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Canadian Securities Administrators

Autorités canadiennes en valeurs mobilières

Request for Comment
Proposed National Instrument 81-107
Independent Review Committee for Mutual Funds

Prepared by the Canadian Securities Administrators

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Introduction

We, the members of the Canadian Securities Administrators (the CSA), are publishing proposed National Instrument 81-107 *Independent Review Committee for Mutual Funds* (the Proposed Rule) for public comment. We will take your comments on the Proposed Rule until April 9, 2004. You can provide your comments by following the procedure we set out under the heading *How to provide comments on the Proposed Rule* below.

This Request for Comment (the Notice) and the Proposed Rule follow on our Concept Proposal 81-402 *Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers* (the Concept Proposal). The Proposed Rule builds on certain concepts introduced in the Concept Proposal and brings us one step closer towards implementing a mandatory fund governance regime that will bring some independence to the management of mutual funds.

The Proposed Rule is intended to regulate all publicly offered mutual funds in Canada. This includes: mutual funds investing in equities, bonds, income securities or money market instruments; balanced funds; index funds; mortgage funds; and funds of funds. It also includes commodity pools, which are presently regulated by Multilateral Instrument 81-104 Commodity Pools. It would not apply to pooled funds sold on the exempt market or the following types of investment funds: hedge funds, closed-end funds, quasi closed-end funds, scholarship plans, labour-sponsored venture capital corporations, and mutual funds that are listed and posted for trading on a stock exchange or quoted on an over-the-counter market.

We expect the Proposed Rule to be implemented as a rule in each of Alberta, British Columbia, Manitoba, Newfoundland, Nova Scotia and Ontario, as Commission regulation in Quebec and Saskatchewan, and as a policy in the remaining jurisdictions represented by the CSA. The commentary contained in the Proposed Rule will be adopted as a policy in each of the jurisdictions represented by the CSA.

Additional information on the Proposed Rule, required for publication in Ontario, can be found in Appendix A of the form of notice published in the OSC Bulletin or on its website at www.osc.gov.on.ca.

The BCSC has specific issues they would like you to comment on. You can find them in Appendix A of the form of notice published in British Columbia.

Purpose

Content of the Proposed Rule: fund governance

The Proposed Rule would introduce a mandatory fund governance regime focused on conflicts of interest. Under the Proposed Rule, each mutual fund manager would be required to establish an independent review committee (IRC) for its funds[1].The IRC would be charged with reviewing all matters involving a conflict of interest between the fund manager's own commercial and business interests and its fiduciary duty to manage its mutual funds in the best interests of those funds. These conflicts will include transactions with entities that are related to the manager, trades between mutual funds, certain changes which currently require an investor vote (referred to as fundamental changes), and situations when a reasonable person would question whether the manager is in a conflict of interest situation.

Where there is a conflict of interest, the fund manager must refer the matter to the IRC and obtain its recommendation. The manager would be allowed to proceed even where the IRC does not agree, but must disclose the IRC's position and the reason for not following the IRC's recommendations to the fund's unitholders.

The existing self-dealing and conflict of interest prohibitions in the Securities Act and National Instrument 81-102 Mutual Funds (NI 81-102) would be repealed, and the discretion of the IRC would effectively replace the prohibitions. The requirement for a securityholder vote on certain changes would be replaced by consideration of the matter by the IRC.

What the Proposed Rule does not contain

Registration for fund managers

The Proposed Rule focuses on two of the three areas of reform described in the Concept Proposal: fund governance and product regulation. It does not elaborate on the registration regime for mutual fund managers. While we believe that a registration regime for mutual fund managers is an important part of a complete regulatory approach to mutual funds, we recognize that a poorly designed system of registration would have no benefits. A number of policy initiatives with a registration component are currently underway. These include the USL project, the OSC Fair Dealing Model, the BCSC Model, and the CSA's Registration Passport System. We propose to delay our work in this area until these other initiatives have evolved further.

A broad oversight role for the IRC and significant relaxation of product regulation

Our current proposal to introduce fund governance, while eliminating the self-dealing and conflict of interest provisions, is much narrower than what we described in the Concept Proposal. The Concept Proposal set out a very robust system of fund governance in

[1] We have replaced the term "governance agency" with "independent review committee" because it is more descriptive and less prone to confusion.

which a group of independent people would oversee all of the fund manager's activities. Among other things, this group would have been asked to oversee performance, monitor fees, and act as audit committee. Given the level of oversight that would have been provided by this group, we proposed to relax much of the product regulation in NI 81-102.

Our decision to narrow the role of the IRC in the Proposed Rule came largely in response to public comment. The respondents to the Concept Proposal asked us not to cast the role of the IRC too broadly. They were concerned that by asking the IRC to oversee management, we would effectively dilute the manager's role. A number of the letters asked us to focus the attention of the IRC on areas where it could add value—while there were divergent views on the appropriateness of each of the proposed responsibilities, everyone agreed that the IRC should concentrate on approving related-party transactions.

Rationales for fund governance

Mutual fund managers owe a fiduciary duty to the mutual funds they manage and, by extension, to the investors in those funds as a whole. The fiduciary duty includes both a duty of loyalty and a duty of competence. This fiduciary duty arises at common law and civil law[2] and is reinforced by the standard of care provisions in the Securities Acts of British Columbia, Alberta, Saskatchewan, Ontario, Quebec,[3] Nova Scotia and Newfoundland.

Conflicts of interest faced by fund managers present a real challenge to their ability to meet their duty of loyalty because the interests of fund managers are not always perfectly aligned with the interests of investors. Regulating these conflicts of interest is a priority for mutual fund regulators, both in Canada and internationally.

As a paper by the Organization for Economic Co-operation and Development (OECD) illustrates, there are at least two approaches to regulating conflicts in the mutual fund context:

> One approach to possible conflicts of interest would be for CIS [collective investment scheme or mutual fund] regulators to impose highly restrictive rules and wide-ranging prohibitions… Most analysts believe that this approach would be excessively rigid. Instead most countries have created well-defined but flexible governance frameworks consisting of two parts: 1) accepted standards of conduct that combine official rules and industry best practice; and 2) well-defined legal and regulatory environments for CIS in which certain designated parties are

[2] The Background Legal Paper we published with the Concept Proposal entitled *Trust Law Implications of Proposed Regulatory Reform of Mutual Fund Governance Structures* prepared by David Stevens of Goodman and Carr LLP discusses these fiduciary duties and conflicts of interest.

[3] The standards in Quebec apply to "registered" persons, not specifically to mutual fund managers. The other provinces impose specific standards on managers of mutual funds.

charged with scrutinizing the activity of the CIS for conformity with those standards. [4]

While most jurisdictions have opted for an approach based on independent oversight of the mutual fund manager, Canadian legislators and regulators previously chose to respond to potential conflicts of interest by simply prohibiting certain relationships or transactions via restrictive rules.[5]

Although our prohibition-based approach to regulating conflicts of interest may be a straightforward way to avoid abuses, we recognize its shortcomings. We know the current approach is too restrictive on the one hand—because it prohibits transactions that are innocuous or even beneficial to investors—and not inclusive enough on the other—because it only deals with certain specific transactions.

Under the Proposed Rule, conflicts of interest would be regulated through a governance regime rather than restrictive rules and wide-ranging prohibitions. Improved mutual fund governance represents a structural solution to the inherent conflicts and it avoids the criticisms of our current regime while offering the following benefits:

- Flexibility and timely decisions. Certain related-party transactions that are currently prohibited may be permitted provided an IRC judges the manager's business interests to be fair and reasonable. The IRC will be familiar with the operations of the fund manager and will, ideally, make responsive and timely recommendations.

- Better investor protection in the area of business conflicts. An independent body will vet a manager's actions taken in *all* conflict situations, not just related-party transactions. These business conflicts are not currently regulated. Every mutual fund complex, large or small, faces these conflicts and could benefit from this review.

- Increased focus on the mutual fund manager's fiduciary obligation to its funds. The mandatory fund governance regime reinforces the fund manager's obligation to act in the best interests of the fund.

- More consistent industry standards. The proposed approach will bring consistency to the industry by requiring all fund managers to formally account for their actions and will impose a single standard across the country.

Ours is a made-in-Canada approach, yet it is consistent with the approach taken by major international regulators. We expect the adoption of independent review committees will enhance the Canadian mutual fund industry's reputation as a well-regulated and governed

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[4] Governance Systems for Collective Investment Schemes in OECD Countries by John K. Thompson and Sang-Mok Choi of the Directorate for the Financial, Fiscal and Enterprise Affairs, Financial Affairs Division Occasional Paper, No.1, April 2001 at 10.

[5] The regulators have broad discretion to grant relief from those prohibitions, however, in practice, this discretion generally has been exercised only in narrow circumstances.

industry. This may afford Canadian mutual funds easier access to international markets where foreign mutual funds are allowed entry.

Why we opted for a more focused approach

The Proposed Rule will bring independent review to the area where every respondent to the Concept Proposal agreed it mattered most, without placing an undue burden on mutual fund managers who have no experience working with an independent board. It will ensure every manager has a minimum level of fund governance in place and we believe this is a good starting point. The Proposed Rule is designed to strike an appropriate balance between improving investor protection and enhancing market efficiency.

The Proposed Rule will focus on conflicts: an area that we find most troubling and an area that we know from considering exemptive relief applications is not easily regulated by prescriptive rules. We believe that an independent review, conducted by a body who is close enough to the fund to understand its workings, and the needs and interests of its unitholders, will be a more effective way to regulate conduct where this is a conflict of interest.

Fundamental changes to the mutual fund

Under the Proposed Rule, certain changes which currently require an investor vote in NI 81-102 (referred to as fundamental changes) would now be referable to the IRC. We believe these changes involve business conflicts which can be reviewed by the IRC. Advance notice of the change would replace the ability of an investor to vote. We recognize, however, that some of the changes currently requiring an investor vote, such as changes to the mutual fund's fees or its investment objectives, are viewed by many investors as changes to the essence of the 'commercial bargain' between investors and the mutual fund. We are not proposing to replace investor meetings with an IRC review in those circumstances.

Inter-fund trading

The Proposed Rule would also permit purchases and sales of securities between mutual funds in the same group (referred to as inter-fund trades). In addition to review by the IRC, inter-fund trades will be subject to specific conditions that address concerns relating to pricing and transparency in the capital markets.

Our long-term vision for fund governance

Although we have significantly refined the role of the IRC in the Proposed Rule, we strongly encourage mutual fund managers and the IRCs to consider whether a broader mandate would be appropriate. Although the Proposed Rule would not regulate this, we hope that fund managers will turn to their funds' IRCs for advice on a variety of matters and will think creatively about how these groups can add value to their fund complexes. We expect that fund governance will evolve with time. Industry practices will certainly develop to supplement the regulatory regime.

Product regulation: the next phase

As we said in the Concept Proposal, we believe it is important to consider a renewed framework for regulating mutual funds. We believe the proposed regime offers us a flexible platform for future regulatory reform.

As a next phase of our work, we will continue to review mutual fund product regulation as a whole. We have already begun consultations with industry, and will continue those consultations with a view to publishing a revised product regulation system for comment.

Form of the Proposed Rule: plain language

The style and format of the Proposed Rule represent a departure from our norm. It is written in plain language without defined terms or complex drafting. Rules and relevant commentary appear side-by-side for ease of reference. The style and format of the Proposed Rule is designed to make it easy to navigate, read, and understand. We see the Proposed Rule as a case study in plain language rulemaking and we intend to build on this approach as we move forward with other initiatives.

Rationales for the use of plain language

We believe securities regulation should be comprehensible to all market participants—from sophisticated securities professionals to investors. The CSA has stated its commitment to clear and simple regulatory requirements in its strategic plan.[6]

Our long-term vision for a consolidated rulebook

Our long-term goal is to create a single rulebook that will set out all of the legal requirements that apply to publicly offered mutual funds and their managers. We hope to bring all existing and future mutual fund regulation together in one place. Like the Proposed Rule, the consolidated rulebook would be written in plain language and would contain both the rules and the commentary that explains the application of the rules.

Background to the Proposed Rule

The Concept Proposal

The modern fund governance debate in Canada has been going on since the mid-1990s. The CSA received reports on the subject from Glorianne Stromberg and Stephen Erlichman in January 1995 and June 2000, respectively.[7] On March 1, 2002, the CSA

[6] See the Canadian Securities Administrators' Strategic Plan for 2002-2005, dated April 2002.

[7] *Regulatory Strategies for the Mid-90s – Recommendations for Regulating Investment Funds in Canada* prepared by Glorianne Stromberg for the Canadian Securities Administrators, January 1995.

released a Concept Proposal that set out our vision for the future of mutual fund regulation in Canada. Fund governance figured as one of the pillars of this proposed regime.

Recent regulatory developments

As we developed the Proposed Rule, we took into account these recent regulatory developments:

Regulatory exemption decisions

During the summer of 2002, members of the CSA began granting exemptions from the prohibitions and restrictions in securities regulation that regulate conflicts between the fund manager's business interests and the best interests of their mutual funds. Some of the exemptions contained the condition that the transactions in question be reviewed by an independent governance committee charged with ensuring they are made in the best interests of the mutual funds. See *In the Matter of Mackenzie Financial Corporation* July 26, 2002 and *In the Matter of Altamira Management Inc. et al* April 7, 2003. The Mackenzie decision and the decisions that followed it indicate that both regulators and the industry accept the role of independent fund governance in the context of related-party transactions.

Uniform securities legislation

In January 2003, we published our Concept Proposal *Blueprint for Uniform Securities Laws for Canada*[8] outlining our proposals for harmonizing securities laws across Canada. Chapter XII Investment Funds sets out our proposals for reforming mutual fund regulation. We intend to draft the uniform securities legislation to complement the Proposed Rule. For example, draft uniform securities legislation would give each securities regulatory authority in Canada the authority to enact the Proposed Rule as a binding rule with the force of law. When drafting the Proposed Rule, we assumed that uniform securities legislation had been enacted in each province and territory. If it is not in force across Canada when we finalize the Proposed Rule, we will modify it, as necessary, to exempt industry participants from having to comply with relevant existing securities legislation, to the extent that we have authority to do this.

Ontario five year review

On May 29, 2003, the Five Year Review Committee created by the Minister of Finance in Ontario released its final report on its securities law review.[9] In that report, the

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Making it Mutual: Aligning the Interests of Investors and Managers – Recommendations for a Mutual Fund Governance Regime for Canada prepared by Stephen I. Erlichman, Senior Partner, Fasken Martineau DuMoulin LLP for the Canadian Securities Administrators, June 2000.

[8] *Blueprint for Uniform Securities Laws for Canada*, a Concept Proposal of the Canadian Securities Administrators, January 30, 2003.

[9] *The Five Year Review Committee Final Report: Reviewing the Securities Act (Ontario)*, prepared by the Five Year Review Committee for the Minister of Finance, March 21, 2003.

committee recommended that the OSC and CSA introduce a requirement for all publicly offered mutual funds to establish and maintain an independent governance body.

The committee went on to recommend that this body have the right to either terminate the mutual fund manager or tell investors about the manager's actions and give them the right to redeem their units at no cost, when, in the reasonable opinion of the independent directors, there is cause. According to the committee, such cause could be shown in situations where the manager has placed its interests ahead of those of unitholders of a mutual fund through self-dealing, conflict of interest transactions or other breaches of its fiduciary obligations.

The committee recommended that the governance body's responsibilities should include: overseeing policies related to conflict of interest issues; monitoring fees, expenses and their allocation; receiving reports from the manager concerning compliance with investment goals and strategies; reviewing auditor appointments; meeting with the fund's auditor; and approving material contracts.

BCSC initiatives

The British Columbia Securities Commission (BCSC) released its *New Proposals for Mutual Fund Regulation: a New Way to Regulate*[10] in November 2002 as part of its initiative to rethink securities regulation in British Columbia. In this report, the BCSC recommended a code of conduct approach to mutual fund regulation that would see our existing rules replaced with general principles and guidance. Its approach to governance is permissive rather than mandatory—each manager would be asked to ensure that it has a suitable governance structure. The question of whether or not the fund manager should act as its own IRC or whether the IRC should be independent would be left to the discretion of the fund manager. Under the BCSC approach, all governance practices would be disclosed and compared to published industry practice guidelines. The *New Proposals* paper and the comment letters submitted in response to it are posted on the BCSC website at www.bcsc.bc.ca.

Staff of the BCSC helped develop the Proposed Rule and contributed their ideas about how our current regulation could be made more principles-based and consistent with the objectives behind the BCSC proposals. When combined with the commitment the CSA has to reviewing mutual fund product regulation that we discussed under the heading Product regulation: the next phase, the BCSC is satisfied the combination of that initiative and the Proposed Rule meets these objectives and will, therefore, not be pursuing a BC-only initiative to reform all aspects of mutual fund regulation in British Columbia at this time.

[10] *New Proposals for Mutual Fund Regulation: A New Way to Regulate*, prepared by the British Columbia Securities Commission, November 14, 2002.

Summary of the Proposed Rule

Application

The Proposed Rule applies only to specific publicly offered conventional mutual funds and regulates those mutual funds and their managers. It also includes commodity pools, which are presently regulated by Multilateral Instrument 81-104 Commodity Pools. It would not apply to pooled funds sold on the exempt market or the following types of investment funds: hedge funds, closed-end funds, quasi closed-end funds, scholarship plans, labour-sponsored venture capital corporations, and mutual funds that are listed and posted for trading on a stock exchange or quoted on an over-the-counter market.

Conflicts of Interest

Where conflicts of interest arise in the fund manager's management of the mutual fund, either from the manager's own commercial and business interests, or when a reasonable person would question whether the manager is in a conflict of interest situation, the fund manager must refer the matter to the IRC for review.

In addition to the review by the IRC, mutual funds that engage in interfund trades are subject to conditions that address concerns relating to pricing and transparency in the capital markets.

Independent Review Committee

Each mutual fund must have an IRC. The Proposed Rule does not mandate a specific legal structure for an IRC, provided the fund manager complies with the requirements for the IRC in the Proposed Rule.

All of the members of the IRC must be independent from the fund manager, the mutual fund and entities related to the fund manager, with the exception of the board of directors of a related trust company.

The role of the IRC is to consider all conflict of interest matters referred to it by the fund manager and decide if the action proposed by the manager is a fair and reasonable result for the mutual fund. The IRC must then make recommendations to the manager. The Proposed Rule permits the manager and the IRC to decide how they will deal with each potential conflict situation in light of the particular circumstances that apply to the manager and the fund.

The Proposed Rule describes the standard of care for members of the IRC, the IRC's authority, appointments to the IRC, and minimum expectations regarding the proceedings of the IRC and disclosure to securityholders about the IRC.

Changes to the Mutual Fund

The fund manager must refer all changes relating to the mutual fund to the IRC. Following the recommendation of the IRC, the fund manager must send advance notice of the change to all securityholders of the mutual fund and allow them to redeem and transfer free of charge to another mutual fund managed by the manager.

Exemptions

Exemptions from the Proposed Rule may be granted by the regulator or securities regulatory authority in each of the jurisdictions.

Transition

The Proposed Rule provides for a transitional period.

Feedback on the Concept Proposal

This part of the discussion paper summarizes the feedback we received in response to the Concept Proposal.

Comment letters

We received 57 comment letters in response to our request for comments on the Concept Proposal. These included letters from:

- Industry trade associations representing mutual fund managers, investment managers, pension managers, life insurance companies and accountants in Canada and abroad. IFIC, the trade association for the mutual fund industry, provided comments on behalf of its members and many respondents expressed support for the position taken in that letter before providing further comments

- 30 mutual fund managers from across the country, including 6 bank-owned managers, a number of small managers, and the managers of 3 owner-operated funds

- The governance agencies for 3 mutual fund groups

- 7 investment management firms

- Lawyers with 5 law firms, 1 lawyer, 1 law student, 1 accounting firm and 1 economist and

- 2 investors and 1 investor advocate.

All comment letters have been posted on the websites of members of the CSA to ensure transparency of the policy-making process. See, for example, the Ontario Securities Commission website at www.osc.gov.on.ca.

We thank all respondents for participating in our work to improve mutual fund regulation.

List of respondents

Association of Canadian Pension Management
Acuity Funds Ltd.
AGF Management Limited
AIM Funds Management Inc.
Association for Investment Management and Research
Association of Labour Sponsored Investment Funds
Altamira Financial Services
Assante Asset Management Ltd.
Barclays Global Investors Canada Limited
Borden Ladner Gervais LLP
BMO Investments Inc.
Certified General Accountants Association of Manitoba
Capital International Asset Management (Canada) Inc.
Canadian Imperial Bank of Commerce
ClaringtonFunds
Canadian Life and Health Insurance Association Inc.
The Board of Governors of The Cundill Funds
Cyril Fleming and Mary Carmel Fleming
Dynamic Mutual Funds Ltd.
The Board of Governors of Dynamic Mutual Funds
Fasken Martineau DuMoulin LLP
Fidelity Investments Canada Limited
Fogler, Rubinoff LLP as counsel to Friedberg Mercantile Group
Fonds des professionnels inc.
Frank Russell Canada Limited
Franklin Templeton Investments Corp.
Guardian Group of Funds
Howson Tattersall Investment Counsel Limited
HSBC Investments Funds (Canada) Inc.
Investment Counsel Association of Canada
Investment Company Institute
The Investment Funds Institute of Canada
Investors Group Inc.
James C. Baillie at Schulich Investment Forum (April 2002)
Ken Kivenko
Lawrence P. Schwartz
Leith Wheeler Investment Counsel Ltd.
Lighthouse Private Client Corporation
Mawer Investment Management
McCarthy Tetrault LLP
McLean Budden Limited
MD Management Limited
Mulvihill Capital Management Inc.
National Bank Securities Inc.
Northwater Capital Management Inc.
PFSL Investments Canada Ltd.
Phillips, Hager & North Investment Management Ltd.
PricewaterhouseCoopers LLP
Robert Druzeta
RBC Funds Inc.
The Board of Governors of the Royal Mutual Funds
William J. Braithwaite, Jennifer Northcote, Simon A. Romano, Kathleen G. Ward and Alix d'Anglejan-Chatillon Stikeman Elliott
Synergy Asset Management Inc.
TD Asset Management Inc.
Tradex Management Inc.
Westcap Mgt. Ltd.
Zenith Management and Research Corporation

Continuing Consultations

In-person meetings

We met with representatives from several fund companies who sent us comment letters. We also met with representatives of Ontario Teachers Group Inc., and two individuals, Robert W. Luba, in his capacity as a member of the AIM Funds Advisory Board, and Paul Bates.

Advisory Committee on Investment Funds

Following the release of the Concept Proposal the Ontario Securities Commission convened an *ad hoc* Advisory Committee on Investment Funds (the advisory committee) to help us work through the technical legal issues presented by our proposals and some of the issues raised by respondents on the Concept Proposal. The members of the advisory committee helped us to identify the issues in difficult areas, gave us feedback on our ideas and worked with us to develop solutions and refine our proposals.

The advisory committee members are all senior lawyers who specialize in investment management issues. They freely made a substantial commitment of their time to debate the issues with us. They are:

- Linda Currie, Osler Hoskin & Harcourt
- Marlene Davidge, Torys LLP
- Stephen Erlichman, Fasken Martineau DuMoulin LLP
- John Hall, Borden Ladner Gervais
- Karen Malatest, Torys LLP
- Lynn McGrade, Borden Ladner Gervais
- David Rounthwaite, McCarthy Tetrault LLP
- David Stevens, Goodman and Carr LLP
- David Valentine, Blake Cassels & Graydon

We greatly appreciate the enthusiastic participation of these very busy individuals. Their insights were invaluable to us.

IFIC Board of Directors Fund Governance Committee

We continued to meet regularly with members of IFIC's Board of Directors Fund Governance Committee (the IFIC committee). They provided valuable insights into the comments we received and acted as a sounding board for our ideas as we revised our proposals. We are grateful for their continued participation in our policy-making process.

These members are:

- Steve Baker, HSBC Asset Management (Canada) Limited
- Michael Banham, Clarica Investco Inc.
- Peggy Dowdall-Logie, RBC Funds Inc.
- Don Ferris, Mawer Investment Management
- David Goodman, Dynamic Mutual Funds Ltd.

- Martin Guest, Fidelity Investments Canada Limited
- Stephen Griggs, Legg Mason Canada Inc.
- Thomas Hockin, IFIC
- Chris Hodgson, Altamira Investment Services Inc.
- Darcy Lake, BMO Investments Inc.
- John Mountain, IFIC
- Mark Pratt, RBC Funds Inc.
- Brenda Vince, RBC Asset Management
- W. Terrence Wright, Investors Group Inc.

Summary of the comments

The comments on our Concept Proposal and our responses to those comments appear as an Appendix to this Notice. We received comments from a broad cross-section of the Canadian mutual fund industry. The sheer number of comments[11] is a testament to the fact that the industry does not speak with one voice. As we read the letters, we were reminded of the industry's diversity. No two letters were the same and we heard divergent views on almost every issue raised in the Concept Proposal.

Notwithstanding the differences of opinion on the concepts we proposed, the industry does appear to share a common starting point. This starting point is a general agreement that some regulatory change is necessary. Some believe our proposed framework holds great promise and they strongly support our proposals. Others remain unconvinced that our approach is the best way to get to the desired end—they feel we have not made the case for the sweeping regulatory reforms contemplated in the Concept Proposal. All in all, there is widespread agreement that change is necessary but there is no consensus on how we should effect this change.

Overarching themes

A number of overarching themes emerged from the comments. These themes coloured many of the comments on specific proposals:

The industry supports our ultimate goal

The industry strongly supports our overall aim of enhancing investor protection while bringing improvements to the workings of the industry. Although all saw investor protection as a laudable end, many respondents reminded us that it must be pursued in tandem with the goal of more functional regulation.

Costs are an issue for both the industry and investors

The industry is sensitive to costs. Many respondents fear the imposition of excessive costs may make the mutual fund industry, or parts of it, less than competitive. The industry agrees that the imposition of fund governance costs must be offset by improvements to the product regulation.

[11] We estimate we received over 750 pages of information.

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The industry prefers a flexible approach to regulation
Industry participants want the flexibility to make decisions that suit their particular circumstances. The industry would generally prefer the regulator to outline general principles and it would like to develop its own best practices.

Mutual fund managers wish to maintain control
Many managers expressed the concern that their business arrangements could be interfered with by IRCs or investors. They would prefer to not to hand any part of their business over to an independent group because they remain ultimately responsible to their mutual funds.

Large fund managers have different interests than smaller fund managers
Respondents asked us to tailor our approach to small managers so that we do not create unjustified barriers to entry into the mutual fund business.

The five-pillared framework

On the whole, the five-pillared framework for mutual fund regulation outlined in the Concept Proposal received favourable comment. We received strong support for our treatment of mutual fund regulation as a total package, rather than simply introducing new regulation on top of old in a piecemeal fashion. The comment letters underscored the importance of our re-evaluating the existing regulation concurrently with, or even prior to, the introduction of fund governance and mutual fund manager registration. Many respondents characterized the reduction in mutual fund regulation as a *quid pro quo.*

Fund governance

General
Although there was widespread agreement that good governance for mutual funds is a positive thing, our proposal to introduce IRCs to oversee all actions of mutual fund managers was met with strongly divergent reactions. Certain industry participants believe fund governance needs to be mandated, while others remain unconvinced. Not surprisingly, those managers who have voluntarily adopted some form of governance tend to support our proposals. In contrast, managers with no such experience tend to fear the costs will outweigh the benefits.

A flexible approach
Respondents commented favourably on our flexible approach to fund governance. They liked the idea that each mutual fund manager could decide how best to incorporate an IRC into its legal structure. They also liked the concept of broad governance principles.

Majority independent members
Our suggestion that a majority of the IRC members be independent of the mutual fund manager received some positive feedback but other views were also heard on this point. Many believe mandated independence is a non-negotiable item. These respondents suggested that principles of good governance would lead us towards 100 percent independence. It was recommended that if management representatives are allowed to sit

as part of the IRC, the management representatives should not vote. Other respondents took the opposing view based on the assumption that management participation in the IRC would assist it to execute its roles and responsibilities.

The role of the IRC

Respondents believe the role of the IRC needs to be defined more precisely. They caution that the role should not overlap with that of the fund manager and should not be overly broad. A number of respondents would prefer to see the IRC's role restricted to making independent assessments of circumstances where the fund manager's interests conflict with those of investors. We should not inadvertently let the fund manager off the hook by shifting some of its duties over to the IRC. We were also told it would be a mistake to equate the role of the IRC with that of a corporate board. Mutual fund investors are not owners of the fund in the same way that shareholders own corporations.

The IRC's responsibilities

Many respondents commented on the minimum responsibilities proposed for the IRC. They believe the responsibilities should not be too extensive. In particular, many of these respondents believe the IRC should not approve the mutual fund manager's policies and procedures, approve benchmarks and monitor performance, or approve financial statements. However, most respondents support the idea of having the IRC approve transactions between the fund manager and entities related to it and other conflict of interest matters. The IRC should not be charged with ensuring the fund manager complies with securities regulation, monitor performance or interfere with the basic commercial bargain (this would include reviewing fees, investment objectives, change of manager).

The IRC's standard of care and liability

We received a number of emphatic comments from respondents who believe a standard of care should not be imposed on IRC members for fear that the threat of personal liability will make it difficult to recruit members at a reasonable cost. We were told that unless liability is limited in some way, IRC members may demand high salaries and the costs of obtaining insurance may be prohibitive. Although the proposed standard of care for governance agency members attracted much comment, very few comments came from people who were opposed to the standard of care as a matter of principle. Instead, the comments were motivated by cost concerns (high salaries, costly insurance and the need for expert opinion), fears of micro-management or an overly cautious approach, and the feeling that potential members might be deterred from acting.

Others agreed that personal liability should attach to the actions of IRC members. A duty of care will ensure the members do a good job, we were told. We were also told that not imposing liability would be a step backwards—without liability, the governance agency would have no credibility. A cap on liability was recommended to us because it will make it easier to recruit qualified members and obtain adequate insurance for them.

Compensation of members

A number of respondents asked us to consider the possibility that an IRC could abuse the power to set its own compensation. Many of these respondents suggested the mutual fund manager should be entrusted with setting compensation.

Appointment of members

Rather than having the IRC members fill vacancies, a number of respondents suggested the IRC should ratify the manager's choices. Most respondents agreed that involvement by the fund manager would not seriously jeopardize the independence of members. Almost every respondent emphasized that investor meetings are not practical. Limited terms were also suggested as a way of ensuring that a rogue IRC does not become self-perpetuating. Respondents highlighted a number of concerns with the suggestion that investors who do not approve of the appointments be able to exit the funds without paying deferred sales charges.

Dispute resolution

Respondents strongly supported our position that an IRC should not be given the power to terminate the management contract on its own. A number of respondents went on to suggest that the governance agency should not be allowed to indirectly terminate the management contract by way of an investor meeting either. This was seen as something that would undermine the investor's choice to engage the manager and was understood by some as another form of expropriation. Respondents generally disliked the fact that our approach to dispute resolution turns on investor meetings. In their view, such meetings are inappropriate mechanisms for resolving disputes. Not only are they costly and labour intensive, but they are also poorly attended. Alternative approaches to dispute resolution were suggested: IRC members could resign en masse or be given recourse to the regulators. We could set a regulatory mechanism or require independent arbitration for dispute resolution. Or we could simply rely on disclosure and the threat of negative publicity.

Recruitment

At various points in the Concept Proposal, we queried whether our proposals would make it difficult to recruit qualified people to serve on IRCs. A handful of respondents with governance experience informed us there is a sufficient pool of qualified individuals in Canada. One respondent went on to say that fund managers should have no trouble filling the seats on their IRCs, so long as they are willing to look beyond the traditional pool of talent. Nearly twenty respondents, none of whom have prior experience in this area, voiced the concern that it would be difficult to recruit qualified, independent members at a reasonable cost. These respondents warned that there is a limited talent pool and that qualified people will not be willing to serve because of fears around personal liability.

Replacing conflict of interest prohibitions with IRC oversight

We stated our intention in the Concept Proposal to replace the related-party prohibitions with IRC oversight. With the exception of two smaller fund managers, the respondents supported the proposed relaxation of any rules that become redundant or unnecessary due to the introduction of fund governance. Some respondents would go even further and

have us eliminate the restrictions on related-party transactions as soon as possible, regardless of whether or not fund governance is introduced.

Fundamental changes

Our decision to re-examine whether investor meetings need to be called when fundamental changes are proposed met with much support. We were told that investor meetings should be avoided at all costs because mutual fund investors are generally not interested in actively participating in the investment management of their holdings. Investor meetings are poorly attended and investors generally accept the status quo or vote with their feet. These meetings are expensive to organize and they are a complex administrative exercise.

We were strongly encouraged to use the IRC as a "proxy" for investors when it comes to approving fundamental changes. Most of the respondents on this point agreed this would significantly reduce costs. The decision to change auditors, in particular, was widely thought to be one the governance agency should make.

Enhanced regulatory presence

Although we did not set out any specific proposals under this pillar, we did pose the question: how can we better carry out our role as regulator? Many of the letters we received underscored the need to begin by reducing the unnecessary administrative costs inherent in our regulatory system, preferably by creating a national securities regulator and/or a uniform body of regulation. Although these initiatives fall outside the ambit of this particular project, the industry feels they are crucial to its success. As the letter from IFIC stated, "the Concept Proposal initiatives will be of no benefit to Canadian mutual fund investors if they are simply added as layers to the pre-existing inefficiencies of our current regulatory regime".[12] IFIC also warned that the industry would not support any proposal that is not implemented and adopted in a standardized and uniform manner across Canada.

Alternatives considered

The Concept Proposal outlined the alternatives we considered in developing the approach we described in that document. It also set out the pros and cons to each alternative. The primary alternatives we considered, but ultimately rejected in favour of the approach set out in the Proposed Rule, include:

- Maintaining the status quo. We described in the Concept Proposal why this alternative is not an option.

- Voluntary governance in the sense used by the British Columbia Securities Commission in their *New Proposals* paper. Given our proposal to focus fund

[12] Letter of IFIC to the CSA (June 4, 2002) 2.

governance on monitoring conflicts and our wish to set consistent industry-wide standards, we have not adopted this option.

- A two-tiered system that would make special accommodation for small managers or for managers with limited conflicts. This system could involve one of the following:

    - no independent oversight requirements if the manager followed a prescriptive regime

    - no independent oversight requirements if the manager were under a specified size or

    - no independent oversight requirements if the manager only experienced a limited number of conflicts.

Again, given our proposal to focus fund governance on all conflicts situations and our belief in the need for consistent industry-wide standards, we have not adopted any of these alternatives.

Summary of cost-benefit analysis

When designing the cost-benefit analysis (CBA) for this initiative, the Office of the Chief Economist at the Ontario Securities Commission (OSC) considered the very different nature of the Canadian fund industry from the markets in the U.S. and elsewhere. Unlike the U.S. Securities and Exchange Commission, Canadian regulators do not require fund governance. Furthermore, the U.S. fund governance regime (out of which most of the research on the topic originates) is quite dissimilar to the Proposed Rule. This left us with limited research that we could apply to the Canadian context.

Where voluntary fund governance boards exist in Canada, they do not operate consistently. In a detailed survey of each of these governance boards, staff of the OSC Investment Funds Branch found a wide spectrum of oversight, ranging from full U.S.-style governance to only a light advisory role. The IRC approach, as proposed, falls somewhere in between. None of the factors surveyed showed enough consistency to be tested statistically. In other words, we have a statistically useful sample of governance as a whole, but we were unable to test the impact of individual fund governance factors on fund effectiveness.

A search of the available studies on governance identified a well-established body of research in three areas: public company board effectiveness, audit committee effectiveness, and mutual fund board effectiveness. Many of these studies provided evidence of a relationship between the intensity of the governance committee oversight and fund performance. We learned that the more frequently a governance committee meets, the greater the feedback provided to the fund manager and the fewer the conflicts

between the incentives of the manager and the benefits to the investors. As a result, investor performance improves. We also believe this may result in higher returns for the fund.

This was also the common thread found by staff of the Investment Funds Branch during their interviews with fund managers. That is, one of the most useful roles of a governance board was to act as a sounding board on "grey areas" where interests of investors and managers may conflict.

The Office of the Chief Economist proposes to construct a model of the most critical factors in determining fund performance (for example, assets under management, dividend yield, etc) using a control variable to test whether or not the number of board meetings held each year has an impact on fund performance. This is consistent with the methodology found in other studies on the subject.

An independent consultant retained by the OSC has already estimated the cost savings to the fund managers from relaxing the restrictions on related party transactions. Canada has a concentrated mutual fund market in terms of the majority of assets controlled by a small number of fund manufacturers, despite the thousands of funds available to the investing public. As well, In addition, many of the largest fund managers are owned by the largest financial institutions. With fewer restrictions on related party transactions, the consultant has concluded there will be more participants in any given issue and liquidity should improve significantly. In addition, firms unrelated to intermediaries will see more competition on new issues. However, both the individual firms currently restricted by the related-party rules and the market overall should benefit, on a net basis, from improved liquidity, lower commission costs and a reduced cost of capital. This is contingent on effective oversight by IRCs.

The Office of the Chief Economist also proposes to estimate the net benefits to a mutual fund of needing to take fewer matters to a vote of its unitholders. Through survey data, we will collect information on the number of votes held, by type, on average and the costs associated with the voting procedure. Excluding the areas where votes will still be required—changes to fees and the fundamental investment objectives—we should be able to calculate the cost savings in a fairly straightforward way. The impact on unitholders from reduced participation in the decision-making process will be more difficult and possibly impractical to approximate. We may be able to reasonably assume that the more direct representation of unitholders' interests by having the IRC involved in matters that formerly required a unitholder vote, should generate significantly greater unitholder benefits than those lost because of less direct unitholder involvement.

Data for the cost estimates was easier to obtain. As in every CBA completed by the Office of the Chief Economist, the estimated top end for costs represents the far extreme in potential expenses. For example, for sample costs of setting up and operating an IRC, we used surveys of salaries and administrative expenses for corporate boards of firms with revenue over $1 billion are used. In comparison, average revenue in the Canadian fund industry was $64 million last year. In addition, it is assumed that all members of an

existing board would sit on all committees, and funds with existing boards will incur the same set-up costs for an IRC as any other funds. The low end estimates are, in general, representative of the costs sustained by the current mutual fund governance boards, including incomplete insurance coverage. Given the limited level of responsibility expected of the IRCs relative to corporate boards, the low end estimates are probably more representative of the ultimate costs. However, the objective is to ensure that the highest potential cost estimate will be is well below the lowest likely benefit.

Most of the benefits and some of the cost savings will be estimated in the next phase of the project. Based on comments received and updated information, the extreme high end of the cost estimate has been revised to $166 million. This represents a high end quote, assuming, for example, that fund companies with existing governance committees will still incur all of the costs associated with setting up and operating an IRC. The low end cost savings from relaxing restrictions on related party transactions and interfund trading at $85 million will offset part of the high end cost estimate for setting up IRCs. Both figures are annual and include unamortized initial outlays. Fund managers that do not have a related party status with one of the large financial institutions are expected to sustain a net loss from these changes, not including other benefits from IRC participation. A separate analysis will be carried out for smaller fund firms in order to assess whether the cost burden is proportionate to the net benefits that could accrue to this segment of the industry.

The proposed methodology for the cost-benefit analysis on the introduction of independent review committees for mutual funds and the analysis of the benefits of relaxing the existing related-party prohibitions are available on the website of the Ontario Securities Commission at www.osc.gov.on.ca and the Commission des valeurs mobilières du Québec at www.cvmq.com.

Related Amendments

Our current regulation of conflicts of interest focuses on the conflicts inherent in a fund manager who contracts for investments or services with related parties. It relies on prohibitions (with the possibility of exemptive relief). This regulation is not uniform among the provinces, is difficult to understand and apply and is repetitive in places.[13]

We intend to replace the current conflicts of interest regime with our proposals in the Proposed Rule. We will amend existing securities legislation and certain provisions of National Instrument 81-102 Mutual Funds where they overlap with the Proposed Rule.

[13] The securities legislation of British Columbia, Alberta, Saskatchewan, Ontario, Nova Scotia, Newfoundland and Labrador and New Brunswick are largely similar. The securities legislation of Quebec also contains certain provisions aimed at conflict situations. National Instrument 81-102 Mutual Funds regulates, on a national basis, principal trading between funds and related parties and mutual funds acquiring securities that have been underwritten by dealers related to fund managers. NI 81-102 overlaps with securities legislation to a degree.

Concurrently, we propose to amend disclosure provisions in National Instrument 81-101 Mutual Fund Prospectus Disclosure and draft National Instrument 81-106 Investment Fund Continuous Disclosure. We intend to publish for comment the consequential amendments at a future date.

How to provide comments on the Proposed Rule

The importance of public comment

We want your input on the Proposed Rule. We need to continue our open dialogue with industry participants if we are to achieve our regulatory objectives while balancing the interests of all stakeholders. We have raised specific issues for you to comment on in shadowboxes throughout the Proposed Rule. We also welcome your comments on other aspects of the Proposed Rule, including our general approach and anything that might be missing from it.

Due date

Your comments are due by April 9, 2004.

Where to send your comments

Comments can be sent to the Canadian Securities Administrators care of:

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th floor, Box 55
Toronto, ON, M5H 3S8
Telephone: 416-593-8145
Fax: 416-593-2318
e-mail: jstevenson@osc.gov.on.ca

and

Denise Brousseau, Secretary
Commission des valeurs mobilières du Québec
800 Victoria Square, Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montreal, Québec H4Z 1G3
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Fax: 514-864-6381
e-mail: consultation-en-cours@cvmq.com

How to format your comments

Send your letters by electronic mail or send us two copies of your letter along with a diskette containing the document in either Word or WordPerfect format.

All comments are public

Please note that we cannot keep your submissions confidential because legislation in certain provinces requires us to publish a summary of written comments received during the comment period. All comments will also be posted to the OSC web-site at www.osc.gov.on.ca to improve the transparency of the policy-making process.

Proposed Rule

The text of the Proposed Rule follows, except in British Columbia.

Questions

If you have any questions about our proposals, please contact the following CSA staff members for clarification:

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