OUTLINE OF REMARKS AT
SCHULICH SCHOOL PANEL DISCUSSION
RE CSA CONCEPT PROPOSAL
FOR MUTUAL FUND GOVERNANCE AGENCIES
APRIL 2, 2002

WHY AM I HERE?

Little present involvement in mutual fund industry, apart from directorates of Sun Life and MFS.

1969 CCMFIC and 1974 draft federal proposals reports -- 1969 report referred to by Mr. Erlichman as "seminal" even while he took fundamental issue with it. I was senior staff member of the 1969 Committee and wrote most of the report; I was co-author with Warren Grover of the 1974 report.

The 1969 report analyzed the "independent director" question in some detail. The federal-provincial committee concluded that mutual funds are vehicles for the pooling of investments under common management. By the selection of the manager and the investment strategy, the investor goes a long way in making the decisions which a board would make in a conventional public company environment. Management can be disciplined through the exercise by investors of their redemption rights if investors are dissatisfied with performance.

The Committee felt that specific areas of concern such as front-running and related party transactions can appropriately be addressed by focussed rules. It recognized that there could be a role for independent directors, but it concluded this would better emerge through operation of the competitive environment or on a self-regulatory basis.

While this is not reflected in the report, I recall there was some discussion of the fact that the independent director requirement in the United States was part of the 1940 Act, which was adopted when the mutual fund industry was only nascent. Our Committee doubted that it was appropriate to dictate this restructuring in an industry which, by 1969, was relatively well developed.

The 1974 report accepted this approach.

I suppose my real mission today is to let you know whether I have changed my mind. In my comments, I will address only the governance proposals in the CSA package, although I cannot resist expressing my pessimism as to the time that might be required for the contemplated relaxation of other rules to emerge after adoption of the governance proposals.

SHOULD THERE BE SUPPORTING RESEARCH?

Erlichman: "even though verifiable empirical proof that an effective governance regime is in the best interests of mutual fund securityholders may never be obtained, common sense indicates that instituting some sort of regime in Canada is in the best interests of securityholders". This is buttressed by a quote from Ira Millstein relating to the boards of public corporations -- a much more obvious situation, to my mind.

The CSA report provides us with a schedule containing:

- data based on interviews and reviews of disclosure documents;
- an analysis projecting initial set-up costs for the industry at $17.9 million and ongoing annual costs at $65.9 million. This does not appear to reflect costs such as increased demands on management's time.

The first study notes that more "than a third of the mutual fund industry in Canada already has governance agencies in place to oversee mutual fund trusts" -- which might be an indication that the issue is being addressed voluntarily, without need for aggressive CSA intervention.

Some studies I would welcome:

- actual volume of complaints to regulators, proportionate to types of funds;
- a survey of mutual fund investors, indicating how many feel the proposals satisfy a cost-benefit analysis. (Query whether the CSA's comments that the costs will not involve an "undue burden" or an "insurmountable obstacle" address the real question.);

- an analysis of the extent of use of "back-end loads" in Canadian mutual funds and the extent to which they inhibit investors from redeeming their shares/units;

- an analysis of the costs and benefits of the requirements in the United States.

THE NOTION OF "INDEPENDENT DIRECTORS" FOR MUTUAL FUNDS

Despite use of "independent governance" and "governance agency", both Erlichman and the CSA proposals are clearly predicated on independent directors. Let's look at how they fit normal notions of what a board of directors does.

The Saucier Report lists five "core functions" of a board of directors:

1) choosing the CEO;

2) settling the broad parameters within which the management team operates (e.g. approving a strategic direction);

3) coaching the CEO and the management team;

4) monitoring and assessing the performance of the CEO, including compensation-setting;

5) providing assurance to stakeholders about the integrity of the corporation's reported financial performance.

In a mutual fund the investor has selected the manager and the investment strategy by his or her selection of a fund. The CSA proposal recognizes this by saying the governance agency should not have the right to terminate the manager, except with investor approval.

But this means that core functions (1) and (2) don't apply at all. Core functions (3) and (4) apply only to a very limited extent. Core function (5) is the only one that seems to me fully applicable in a mutual fund context.

The question is whether the aggressive and mandatory intervention in mutual fund structure proposed by the CSA is justified by this.

A DIGRESSION -- IFIC CODE ON PERSONAL INVESTING

In 1996, I prepared a report for IFIC on the regulations of personal investing activities by mutual fund investment managers. I recommended a code whereby each mutual fund organization would designate an independent person with authority to surveil this trading. My recommendations were substantially implemented by IFIC in May 1998. I am not aware of any subsequent criticism of the approach taken, which I take as an indication that it is generally regarded as adequate to deal with the issue.

I mention this only as an example that there are alternative techniques available to address the issues, and that self-regulation has a legitimate role to play.

COMMENTS ON CSA PROPOSALS

The CSA must indeed be troubled by the extent of the problem to be dealt with by the structural proposals, after over 30 years of discussion. A self-perpetuating group, determining its own compensation, and with significant authority is stiff medicine. The proposals acknowledge that competitive unfairness will result if corresponding rules are not applied to like vehicles such as pooled funds, but no specific proposals are made.

The tantalizing prospect is held out that implementation of this regime might be followed by a relaxation of some existing rules. No specific proposals are made in this connection.

The proposal document is well written and carefully presented, but it is very much an overview. Important and complex issues are left unaddressed. An obvious one is the indemnification of the independent directors: the report makes clear that the authors have thought about this, but I think they might have underestimated the difficulty and importance of the issue.

Another complex issue will be the use of the proxy mechanism. Meetings of investors will be potentially of great importance under the proposed regime. They are the only pressure-valve contemplated to control a board that is self-perpetuating and fixes its own compensation. But consider the problems if the manager of a complex with, say, thirty mutual funds that share the same independent directors decides that the independent directors have gone beyond the

bounds and should be dismissed. The manager will then call meetings of the investors of the thirty funds.

Presumably, these will be separate meetings. Who will control the proxy mechanism? It is well known that mutual fund investors tend (probably even more than shareholders of public corporations generally) to support management's recommendations. Will the management recommendation be decided by the management company? By the independent directors? By the fund trustees? In any event, there would be the prospect of thirty proxy battles being waged simultaneously. As a practicing lawyer, probably I shouldn't complain -- it would be great for the legal profession.

And then, what happens if the investors in some of the funds support dismissal of the independent directors while others do not? Is the manager then to be left in the worst of all worlds, being required to continue to tolerate the former group on some funds while incurring the additional expense of a new group on other funds?

A lot of additional thought is needed here, and this is far from the only issue that would arise on the detailed implementation of the proposals.

"BACK-END" SALES CHARGES AS A SPECIFIC CASE

My suggestion that back end sales charges and their impact should be the subject of further analysis reflects the possibility that these might merit special treatment. If there are funds that have such a large proportion of investors who are subject to back end charges that the discipline of the redemption feature is effectively removed, then those funds might be a special case. Certainly the argument favouring the CSA proposals seems to me stronger for funds of which this is true than for the industry generally.

CONCLUSIONS

This is not an enormous issue. The Canadian mutual fund industry is not threatened by the CSA proposals. Implementation of the proposals might be a nuisance, even a costly nuisance. But it might be marginally beneficial to some investors and the extra costs would probably be comparatively easily absorbed.

This does not mean the case has been made for this aggressive regulatory intervention. I hope the reaction to the CSA proposals will be such as to require a more rigorous analysis to determine whether there is a real need to be satisfied.

If, then, the key issue I was supposed to talk about is whether I have changed my mind since 1969, the answer is that I have not. I think the CCMFIC's reasoning has withstood the test of the intervening years, subject only to my comments about mutual funds in which a substantial portion of the investors are subject to back-end sales charges.

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