Companion Policy 81-104
Commodity Pools

Companion Policy 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 *Investment 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]~~[INTENTIONALLY BLANK~~]~~

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.