selling and National Instrument 81-106 *Investment Funds Continuous Disclosure* and Companion Policy 81-106CP *Investment Funds Continuous Disclosure* and related amendments (NI 81-106)

Dear Ms. Goldberg:

Further to the Canadian Securities Administrators Notice of Amendments to National Instrument 81-102 *Mutual Funds* and Companion Policy 81-102CP published on February 9th, 2012, publicly offered mutual funds are now permitted to engage in limited short selling practices. We would like to engage in a dialogue on certain disclosure matters related to permitted short selling for investment funds subject to NI 81-106. We reviewed the amendments in order to consider disclosure implications. While reviewing we focussed on how to promote comparability and transparency for investors and believe that consistency in disclosure across the industry is an important consideration.

The short selling of securities by investment funds is an investment activity which produces some notable differences in accounting related to the cost of the activity compared to other available investment strategies, while achieving similar economic exposure.

Clarity and Transparency for Continuous Disclosure

With the ultimate goal of enhancing an investor's understanding of the significance of fund performance, expenses incurred and overall financial position, we believe it to be prudent to provide additional guidance to investment managers for transparent and consistent treatment of expense ratios.

We agree with the requirements of NI 81-106 to present both a Management Expense Ratio (MER) and a Trading Expense Ratio (TER) for all funds. We believe that having two separate expense ratios provides valuable information to investors about the ongoing management and administrative costs as well as, but separately from, the costs associated with executing the fund's investment trading strategy. When these ratios are viewed over time, there is added transparency around the impact of changes in the fund's investment strategy during different periods of market conditions as well as the historical annual costs of management and administration.

However, we have concerns that a lack of precision in the definition of MER in NI 81-106 as currently written leaves it unclear as to whether short selling costs should be included in the MER or in the TER. This could lead to anomalous results for expense ratios and impede the comparability and transparency for funds which choose to engage in short selling. The current wording of the Rule, without additional CSA guidance could therefore place such funds at a competitive disadvantage to others with economically similar strategies and exposures but that do not engage in short selling. Funds may decline to engage in short selling as a result of this anomaly, which would eliminate a valid investment strategy option and might not be in the best interests of clients.

We believe that it is substantively more accurate that the cost of short selling such as dividends on short securities be treated as TER costs. In addition to the definition of MER in NI 81-106, there is a common understanding about what is and is not included in MER. For example, we have provided below the explanations of MER and TER provided by two well-known reporters:

John Heinzl[1] an Investment Reporter and Columnist for The Globe & Mail recently wrote "The MER is the percentage of a fund's assets paid out annually for management fees and day-to-day operating expenses such as record keeping, audit and legal fees, and costs for sending out prospectuses and annual reports."[2]

Rob Carrick, a reporter for The Globe & Mail describes MERs as follows: "Here's how the MER works. First, almost all the fees associated with running a fund are gathered together, including management and administrative fees. Next, these fees are compared to the total assets in the fund. What you end up with is a ratio showing you the percentage of the fund's assets that are eaten up by fees every year."

On TERs, Mr Carrick states: "I said earlier that the MER includes almost all the fees associated with a mutual fund. Curious about what isn't included? Mainly, trading costs — the brokerage commissions a fund pays for buying and selling securities. These trading costs can add as much as one percentage point, perhaps even more, to a fund's total cost, depending on how much trading a fund manager does. You can find hard information on the cost of trading in a mutual fund's semi-annual management report on fund performance. Look for the trading expense ratio, or TER, which expresses trading costs as a percentage of fund assets. Add the MER to the TER and you've got the total cost of owning a fund."[3]

Without influence, the popular press and likely investors in general have for many years already associated MERs with the general administrative costs of running and managing a fund and the TERs as the cost of executing a portfolio advisors trading strategy. To include the dividends from short positions in

[1] John Heinzl has been writing about business and investing since 1990. He earned a master's degree from the University of Western Ontario's Graduate School of Journalism and completed the Canadian Securities Course with honours. His weekly Yield Hog columns explore the world of dividend stocks, bonds and other income-producing securities, and his explanatory Investor Clinic columns and videos aim to inform and educate investors who want to take control of their money.

[2] http://www.theglobeandmail.com/globe-investor/investor-education/investor-clinic/your-questions-gold-stocks-fund-fees-and-rrsps/article2421849/

[3] http://www.canadianliving.com/life/money/investing_in_mutual_funds_learn_these_5_terms_to_discover_how_you_can_get_the_best_value_from_your_investment.php

MERs would reduce the transparency and meaning of the two metrics. Therefore, guidance should be provided so that this is uniformly applied across the industry. In the absence of guidance, investment funds may treat short selling expenses differently which will lead to comparability issues and confusion in the marketplace.

We have provided an example below to illustrate the differences that could result from inconsistent treatment of costs of short selling.

Example

Fund X periodically uses short selling to benefit from anticipated declines in the value of select stocks. Fund Y periodically enters into option (or other derivative) contracts to achieve very similar, but not identical, economic exposure. Fund X's cost of borrowing securities and any dividends declared on equities sold short are captured as expenses in accordance with generally accepted accounting principles (GAAP) and the change in the fair value of equities sold short is captured within realized or unrealized gain/loss. While changes in the value of Fund Y's option contracts (for the same equities as Fund X), are also captured within realized or unrealized gain/loss (including premium paid on options that expire worthless) as required by GAAP, the related transaction costs are shown separately as transaction costs. All other management and administrative costs for Fund X and Fund Y are equivalent.

Principles of transparency and comparability dictate that an investor should expect similar MERs and divergent TERs for Fund X versus Fund Y. However, in the absence of additional guidance in NI 81-106, Fund X may interpret the existing language to require the costs associated with a short-selling strategy to be included with MER instead of TER, thereby creating investor confusion about the ongoing management and administration costs of Fund X versus the costs associated with the investment strategies employed by Fund Y. Equally, from period to period as Fund X changes the extent of use of this investment activity, the MER could change significantly, causing further investor confusion as to the relative consistency of the MER.

Recommendation

We would like to engage in a dialogue with the CSA to discuss a solution to the issues arising out of the amendments to NI 81-102 referred to above. The solution could be one of the following:

- a principles-based amendment to NI 81-106 to provide additional guidance on the intent of the MER and TER and the nature of expenses to be included therein; or
- the publication of a staff bulletin to provide additional guidance on the calculation of the MER and TER; or
- guidance provided through a CSA Q&A to assist investment managers in appropriately calculating the MER and TER.

We would propose that, as a starting point, MER be reflective of the ongoing costs of managing and administering the fund, and TER be reflective of the costs of executing the investment strategy such as the derivative expense above.

We believe that this would provide more relevant comparability between funds and improve investors' understanding of the costs of executing more complex investment strategies.

Yours truly,

The Investment Funds Institute of Canada

By: Joanne De Laurentiis
President & Chief Executive Officer