NATIONAL INSTRUMENT 81-104
COMMODITY POOLS

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NATIONAL INSTRUMENT 81-104
COMMODITY POOLS

PART 1 DEFINITIONS, APPLICATION AND INTERPRETATION

1.1 Definitions

(1) In this Instrument

"Canadian Securities Course" means a course prepared and conducted by the Canadian Securities Institute and so named by that Institute as of the date on which this Instrument comes into force, every predecessor to that course, and every successor to that course that does not narrow the scope of the significant subject matter of the course;

"Chartered Financial Analyst Program" means the three level program prepared and conducted by the Association for Investment Management and Research, and so named by that Association as of the date on which this Instrument comes into force, every predecessor to that program, and every successor to that program that does not narrow the scope of the significant subject matter of the program;

"commodity pool" means a mutual fund, other than a precious metals fund, that has adopted fundamental investment objectives that permit it to use or invest in

(a) specified derivatives in a manner that is not permitted by National Instrument 81-102 *Mutual Funds*, or

(b) physical commodities in a manner that is not permitted by National Instrument 81-102;

"Derivatives Fundamentals Course" means a course prepared and conducted by the Canadian Securities Institute and so named by that Institute as of the date that this Instrument comes into force, every predecessor to that course, and every successor to that course that does not narrow the scope of the significant subject matter of the course;

"independent review committee" means the independent review committee of the investment fund established under National Instrument 81-107 *Independent Review Committee* for Investment Funds;

"mutual fund restricted individual" means an individual registered as a dealing representative of a registered dealer, if the activities of that individual are restricted to trading in securities of mutual funds; and

"precious metals fund" means a mutual fund that has adopted fundamental investment objectives, and received all required regulatory approvals, that permit it to invest in precious metals or in entities that invest in precious metals and that otherwise complies with National Instrument 81-102.

(2) Terms defined in National Instrument 81-102 and used in this Instrument have the respective meanings ascribed to them in National Instrument 81-102.

1.2 Application - This Instrument applies only to

(a) a commodity pool that

(i) offers, or has offered, securities under a prospectus for so long as the commodity pool remains a reporting issuer, or

(ii) is filing a preliminary prospectus or its first prospectus; and

(b) a person or company in respect of activities pertaining to a commodity pool referred to in paragraph (a) or pertaining to the filing of a prospectus to which subsection 3.2(1) applies.

1.3 Interpretation

(1) Each section, part, class or series of a class of securities of a commodity pool that is referable to a separate portfolio of assets is considered to be a separate commodity pool for purposes of this Instrument.

(2) For the purposes of a commodity pool complying with section 2.3 of National Instrument 81-102, the definition of the term "public quotation" used in the definition of the term "illiquid asset" in section 1.1 of National Instrument 81-102, includes any quotation of a price for foreign currency forwards and foreign currency options in the interbank market.

PART 2 INVESTMENT RESTRICTIONS AND PRACTICES

2.1 Investment Restrictions and Practices

(1) Section 2.1 of National Instrument 81-102 does not apply to restrict the exposure of a commodity pool to a counterparty of the commodity pool in specified derivatives transactions.

(2) The following provisions of National Instrument 81-102 do not apply to a commodity pool:

1. Paragraphs 2.3(d), (e), (f), (g) and (h).

2. Paragraph 2.7(1)(a).

3. Subsections 2.7(3), (4) and (5).

4. Sections 2.8 and 2.11.

PART 3 NEW COMMODITY POOLS

3.1 Non-Application - Sections 3.1 and 3.2 of National Instrument 81-102 do not apply to a commodity pool.

3.2 New Commodity Pools

(1) No person or company shall file a prospectus for a newly established commodity pool unless

(a) an investment of at least $50,000 in securities of the commodity pool has been made, and those securities are beneficially owned, before the time of filing by

(i) the manager, a portfolio adviser, a promoter or a sponsor of the commodity pool,

(ii) the directors, officers or shareholders of any of the manager, a portfolio adviser, a promoter or a sponsor of the commodity pool, or

(iii) any combination of the persons or companies referred to in subparagraphs (i) and (ii); and

(b) the prospectus of the commodity pool states that the commodity pool will not issue securities other than those referred to in paragraph (a) unless subscriptions aggregating not less than $500,000 have been received by the commodity pool from investors other than the persons and companies referred to in subparagraphs (i) and (ii) of paragraph (a) and accepted by the commodity pool.

(2) A commodity pool may redeem, repurchase or return any amount invested in, securities issued upon the investment in the commodity pool referred to in paragraph (1)(a) only if

(a) securities issued under paragraph (1)(a) that had an aggregate issue price of $50,000 remain outstanding and at least $50,000 invested under paragraph (1)(a) remains invested in the commodity pool; or

(b) the redemption, repurchase or return is effected as part of the dissolution or termination of the commodity pool.

3.3 Prohibition Against Distribution - If a prospectus of a commodity pool contains the disclosure described in paragraph 3.2(1)(b), the commodity pool shall not distribute any securities unless the subscriptions described in that disclosure, together with payment for the securities subscribed for, have been received.

3.4 [Repealed]

PART 4 PROFICIENCY AND SUPERVISORY REQUIREMENTS

4.1 Proficiency and Supervisory Requirements

(1) No mutual fund restricted individual shall trade in a security of a commodity pool unless that individual

(a) has received at least a passing grade for the Canadian Securities Course;

(b) has received at least a passing grade for the Derivatives Fundamentals Course;

(c) has successfully completed the Chartered Financial Analyst Program; or

(d) meets the proficiency standards applicable to trading in securities of commodity pools required by a self-regulatory organization of which the individual, or his or her organization, is a member if the securities regulatory authority or regulator has completed any required review, approval or non-disapproval of the regulatory instrument of the self-regulatory organization that establishes those proficiency standards.

(2) No principal distributor or participating dealer shall trade in a security of a commodity pool in the local jurisdiction unless the individual designated by the principal distributor or participating dealer to be responsible for the supervision of trades of securities of commodity pools in the local jurisdiction has received at least a passing grade for the Derivatives Fundamentals Course or has successfully completed the Chartered Financial Analyst Program.

(3) Despite subsection (2), but subject to compliance with securities legislation, a principal distributor may agree to act as principal distributor of a commodity pool and may trade in securities of a commodity pool if all trades are effected through a participating dealer that satisfies the requirements of subsection (2).

4.2 [Repealed]

PART 5 INCENTIVE FEES

5.1 Non-Application - Part 7 of National Instrument 81-102 does not apply to a commodity pool.

5**.2 Incentive Fees -** A commodity pool shall not pay, or enter into arrangements that would require it to pay, and no securities of a commodity pool shall be sold on the basis that an investor would be required to pay, a fee that is determined by the performance of the commodity pool, unless

(a) the payment of the fee is based on the cumulative total return of the commodity pool for the period that began immediately after the last period for which the performance fee was paid; and

(b) the method of calculation of the fee is described in the prospectus of the commodity pool.

5.3 Multiple Portfolio Advisors - Section 5.2 applies to fees payable to a portfolio adviser of a commodity pool that has more than one portfolio adviser, if the fees are calculated on the basis of the performance of the portfolio assets under management by that portfolio adviser, as if those portfolio assets were a separate commodity pool.

PART 6 REDEMPTION OF SECURITIES OF A COMMODITY POOL

6.1 Frequency of Redemptions - If disclosed in its prospectus, a commodity pool may include, as part of the requirements established under subsection 10.1(2) of National Instrument 81-102, a provision that securityholders of the commodity pool shall not have the right to redeem their securities for a period up to six months after the date on which the receipt is issued for the initial prospectus of the commodity pool.

6.2 Required Notice of Redemption - Despite section 10.3 of National Instrument 81-102, a commodity pool may implement a policy providing that a person or company making a redemption order for securities shall receive the net asset value for those securities determined, as provided in the policy, on the first or second business day after the date of receipt by the commodity pool of the redemption order.

6.3 Payment of Redemption Proceeds - The references in subsection 10.4(1) of National Instrument 81-102 to "three business days" shall be read as references to "15 days" in relation to commodity pools.

PART 7 [Repealed]

PART 8 CONTINUOUS DISCLOSURE   FINANCIAL STATEMENTS

8.1 [Repealed]

8.2 [Repealed]

8.3 [Repealed]

8.4 [Repealed]

8.5 Leverage Disclosure

(1) A commodity pool shall include in its interim financial statements and its audited financial statements disclosure of the minimum and maximum level of leverage experienced by the commodity pool in the period covered by the financial statements, together with a brief explanation of how the commodity pool uses the term "leverage" and the significance of the maximum and minimum levels of leverage to the commodity pool.

(2) The information required by subsection (1) may be included in the body of the financial statements or in notes to the financial statements.

8.6 [Repealed]

PART 9 [REPEALED]

PART 10 EXEMPTION

10.1 Exemption

(1) The regulator or the securities regulatory authority may grant an exemption from this Instrument, in whole or in part, subject to such conditions or restrictions as may be imposed in the exemption.

(2) Despite subsection (1), in Ontario, only the regulator may grant such an exemption.

PART 11 EFFECTIVE DATE AND TRANSITIONAL

[Note: This unofficial consolidation does not include PART 11, which contains the original historical coming-into-force provision for this Instrument.]

COMPANION POLICY 81-104CP TO

NATIONAL INSTRUMENT 81-104 COMMODITY POOLS

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COMPANION POLICY 81-104CP TO

NATIONAL INSTRUMENT 81-104 COMMODITY POOLS

PART 1 PURPOSE AND BACKGROUND

1.1 Purpose - This Policy clarifies how National Instrument 81-104 (the "Instrument") integrates with National Instrument 81-102 *Mutual Funds*, and brings certain matters relating to the Instrument to the attention of persons or companies involved with the establishment or administration of commodity pools.

1.2 What the Instrument Covers

(1) The Instrument regulates publicly offered mutual funds that use certain alternative investment strategies involving specified derivatives and commodities. The Instrument defines the term "commodity pool" as a mutual fund that is permitted to use or invest in specified derivatives and physical commodities beyond what is permitted by National Instrument 81-102. Industry players refer to these mutual funds as "commodity pools" and the members of the Canadian Securities Administrators that have implemented the Instrument (the "CSA") have retained this term to describe these mutual funds.

(2) The CSA note that the Instrument specifically allows commodity pools liberalized use of derivatives, leverage strategies and commodities so that they can pursue traditional commodity pool investment strategies. By implementing the Instrument, the CSA are not providing relief for all alternative investment strategies that may be adopted by investment funds. In particular, the CSA point out that a number of strategies, including non derivative-related short selling, cannot be followed by commodity pools and other mutual funds due to prohibitions contained in National Instrument 81-102. A person or company that wishes to sell to the public investment funds that use alternative investment strategies not contemplated by the Instrument should consider using available exemptions from prospectus requirements or structuring the fund as a closed end investment fund. The CSA will consider on a case by case basis applications for exemptions from applicable restrictions contained in National Instrument 81-102 if a mutual fund structure is proposed. Any application for exemption should describe how the proposed alternative investment strategy meets the policy goals behind the rules in National Instrument 81-102 and why a mutual fund structure is in the public interest.

1.3 Background to the Instrument - The CSA developed the Instrument in order to create an updated uniform national regulatory regime for commodity pools. Commodity pools have been sold in most jurisdictions in Canada under prospectuses filed with the CSA for over twenty years. The Ontario Securities Commission published a policy statement, OSC Policy Statement 11.4 *Commodity Pool Programs*, to set parameters for the operation and administration of these investment vehicles. The other members of the CSA regulated commodity pools through exemptive orders giving relief, on conditions, from requirements of applicable securities legislation in their jurisdiction, including National Instrument 81-102 and its predecessor instrument. The exemptive relief orders were largely consistent with the guidelines contained in the Ontario policy statement. The Ontario Securities Commission and the other members of the CSA that have implemented the Instrument recognize that the Ontario policy statement has become outmoded and no longer reflects the regulatory approach now favoured by the CSA.

1.4 Regulatory Principles for Commodity Pools

(1) The CSA considered the following regulatory principles in developing and implementing the Instrument:

(a) Commodity pools should be regulated in the same manner as conventional mutual funds, except in respect of their use of specified derivatives and leverage strategies. Therefore, commodity pools are defined in the Instrument as a type of mutual fund, so that the rules of National Instrument 81-102, and other applicable securities legislation apply except as provided otherwise in the Instrument.

(b) Commodity pools should be granted greater freedom in their use of specified derivatives and leverage strategies than conventional mutual funds, in exchange for requirements which, among other things, are aimed at increasing the information available to investors about the investment strategies, risks and on-going performance of commodity pools. Therefore, the Instrument generally exempts commodity pools from the specified derivative rules of National Instrument 81-102.

PART 2 GENERAL STRUCTURE OF THE INSTRUMENT

2.1 Relationship to Securities Legislation Applicable to Mutual Funds

(1) Since by definition, commodity pools are mutual funds, they are subject to mutual fund rules unless those rules are specifically excluded. The Instrument contains only those provisions that are specific to commodity pools. Provisions applicable to all mutual funds, including commodity pools, are contained in National Instrument 81-102.

(2) Persons involved with the establishment or administration of a commodity pool should review the following rules:

1. National Instrument 81-102. That National Instrument contains general rules concerning the operation of mutual funds, all of which are applicable to commodity pools unless specifically excluded by the Instrument.

2. Applicable mutual fund related securities legislation. For example, commodity pools are subject to the financial statement reporting requirements for mutual funds, except as varied or supplemented in the Instrument.

3. Prospectus requirements of the securities legislation of a jurisdiction applicable to long form issuers generally, and mutual funds in particular. National Instrument 81-101 *Mutual Fund Prospectus Disclosure* does not allow commodity pools to use the prospectus disclosure system created by that National Instrument.

4. Securities legislation of a jurisdiction that applies to dealers in securities of a mutual fund. Since commodity pools are mutual funds, dealers registered in a jurisdiction to sell mutual funds can trade in these securities. The Instrument imposes additional proficiency

requirements for salespersons who are registered to sell only mutual funds and for the supervisors of trades in commodity pools.

2.2 Derivatives Use

(1) The regime implemented by the Instrument is designed to allow commodity pools considerable freedom in entering into derivatives transactions. Commodity pools are not subject to the majority of sections 2.7 and 2.8 of National Instrument 81-102, which contain most of the rules governing specified derivatives used by mutual funds. Commodity pools, however, remain subject to the main investment restrictions and rules governing investment practices contained in National Instrument 81-102 that do not relate directly to derivatives or commodity transactions.

(2) Commodity pools remain generally subject to section 2.1 of National Instrument 81-102 except as provided in subsection 2.1(1) of the Instrument. Section 2.1 of National Instrument 81-102 contains the prohibition against a mutual fund investing more than 10 percent of its net assets in the securities of an issuer. The effect of subsection 2.1(1) of the Instrument is that a commodity pool need not be restricted by this prohibition in relation to its specified derivatives transactions with any one counterparty. That is, a commodity pool may "invest" more than 10 percent of its net assets with any one counterparty in one or more specified derivatives transactions. This exception to the 10 percent rule is designed to allow commodity pools greater flexibility in their specified derivatives transactions. However, a commodity pool remains subject to the 10 percent rule in relation to any securities of any issuers, including counterparties, other than the "securities" acquired from counterparties in specified derivatives transactions. A commodity pool may enter into an unlimited number of specified derivatives transactions with any counterparty without regard to the 10 percent rule, but remains subject to the 10 percent rule in relation to any, for example, common shares of that counterparty acquired by it. In addition, the "look through" rule contained in subsection 2.1(3) of National Instrument 81-102 will still apply to those specified derivatives transactions, requiring a commodity pool to take into account the underlying interests of specified derivatives transactions in order to ensure compliance with section 2.1 of National Instrument 81-102.

(3) Commodity pools, as with other mutual funds, remain subject to paragraphs 2.6(b) and (c) of National Instrument 81-102, which prohibit mutual funds from purchasing securities on margin or selling securities short, unless these strategies are permitted by sections 2.7 or 2.8 of that National Instrument. Commodity pools contemplating purchasing securities on margin or selling securities short in connection with their specified derivatives strategies should review sections 2.7 and 2.8 of National Instrument 81-102 to determine permissible practices. Any other strategy which involves purchasing securities on margin or selling securities short is not permitted for commodity pools, in the same manner as that other strategy is not permitted for conventional mutual funds. The Instrument exempts commodity pools from most of the provisions of sections 2.7 or 2.8 of National Instrument 81-102, but is not intended to remove the permission to purchase securities on margin or sell securities short in specified derivatives transactions provided for in paragraphs 2.6(b) and (c) of National Instrument 81-102.

PART 3 [REPEALED]

PART 4 LIMITED LIABILITY

4.1 Limited Liability

(1) Mutual funds generally are structured in a manner that ensures that investors are not exposed to the risk of loss of an amount more than their original investment. The CSA consider this a very important and essential attribute of mutual funds. This is especially important in the context of commodity pools. One of the most important rationales for the existence of commodity pools is that they enable investors to invest indirectly in certain types of derivative products, particularly futures and forwards, without putting more than the amount of their investment at risk. A direct investment in some derivative products could expose an investor to losses beyond the original investment.

(2) The CSA expect that commodity pools will be structured in a manner that provides as much assurance as possible to their securityholders that securityholders will not be at risk for more than the amount of their original investment. The CSA recommend that commodity pool promoters and managers consider other ways, apart from the structuring of a pool, to limit the liability of securityholders. For example, commodity pools could enter into contracts only if the other party to the agreement agreed to limit recourse under the agreement to the assets of the pool.

(3) Mutual funds structured as corporations do not raise pressing liability problems because of the limited liability regime of corporate statutes.

(4) Mutual funds structured as limited partnerships may raise some concerns about the loss of limited liability if limited partners are viewed as participating in the management or control of the partnership. The statute and case law concerning when limited partners can lose their limited partner status, including the Quebec Civil Code, varies from province to province. The risks associated with this type of structure in the jurisdictions where the prospectus is filed should be disclosed.

(5) Mutual funds structured as trusts are subject to their constitution and the common and civil law of trusts. A commodity pool operator should consider this law, together with the factual circumstances surrounding the establishment of the commodity pool, including the ability of the investors in the commodity pool to influence the administration and management of the commodity pool, to ensure that investors' liability is limited to the amount they have invested in the commodity pool. If applicable, a commodity pool should disclose in the prospectus the risks associated with the structuring of a commodity pool as a trust in relation to the possibility that purchasers of securities of the commodity pool may become liable to make an additional contribution beyond the price of the securities.