

May 17,2002

**John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th floor, box 55
Toronto, Ontario, M5H3S8**

**Denise Brousseau, Secretary
CVMQ
800 Victoria Square
Stock Exchange tower
P.O. Box 246, 22nd floor
Montreal, PQ H4Z1G3**

Dear Denise and John:

Concept proposal 81 -- 402 is a welcome and timely step in regulating the rapidly expanding Canadian mutual fund industry. It is a great first step. As a long time investor advocate, I have been concerned with the behavior of mutual fund managers and the boundaries (or lack of) placed upon them.

Some examples:

- 1 a dividend fund invested in nondividend equities**
- 2 an equity fund promoted as” actively managed” is actually a closet index fund with a 2.3 percent MER**
- 3 requests for proactive actions against selected fund holdings [e.g. Nortel] have gone unanswered (20 class actions but not one Canadian fund is yet a participant)**
- 4 disclosure of portfolio manager changes is never done efficiently**
- 5 cost transfers between operating units involving bank- owned funds is a real conflict of interest issue**
- 6 the chairman of the fund governance committee is a member of the Board of the parent bank.**
- 7 a request to obtain a copy of the funds ethics policy was denied**

The are so many issues regarding fund governance, they are too numerous to cover them all here. A governance checklist is attached (Attachment I) as an indication of the issues to be addressed. A good reference is also the “Report of the advisory group on best practices for fund directors: Enhancing a culture of independence and effectiveness” released June 24, 1999 by the Investment Company Institute in the U.S.

Anyway here is my input:

Issue 01- with the experience I've had, I'd prefer alternative 3. The industry has not yet earned the right to operate under alternative 4.

02 -the alternatives are fine, the status quo would be unacceptable to unitholders. Alternative 3 gives the industry the benefit of the doubt.

03 -labor sponsored income funds should be covered by the new regulation. They are effectively mutual funds with the added challenge of portfolio valuation.

04 no comment

05- the industry is large, growing and powerful. The regulators need to be more proactive - perform audits, have complaint hotlines and prosecute funds that cross the line. Individual unitholders do not have the financial or legal resources to defend their rights. Hopefully, Enron has taught regulators as well as investors a lesson.

06 -fund governance is a necessity. The growing power and influence of fund companies begs for more constraints and surveillance.

07 /0 8- no comment

09- there's no question that the Board of Directors of a fund manager are not, and would not be perceived to be effective governance agents.

10- no comment

11- there may indeed be a practical limit to the number of funds that an agency can handle, but nothing stops them from adding members or hiring outside resources/consultants.

12- I do not believe it would be difficult to recruit members. Many retirees, investment activists and advocates are readily available, including myself.

13 no comment

14 -everything seems fine except perhaps para. (g). With funds getting very large (> half-million dollars) a separate audit committee would appear appropriate.

Some suggested additions:

- **procurement and outsourcing services**
- **manager performance review/compensation**
- **derivatives usage**
- **proactive litigation to defend unitholder interests e.g. YBM Magnetics case**
- **ethics management (policy, training, annual compliance certifications)**
- **ISO 9000 certification**
- **quality control -- productivity improvement**

16 -No, an audit committee is different than governance and should be with financial transactions, valuation, currency issues, reporting systems, security and privacy etc.

17- I support the view that a liability limitation is not in the public interest

18/19 -no comment

20 -the Board, audit committee or the external auditor can be assigned the task of recruiting agency members. This could include Web recruiting or solicitation in the prospectus.

21 -the fund manager should be kept as far away as possible from making agency appointments. See 20.

22 -qualification guidelines are a key success factor.

23 -the agency should not set its own compensation .The compensation range can be established annually by an independent human resources firm and the fund manager picking the compensation level within the range. I do not believe giving the fund manager veto power will send the right signals.

24- the agency must have the right to terminate the fund manager. If not, they would have to resign. I do not believe an investor meeting is necessary or cost-effective.

25 idea sounds fine but why not establish a five-year term with staggering

26- I would add (e) governance initiatives for the coming year

27-I think 4 months would be adequate to establish an agency.

28- a good operating manual and a 4 to eight hour training course should be adequate for governance committee members

29- in order to move the process forward the idea that the governance agency can control fund managers should be accepted. If this subsequently proved unworkable, than registration can be introduced

30 -I agree with the IFIC recommendation

31- a minimum capital requirement is a sound idea. I would keep it if relatively low at the outset and modify it if deemed necessary. The Stromberg report recommendation seems to be practicable

32- the identified risks appear complete. I am not sure if environmental or safety are applicable

33- internal controls might also include style drift, mandate compliance, management information systems, handling of order entry and proxy voting practices. Procedures were also be needed for outsourced administrative services

34/35- I cannot comment on the usefulness of a section 5900 report. I can however suggest ISO 9000 registration. This system has been applied by many other industries including insurance, brokerage, auto, electronics, aerospace and banking. The National Quality Institute could be useful in providing guidance

36- disclosure is one of the most pressing issues regarding mutual funds especially share voting practices, performance reporting, portfolio/manager changes, litigation and material event information

37- it is realistic and important to monitor related- party transactions. It is possible that fund companies will restructure themselves in an attempt to avoid the new governance mechanisms

Issue 38- there should be an annual review of auditors.

I also believe there should be a mechanism for unitholders to register concerns or file complaints about fund operations. An example would be a fund managers lack of diligence in

pursuing companies that have committed fraud in order to recoup any losses that fund unitholders may have incurred.

I hope this is useful to you. Should you require any additional information please do not hesitate to contact me.

Respectfully,

**Ken Kivenko
Investor Advocate
2010 Islington Ave. suite 2602
Etobicoke, Ont. M9P3S8
416- 244-5803
kenkiv@sympatico.ca**

**Attachment I
February /2002**

Mutual Fund Governance-Self Assessment Checklist

“Regulated entities can never be too well supervised”

**-Steve M. Cutler
Director, Division of Enforcement
U.S. SEC**

Introduction: Fund governance is an essential process made up of a set of integrated systems, policies, procedures and controls that answers the questions of how things are done, who does what and how the repetitive players are accountable for their actions. Deficiencies in fund governance matters can have very practical adverse consequences for investment funds, investor returns and for the sponsors of the funds. Fund governance is more than just the need for independent boards. Governance involves adherence to fiduciary standards that are optimum not just better than good enough, including oversight mechanisms, operating procedures, policies, proper business practices/ethics, compliance, communications etc.

It involves:

- **Setting investment policy that defines a fund’s risk-reward character, benchmark and clearly spells out whether the” fund” mandate is to strive for absolute total return objectives (ideal for tax sheltered accounts) versus tax efficiency creation of wealth objectives (ideal for taxable accounts)**

- Evaluating overall performance, operational processes and unitholder service/communications/disclosure practices
- Preventing, assessing and resolving conflicts of interest
- Monitoring congruence between the portfolio characteristics and stated mandate
- Assuring regulatory/legal compliance
- Evaluating the performance and behaviors of the individuals investing unitholders money

1.0 Independent Board:

- (a) Has an Independent Board been established to represent unitholder interests with authority to recommend or provide solutions to identified or perceived problems or issues? The out how
- (b) Are at least two-thirds of the directors independent?
- (c) Are independent Directors selected and nominated by the incumbent independent directors?
- (d) Do fund Directors have adequate D&O insurance?
- (e) Are former officers or Directors of a fund's investment advisor, principal underwriter or certain of their affiliates precluded from serving as independent Board members?
- (f) Do fund Directors invest in the mutual funds run by the Company?
- (g) Do independent Directors have access to qualified independent investment company counsel and the funds external auditors or other experts as required?
- (h) Has proper consideration been given to establishing special independent committees for audit, HR/Compensation and Governance?
- (i) Do independent Directors meet separately from management in connection with their consideration of the fund's advisory and underwriting contracts, custodial service contracts and distribution contract(s)?

2.0 Policies and Procedures:

- (a) Do written procedures exist for new account openings, proper processing of purchase/redemption transactions, supervision of

trades, compliance officer duties and responsibilities and other job descriptions?

- (b) Does the fund Company have a written, open, well-communicated ethics policy approved by the Governance Board?**
- (c) Is there a written conflict of interest policy and are staff required to sign off?**
- (d) Is there a policy regarding litigation if an investment holding has fraudulently impaired unitholder returns?**
- (e) Has a share voting policy of securities held been established, communicated and been deemed to be in the best interests of unitholders?**
- (f) Are share voting practices disclosed to unitholders a priority?**
- (g) Do fund Directors approve trading practices and procedures for principal transactions with affiliates, underwritings, affiliated broker transactions, repurchase agreements and securities tendering?**
- (h) Do fund directors oversee personal investing by fund managers?**
- (i) Does the Board approve fund Distributions amount and timing?**
- (j) Is there supervision of fund voting to ensure unitholder interests are protected?**
- (k) Does fund monitor its larger investments for effective corporate governance?**

3.0 Proper Business Practices:

- (a) Are fund names congruent with fund holdings?**
- (b) Is it a Company value that unitholder returns is Job #1?**
- (c) Is there a toll-free hotline in place for staff or unitholders to anonymously submit claims of unethical behaviour?**
- (d) Are unitholders unduly pressured into borrowing money to buy funds?**
- (e) Have trailer fees or non-cash incentives been examined as a possible source of unitholder abuse?**
- (f) Are services provided commensurate with fees charged?**
- (g) Have unitholder rights been unduly limited or constrained?**

- (h) Do multiple- class fund arrangements require Board approval?**
- (i) Is there adequate supervision of sub-advisor activities and compliance procedures?**
- (j) Are selective corporate stock buybacks (at premium) monitored for fund opportunity loss?**

4.0 Books and Records:

- (a) Are books and records maintained current, accurately and securely?**
- (b) Are reviews routinely carried out to review cost allocations for appropriateness, legality, accuracy and fairness?**
- (c) Are rates of exchange, valuation of private/low volume holdings and similar discretionary accounting practices approved by the Board and disclosed?**
- (d) Is the liquidity of the portfolio monitored?**
- (e) Do those authorized to effect trades submit quarterly reports to the compliance officer of their personal investing?**

5.0 Sales Practices:

- (a) Are clients' needs assessed to determine suitability of fund investments & terms?**
- (b) Are procedures in place to ensure professional skills are not paid to unduly influence investors?**
- (c) Has consideration been given to use of a point –of –sale document to ensure unitholders are informed of their investment terms, risks and fees?**
- (d) Are prospectuses supplied to unitholders at time of sale?**
- (e) Are fees and penalties charged fair and reasonable?**
- (f) Are recognition awards such as free trips, gifts and other non-cash incentives monitored for appropriateness?**

6.0 Advertising and Promotion:

- (a) **Are procedures in place to ensure ads and marketing materials are honest, clear, accurate and legal?**
- (b) **Is the use of unregistered/unlicensed shills avoided?**
- (c) **Is the use of misleading charts, statistics or references pro-actively avoided?**
- (d) **Are fund returns computed and presented accurately and clearly?**
- (e) **Are key fund metrics such as: Beta, turnover and volatility provided in sales documents?**

7.0 Productivity:

- (a) **Do procedures exist for awarding trading and other service contracts to the lowest responsible responsive bidder?**
- (b) **Are there established measures of quantitative goals for productivity improvement?**
- (c) **Are productivity initiatives used to reduce the MER?**
- (d) **Have cycle time reduction techniques and technology been applied to accelerate the speed of delivery of Annual and Interim reports, account transfers and other time-sensitive information?**

8.0 Quality Control:

- (a) **Is a Total Quality or ISO 9000 system in place to detect errors/omissions and provide continuous improvement?**
- (b) **Is style drift or divergence monitored and corrected when appropriate?**
- (c) **Is unitholder satisfaction surveyed and/or measured and benchmarked against peers/best practices?**
- (d) **Are databases, benchmarks, math models and return calculations routinely validated for appropriateness & accuracy?**
- (e) **Are the funds' independent auditors doing a good job in protecting unitholder interests?**
- (f) **Is there a documented unitholder complaint and redress procedure?**

- (g) Are investments in derivatives monitored?
- (h) Does the fund manager pro-actively promote performance improvements in its investment holdings via meetings with senior management?

9.0 Unitholders Communications/Disclosure:

- (a) Are unitholder communications timely, understandable, complete and accurate?
- (b) Can unitholders easily reach staff including portfolio managers?
- (c) Do Annual and Semi-Annual Reports provide specific, timely insight into the fund performance?
- (d) Are personalized risk-adjusted return reports and readable useful statements prepared for unitholders?
- (e) Has an Ombudsman position been established?
- (f) Is there accurate and timely disclosure of material events such as a change in fund manager?
- (g) Is the fund's prospectus a good representation of the fund's actual operations and objectives?
- (h) Are unitholder taxation issues including unrealized capital gains exposure clearly and openly explained?
- (i) Are unusual gains due to IPO's for example disclosed to unitholders and potential investors?

10.0 Compliance System

- (a) Are compliance policies documented, adhered to and routinely updated?
- (b) Is there a compliance officer whose duties are focused on compliance with applicable securities, laws and regulations?
- (c) Does the Board select the fund's external Auditors?
- (d) Does the board review registration statement (including prospectus), Annual Information Form and financial statements?

- (e) **Is it the responsibility of the Board to handle regulatory problems?**

11.0 Information Systems:

- (a) **Are information systems in place to assess the performance of fund operations, effectiveness of controls and unitholder satisfaction?**
- (b) **Are client files backed up and is there a Disaster Recovery Plan in place?**
- (c) **Are adequate controls in place to safeguard unitholders information privacy and security?**
- (d) **Are modern IT tools used to reduce unitholder record keeping burden?**
- (e) **Do procedures prevent the unauthorized release of client's confidential information?**
- (f) **Is accountability reporting done in a transparent manner? (Are the right things reported to the Board at the right time and in the appropriate level of detail)**
- (g) **Does the Board undertake a regular assessment of information and the processes through which it is created and communicated?**

12.0 Internal Controls:

- (a) **Are duties segregated as appropriate to reduce/prevent fraud?**
- (b) **Does the fund have an effective internal audit function?**
- (c) **Are internal audit reports submitted to the Governance Board?**

13.0 Human Resources:

- (a) **Are sales and other key functional staff trained and registered/certified as required?**
- (b) **Are bonuses and salary increases paid primarily to those who contributed to superior unitholder returns?**
- (c) **Are background checks run on employees as part of the recruitment process?**
- (d) **Do staff receive periodic ethics training and are they required to sign an annual ethics statement of compliance?**
- (e) **Has a substance abuse testing program been implemented?**
- (f) **Is there a rigorous interview process for the selection of fund managers and approval of advisory/ subadvisory contracts?**
- (g) **Is the sales commission structure set-up to discourage undue Switches?**
- (h) **Is there a formal evaluation of the portfolio managers performance taking into account it's investment objectives, strategies and risk as well as complying with the policies set for the particular fund in achieving its performance goals?**
- (i) **Does the fund comply with employment equity and equal opportunity/diversity goals?**
- (j) **Does the ethics policy or other policy require employees to report inappropriate action/behaviour of co-workers, evidence of waste or breaches of regulations/laws?**
- (k) **Is style drift monitored?**

14.0 M&A:

- (a) **Are independent fairness opinions obtained and communicated to unitholders in the event of fund mergers?**
- (b) **Are controls in place to ensure existing unitholders are treated fairly?**
- (c) **Is there a review of how post-merger returns are reported to the public?**

Ken Kivenko
Investor Advocate